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INSIGHTS WEBINAR SUMMARY

More Than Just a Rotation: A New Era for Value

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Why Has This Past Decade Been Difficult for Value Investors?

- Rapid technological innovation fueled growth equities' dominance and drove changes in the competitive dynamics of many sectors, the majority of which are overrepresented in value investing.
- Equities CIO and U.S. Select Value Equity Portfolio Manager John Linehan attributed value's decade-plus underperformance to four principal reasons. (1) Low interest rates afforded by a decade of highly accommodative central banks favored long-duration assets like growth equities, whose future free cash flows were discounted at lower rates. (2) Following the global financial crisis (GFC), economic recovery was tepid, and companies offering differentiated products were best able to outperform the market. (3) The rapid pace of innovation, the proliferation of artificial intelligence, and the rise of platform companies generally forced value companies onto the side of being disrupted. (4) The level of investors' expectations for growth rose dramatically, fueling growth's surge.

What Has Changed? Why Now?

- Since September 1, 2020, the share prices of value companies, as measured by the Russell 1000® Value Index, have outperformed growth, as measured by the Russell 1000 Growth Index, by over 20%.
- The magnitude of growth's long-term outperformance, juxtaposed with the intensity of this recent value resurgence, has piqued the interests of fundamental investors and asset allocators alike.
- Our Asset Allocation Committee moved to overweight value versus growth in September 2020 to take advantage of the extreme relative valuation opportunity. They also anticipated that value would do better in a recovery from a macro perspective and sentiment had begun to favor value. What's more, a number of our research analysts were upgrading value-oriented stocks and sectors from a fundamental perspective.
- Head of Global Multi-Asset Sébastien Page described value as the new momentum trade: Over a third of stocks in the cheapest quintile are now in the highest momentum quintile as of May 2021. This represents the most overlap we have seen in the valuation and momentum factors since such data became available in 1995.
- John Linehan argued that the rotation follows a similar pattern seen over the last 40 years in which growth outpaces value and value then resurges when the level of expectations associated with growth reaches extremes. While a reasonable case can be made for value investing today given current market conditions, investors should assess their allocations to ensure proper exposure to value over the long term.

Local Responses to the Global COVID-19 Pandemic Have Varied, Creating Opportunity

- Global Value Equity Portfolio Manager Sébastien Mallet noted that while the novel coronavirus sparked a global pandemic, response rates varied widely and ultimately determined the sequenced recovery of economies.
- Asian nations have historically responded to pandemics effectively, having managed through previous viral outbreaks such as SARS and MERS. As a result, many of their domestic economies remained open during the pandemic.
- Some countries, such as the United States and the United Kingdom, managed vaccination programs exceptionally well. Today, nearly 50% of people in both of these countries have been partially vaccinated. As a result, their economies have largely reopened, and share prices reflect the recovery.
- Europe and Japan have histories of litigation around vaccination regimens. As a result, roughly 25% of Europeans and only 3% of Japanese citizens have been vaccinated to date, dampening their recoveries. Conditions in emerging market (EM) economies also vary widely. This dispersion creates opportunities to identify reopening trades not yet priced into the market.
- Compelling investment opportunities exist in the U.S., but on the margin, we are finding more attractive fundamentals and significant valuation opportunities in Europe and outside of the U.S.

Macroeconomic Tailwinds Support the Value Rotation

- Sébastien Page noted that the durability in this recent rotation is contingent on the path of interest rates and inflation. He shared the findings of a recent study, which indicated that the direction and level of inflation and interest rates drive asset returns.
- Asked whether we are facing a regime shift, Sébastien Page noted that inflation should settle higher, given that we are at peak reopening levels. However, the bigger debate is about how much higher inflation will settle after working through the base effects. And while the study suggests a regime shift is hard to predict, Sébastien noted that this time could be different.
- According to Sébastien Mallet, COVID-19 may have brought the world into Modern Monetary Theory (MMT), a paradigm in which fiscal deficits are not a concern as a result of the unconventional fiscal and monetary tactics undertaken by governments and central banks. MMT may drive inflation and rates higher, which would bode well for cyclicals and financials.
- Based on an interest rate study of the U.S. Treasury 10-year note yield from 1926 to 2019, rising interest rates have typically supported value stocks, as they are shorter-duration assets.

Our Core Tenets of Fundamental Value Investing

- We believe the current risk/reward profile favors value.
- Seeking out value opportunities means having a solid understanding of the nuances of companies and capital markets in different regions. Through this, we can get comfortable trading quality for valuation and upside potential. In Russia, for example, politics and capital allocation are important to investors, whereas in Korea, investors place significant emphasis on dividends and share buybacks.

Maintaining a Strategic Value Allocation

- We recognize that growth stocks have many compelling long-term attributes, namely their disruptive power and their ability to harness technological innovation.
- However, diversification is key for multi-asset investors who seek to remain fully invested. The COVID-19 pandemic has caused major transformations to occur, accruing benefits to both growth and value investors. A balanced exposure to style leadership, with tactical tilts, affords investors upside potential and helps to minimize downside risk.
- The conditions today are a great environment for selective value investing, in our view.

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