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THE ANGLE

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Fresh perspectives on the market outlook.

A PERFECT STORM FOR GROWTH INVESTING?

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KEY POINTS

- Despite promising long-term prospects, value stocks have lagged growth stocks in the last decade
- The underperformance of value is rooted in a unique combination of market and economic factors, including the rise of tech, and low interest rates and inflation
- This environment may shift in the near term, and investors need to position their portfolios accordingly

In the ten years since the financial crisis, growth stocks – particularly in technology – have shot ahead of value stocks. But the debate about which investment style will deliver better long-term returns is far from over. Growth stocks have been fueled by a number of factors unique to this economic cycle. When the market changes, investors should be prepared for a potential value comeback.

IS THE 100-YEAR VALUE CYCLE OVER?

In theory, value investing should outperform growth investing over the long term. While growth stocks are expected to grow at an above-average rate compared to the market, value stocks are those that appear attractive on a relative basis. Because they are bought at a price below intrinsic value, the idea is that price eventually converges with value.

This was the theory. In practice, however, value has lagged growth since 2007 – the longest bull market for growth ever – and consequently fallen out of favour. Why have the tides shifted? And what does it mean for investors?

WHEN VALUE LOST VALUE

Like any other investment, value and growth go through valuation cycles. One way to measure valuation of stocks is their price-to-earnings (P/E) ratios. Typically the P/E of growth stocks is higher than that of value stocks – not surprising, as one definition of value stocks is stocks with relatively low P/E. However, in 2008 the P/E of value surpassed that of growth.[1]

Relative valuations could be one of the catalysts starting the growth cycle. However, in 2010 the P/E of value fell back below that of growth; so, while valuations could be a trigger to the growth cycle, they don't seem to be a reason to sustain it.

FAANGS VERSUS FINANCIALS

During the late-1990s technology bubble, investors underestimated the business risk of tech companies and overestimated their future prospects, and in 2000 the bubble popped. Since 2008, however, tech companies have not just succeeded but exceeded expectations, with the so-called FAANG – Facebook, Apple, Amazon, Netflix and Google – taking off.

During the same period, financials have performed broadly in line with the general market. Low interest rates and the flat yield curve, coupled with heavy post-financial-crisis regulations and competition, dented the profitability of financial services firms.

This goes some way to explaining the divergence of growth and value in the last decade because financial companies tend to be value stocks, and technology companies, growth stocks.[2] Indeed, the performance of tech versus financials has followed that of growth versus value since 2008.[3]

INTEREST RATES, INFLATION AND ECONOMIC GROWTH

Typically, growth stocks exhibit higher duration (interest-rate sensitivity) than value stocks. This is consistent with the expectation that a higher proportion of cash flows from growth stocks will be received in the relatively distant future. As a result, growth stock cash flows are more sensitive to changes in interest rates.

Since 2008, due to the slow pace of economic growth, the prolonged economic recovery and quantitative easing, growth stocks have benefitted from low inflation and interest rates.

A PERFECT STORM

In the last decade, the unique combination of low rates; the tech rally; valuations favouring growth; and the economic cycle have created a perfect storm supporting growth. The chart shows how, in the years before and after the financial crisis:

1. US 10-Year Treasury yields started on their course towards zero (light blue line)

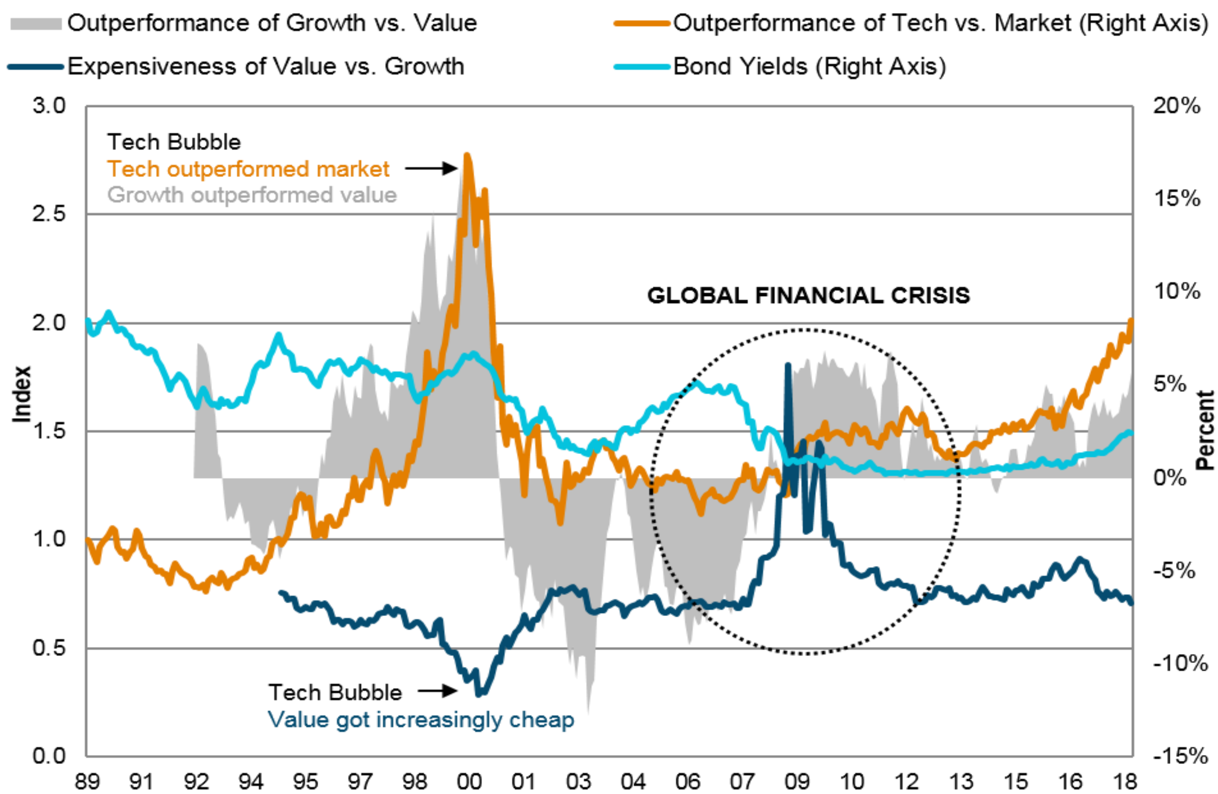
2. Value got expensive relative to growth, then cheapened sharply (dark blue line)

3. Tech stocks began their outperformance trend versus the broader stock market (yellow line)

4. Growth began by underperforming value, then pulled ahead (grey shading)

[1] T. Rowe Price and Bloomberg Index Services, Inc. January 1995 through May 2018. P/Es of Russell 1000 Growth Index and Russell 1000 Value Index.
[2] T. Rowe Price and Russell. As of 31 March 2018.
[3] T. Rowe Price and Bloomberg Index Services, Inc. October 1989 through May 2018. S&P Information Technology, S&P Financials, Russell 1000 Growth, Russell 1000 Value.

A Perfect Storm for Growth Stocks



Past performance is not a reliable indicator of future returns.

As of May 2018
Sources: T. Rowe Price and Bloomberg Index Services, Inc. October 1989 through May 2018. S&P Information Technology, S&P 500, Russell 1000 Growth, Russell 1000 Value, US Generic Government 10 Year Yield.

But will these conditions continue? Rates in the US have been moving higher; valuations no longer favour growth; the economic cycle is likely to enter a recession at some point; and tech might lose steam due to rich valuations and regulations while financials may fare better due to steepening yield curve and de-regulation.

In short, value may stage a comeback.

Investors can prepare for this outcome by holding portfolios that not only strike a balance between value and growth, but also which are nimble enough to adapt to new regimes. Active strategies, based on fundamental research, can adapt better than quantitative strategies, which assume the continuation of the status quo – systematically betting on factors might be a losing game for years when a strategy's factors are out of favour.

With the value versus growth debate pivoting, the age of fundamental active strategies could be upon us.

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