Global Equities
THE MISCONCEPTIONS OF GROWTH AND VALUE INVESTING

KEY POINTS

 With the current market cycle now in its 10th year – a decade during which Growth has significantly outperformed Value investing – discussions around a potential style inflection point have started to intensify.

 Many investors still seem to view Growth and Value investing in very binary terms. However, we do not believe that a clear and definitive line separating the two styles exists, nor do we feel it necessary to try and pick the inflection point.

 From finding non-traditional Growth opportunities that others overlook, to uncovering real value in emerging markets, the traditional domain of Growth investors, there are rewards for those who are prepared to look beyond the traditional style definitions.

In the decade since the end of the global financial crisis, Growth stocks have substantially outperformed their Value counterparts. However, with the post-crisis expansionary phase now in its 10th year, the prospect of an eventual slowdown grows ever nearer. Having been out of favour for much of the past decade, Value stocks are attracting attention again. Are we nearing a potential inflection point in the Growth-Value relationship? With this in mind, we spoke to experts on each side of the divide, and spanning both developed and emerging markets, about some of the common misconceptions surrounding Growth and Value investing.

WHAT DO YOU THINK IS MOST MISUNDERSTOOD ABOUT SUCCESSFUL STRATEGIES INVESTING IN GROWTH AND VALUE?

Taymour Tamaddon: As a Growth investor, perhaps the biggest misconception is that all our attention is, and should be, spent on finding the most dynamic, fastest growing, companies out there. This is obviously a large part of what we focus our efforts on – trying to identify early those dynamic, innovative companies that are on the right side of change.
The biggest impact so far has been on small cap companies. Around 30% of companies listed on the small cap Russell 2000 Index are not making profits, and many of those firms were heavily funded by QE (the flow of money into biotechs has also been a factor here). However, if the Fed’s hikes are modest and controlled, there will be some negative impact on earnings, but it’s unlikely to be excessive.

However, there are two other Growth “buckets” where we also spend a great deal of time looking for opportunities. The first of these focuses on companies where we believe the market is underestimating the durability of growth. For example, we might like a company that is expected to grow at 10-15% per annum. In this instance, we don’t necessarily think that the company is going to surprise the market and grow by 20-25%. It is simply that we believe the potential runway for growth is much longer, more durable, than the market is anticipating. Instead of growing at 10-15% for three or four years, we might think it can continue at this rate for 10 years.

“One of the obvious signals of heightened risk seems to be when a misallocation of capital is evident, i.e. market bubbles. So far, I don’t see any obvious large pockets of misallocated capital.” – TAYMOUR TAMADDON

The beauty of these durable growth companies is that, over an extended period, they can potentially deliver significant compounded returns for clients. This type of company is unlikely to be among the top performers in any single year. But, when you look back over a five or 10-year period, the real value creation is evident.

Take aerospace company, Boeing, for example. Two years ago, I was talking up Boeing’s prospects and a lot of clients questioned why I would own such a highly cyclical company in a Growth portfolio. Nobody could really foresee Boeing as having any kind of durable growth profile. However, Boeing is one half of what is effectively a global duopoly and it is a less cyclical business than the market believes. Air passenger trends are favourable globally, while Boeing’s 787 aircraft, with its composite fuselage, is the most innovative and fuel-efficient product available and, as such, is attracting strong demand and generating significant free cash flow. Two years later and we still own Boeing today.

The third bucket in our Growth framework is made up of companies that the market has effectively left for dead. That is, companies that are positioned on the wrong side of change, but which, through either self-innovation or market changes, can find themselves on the right side. Not only do these companies subsequently grow at a faster rate, they also experience multiple expansion, i.e. investors willing to pay a higher price for expected increased future earnings.

PayPal is a good example of a company in this third bucket. Just two and a half years ago, PayPal was growing at a healthy 16-20% p.a., yet was trading at a low comparative valuation. This was because investors clearly believed that PayPal was on the wrong side of change. At the time, the two giants in the payments space, MasterCard and Visa, wouldn’t partner with PayPal – they basically didn’t want this new entrant to exist at all. However, fast forward 18 months, and with PayPal not going away, Visa and Mastercard eventually agreed to sign deals, along with many financial institutions who are the large issuers of credit cards. So, PayPal went from being on the wrong side of change, to suddenly being a strategic partner in the vast global payments industry.

Ernest Yeung: I am on the other side of the discussion and, as a Value investor and, more specifically, an emerging markets (EM) Value investor, perhaps the biggest misconception is that attractive Value opportunities in the EM region are few and far between.

This is not surprising, given EMs tend to be associated with high growth. A survey of the current EM investment universe shows that c. 87% of all active money is in core and Growth portfolios, meaning just 13% of total money flows is value-focused.
“As a Value investor and, more specifically, an emerging markets Value investor, perhaps the biggest misconception is that attractive Value opportunities in the EM region are few and far between.” – ERNEST YEUNG

Given this huge bias towards core/Growth there are many areas that are being overlooked or forgotten. This disparity between the two investment styles is perhaps the biggest disconnect between emerging and developed markets, in my view.

For example, I can currently buy what are, in my view, some of the best franchise banks and best insurance companies in emerging markets, at historically low prices. Of course, the widely held perception is that financials are cheap for a reason. This might be true for developed markets (DM), where financials are struggling due to depressed 10-year bond yields. However, there are 30 different countries in the emerging market universe. And unlike developed markets, the yield curve in some central and eastern European countries, as well as China, has been steepening for two years. Also, capital spending in EMs is at a 15-year low, so I expect this to pick-up going forward. With increased capex comes job creation, rising wages and loan growth. So, EM financials look well positioned currently, in contrast to their developed market counterparts.

Another misconception is that the same rules apply, whether it is emerging or developed markets. However, Value investing in EM is very different from Value investing in DM. For example, many DM Value investors will focus on buying “falling star” companies, average down the cost, and then wait for some catalyst to trigger mean reversion. However, mean reversion doesn’t really happen in EMs. Cheap stocks can stay cheap for a very long time due to opaque ownership structures, weaker governance and a prevalence of family and state-owned companies, among other factors. There are also very few takeover stories or leveraged buyouts EMs. So, there are limited opportunities to buy genuinely cheap P/E or P/B companies and simply wait for them to pay off.

Accordingly, I tend to focus on the forgotten areas, the markets and companies that nobody else is looking at. For example, little is heard about the Middle East as a constructive place to invest. In fact, the Middle East has outperformed broader emerging markets considerably in 2018, supported by a high dividend yield and the current strength of oil prices.

South Africa is another forgotten country that nobody really talks about. Even the local entrepreneurs tend to take any profits they make and invest them outside South Africa. However, the country is home to some good quality companies, so this is another market we like.

Yoram Lustig: Rather than a particular side, I take a more holistic view of the Growth/Value landscape, in the context of potential sources of return. In the multi-asset space, when we construct a solution we want to have exposure to as many potential sources of return as possible, including Growth and Value and large and small cap investments. The first way that we try to create returns for investors is through the blend of these exposures. In terms of Value and Growth, we try to keep a healthy balance between the two as it can be challenging to predict when one is going to outperform the other.

The second way we can help investors is via tactical asset allocation, i.e. dynamically allocating between asset classes and assets to generate alpha. Here, we have an asset allocation committee that formulates views about whether Value or Growth is likely to outperform. However, we do not need to predict an inflection point between the two styles. Instead, if we can see that the cycle of Growth or Value is building, we simply lean into that cycle, adding value through tactical asset allocation.

Finally, disciplined portfolio rebalancing is important. It makes sense to rebalance a portfolio regularly to maintain a healthy profit-taking discipline. Over the past decade, for example, you would periodically take some profits from the outperforming Growth exposure and buy Value.
This might seem counter intuitive, given Value’s ongoing underperformance, however, you are buying the Value stocks that our PMs have chosen – quality companies that they expect to do well over the long term. In effect, you are taking profits from past winners and buying expected future winners.

WHERE TO NEXT? WILL GROWTH CONTINUE TO LEAD OR IS VALUE READY TO SHINE?

**Yoram Lustig:** To try and answer this question, it is important to try and understand why Growth has outperformed Value so strongly over the past decade. In developed markets, this has obviously been driven by the growth in technology stocks in recent years. However, this could change. If a global trade war develops, for example, the technology sector would be one area to suffer. High valuations could also be a stumbling block for the technology sector. Meanwhile, on the Value side, financials stand to benefit if the U.S. yield curve suddenly steepens.

Growth investing has also benefitted from low interest rates over the past decade. If you think about Growth investments, they have a long duration because their cash flows are further into the future. In contrast, Value stocks tend to pay high dividends today, so a rising rate environment will not be as supportive for Growth investing going forward. Finally, the economy will also play a part. Value stocks tend to perform well when there is an economic slowdown, and, at some point, we will see a slowdown.

**Taymour Tamaddon:** From a Growth perspective, one of the potential influences that I focus on is inflation expectations. Historically, a relatively low, stable inflation environment has seen Growth investing do very well. This is the environment we are currently in, and that is expected in the near term, but I am always looking for any changes in the outlook. So, I am also very focused on interest rates. The Federal Reserve currently faces conflicting concerns, namely, which poses the greater risk; keeping interest rates low, or raising them? For me, I think the bigger risk would be to raise interest too quickly, so I think the Fed will be very watchful going forward. Finally, I am constantly watching for any early signs of recession. Historically, Value has significantly outperformed Growth during recessionary periods. One of the obvious signals of heightened risk seems to be when a misallocation of capital is evident, i.e. market bubbles. So far, I don’t see any obvious large pockets of misallocated capital.

**Ernest Yeung:** As an EM Value investor, I also need to consider the potential impact of a peak in the U.S. economy. EM and U.S. stock markets have a correlation of around 0.75. So, if the U.S. economy rolls over EM will not be immune to the slowdown. However, even in the event of such a headwind developing, we would simply buckle down and work even harder to find companies with the potential to improve and outperform in a tougher market environment. A crucial point to remember is that, for investors in the EM Value space, the luxury of valuation multiples at very low levels, remains.
Key Risks - The following risks are materially relevant to the strategies highlighted in this material:

Transactions in securities of foreign currencies may be subject to fluctuations of exchange rates which may affect the value of an investment. The strategy is subject to the volatility inherent in equity investing, and its value may fluctuate more than a strategy investing in income-oriented securities. Returns can be more volatile than other, more developed, markets due to changes in market, political and economic conditions. The strategy has increased risk due to its ability to employ both growth and value approaches in pursuit of long-term capital appreciation.

Important Information
The specific securities identified and described above do not represent all of the securities purchased, sold, or recommended by T. Rowe Price and no assumptions should be made that the securities identified and discussed were or will be profitable.

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. Past performance is not a reliable indicator of future performance. The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request.

It is not intended for distribution to retail investors in any jurisdiction.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA—Issued in the European Economic Area by T. Rowe Price International Ltd, 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

T. ROWE PRICE, INVEST WITH CONFIDENCE and the Bighorn Sheep design are, collectively and/or apart, trademarks or registered trademarks of T. Rowe Price Group, Inc. All rights reserved.