Playing Field Is Now More Even for Value

Headwinds dissipating and valuations at trough levels.

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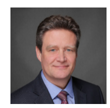
KEY INSIGHTS

- Past headwinds of low interest rates, technological disruption, and narrow leadership of growth companies have dissipated.
- With a more normalized environment and even playing field, value stocks can once again perform their more traditional role for investors.
- Valuation metrics are appealing with investors given the opportunity to buy stocks at trough-level valuations in some cases.



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A value style of investing has a long history of delivering above-market returns. However, since the global financial crisis (GFC), it has been one of the worst performance periods on record for value. The last few years have proved a particularly challenging period given a backdrop of low growth, suppressed interest rates, and bouts of volatility. This has led to a dominance of growth and quality factors creating a meaningful headwind for value-oriented stocks.

There are, however, signs of material evolution in the market environment that should reverse some of the headwinds for value funds—or at least make it a more level playing field—allowing value funds to play a valuable role once again in investors' portfolios.

The Past: Meaningful Headwinds Provided a Challenging Environment for Value Investors

While growth stocks have a natural tendency to go through an outperformance cycle when broad-based growth becomes scarce (because investors become more willing to pay a premium), the magnitude of underperformance of value factors has been one of the largest investment puzzles in recent years. There is no single reason but, rather, a combination of interrelated headwinds.

The anemic economic rebound we witnessed post the GFC has been a major factor. In previous economic cycles, value had tended to benefit as economic recoveries produced wider profit rebounds and changed the market's perception of discounted companies. In recent years, any recovery frequently undershot expectations with economies struggling to close output gaps (particularly in Europe), providing a headwind to value.

The tepid economic upturn led central banks to persist with near zero interest rates and further monetary stimulus, driving bond yields to all-time lows.

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1.05x

Current price-to-book ratio of MSCI EAFE Value Index.[2]

Past Headwinds Now Dissipating as We Look to the Future

The future looks brighter for value due to a combination of factors

Past	Future
Low economic growth	Inflation
Ultralow interest rates	Rising interest rates
Deflation	Higher bond yields
Disappointing profits (value companies)	Greater fiscal spending
Dominance of select group of growth companies	De-globalization

For illustrative purposes only. Actual future outcomes may differ materially from any forward-looking statements made.
Source: T. Rowe Price.

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This low interest rate environment penalized financial stocks, which make up the largest sectoral component of value. More fundamentally, it drove investors to rerate the valuations of future earnings of growth companies compared with the near-term cash flows of value.

Meanwhile, as the anemic economy led many traditional cyclicals to undershoot profit expectations, a cohort of emerging technology companies, most notably the internet platforms, materially overshot expectations of growth rising to dominate market indices. This technology disruption blunted growth prospects of many incumbent businesses. Technological change is, of course, not new, but the current cohort of growth companies was unusually strong, supported by nearly limitless money at ultra low interest levels to fund early-stage growth.

The Future: Headwinds Dissipating and Attractive Valuations

Many of the headwinds for value investing are now fading, and we believe that “the times they are a-changin’.” We are seeing populism rise and increasing demands for intervention. We have seen greater fiscal support with modern monetary theory and “helicopter money”[1] becoming more commonplace. While more recently we have had supply chain problems (emanating from the pandemic), there has also been a more general retreat from globalization. The resultant rapid rise in inflation has benefited value areas of the market, in particular, commodities and financials. Most significantly this has led to a reversal of the long-term downtrend in bond yields. From a peak of over a quarter of global government bonds having negative yields, now only a handful remain (mostly in Japan).

The investment case for value, however, is not predicated on a sudden shift in the macroeconomic environment or technological winds. Even though value can offer investors a hedge against inflation, we don’t necessarily need structurally higher inflation to benefit from its attractiveness.

Market Currently Offering a Second Bite of the Cherry

Of more importance is what is already priced into expectations. Many value companies offer investors a very low bar to overcome. With the MSCI EAFE Value Index (Figure 1a) currently offering a price-to-book ratio of 1.05x,[2] we believe the style factor is attractive from

[1] Whereby the central bank transfers money to the public to help boost economic output.
[2] Source: Financial data and analytics provider, FactSet. Copyright 2022 FactSet. All Rights Reserved. As of July 31, 2022.

Absolute Valuations for Value Look Appealing

(Fig. 1a) MSCI EAFE Value Index just above 1.0 times price to book

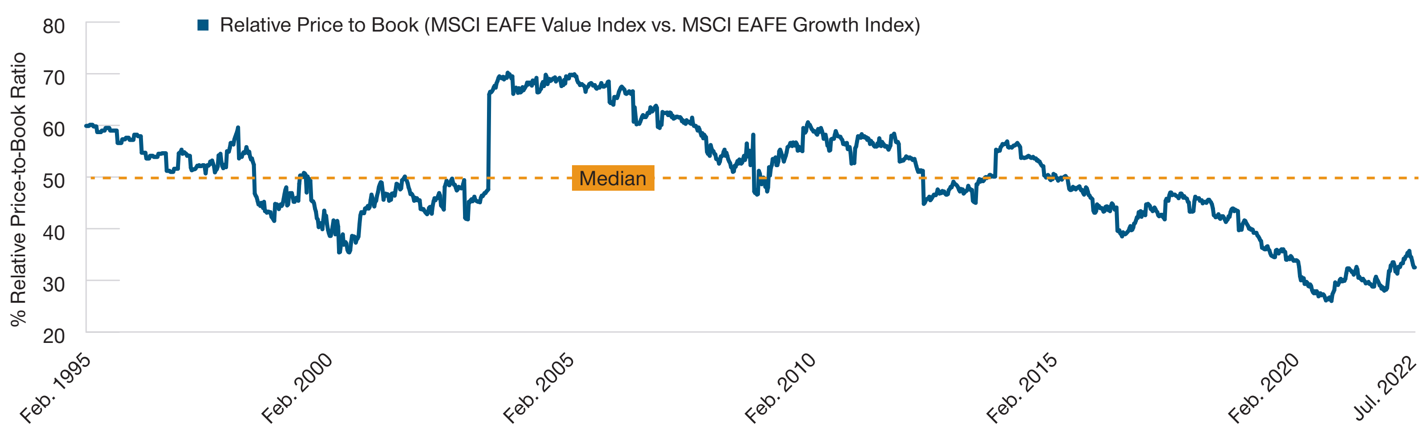
Data from February 3, 1995, through July 31, 2022. **Past performance is not a reliable indicator of future performance.**
Source: Financial data and analytics provider, FactSet. Copyright 2022 FactSet. All Rights Reserved.

a historical perspective. To be clear, it has only been below 1 on three previous occasions: the global financial crisis (0.76), the eurozone crisis (0.88), and during the onset of the pandemic (0.70).[3] With the average dividend yield being 4.8% and a forward price to earnings (P/E) of just 8.8 times earnings, we believe there is much to offer to investors.[3]

We would also highlight that the differential has grown between growth and value. Figure 1b reflects how the price to book of value was valued at 69.2% of the growth valuation in 2003 (as of August 29, 2003), but now is only at 32.5% of the growth valuation today (as of July 31, 2022). The discount has approximately doubled in that time, making the style factor even cheaper.

The Difference Between Growth and Value Has Widened

(Fig. 1b) The discount has doubled since 2003

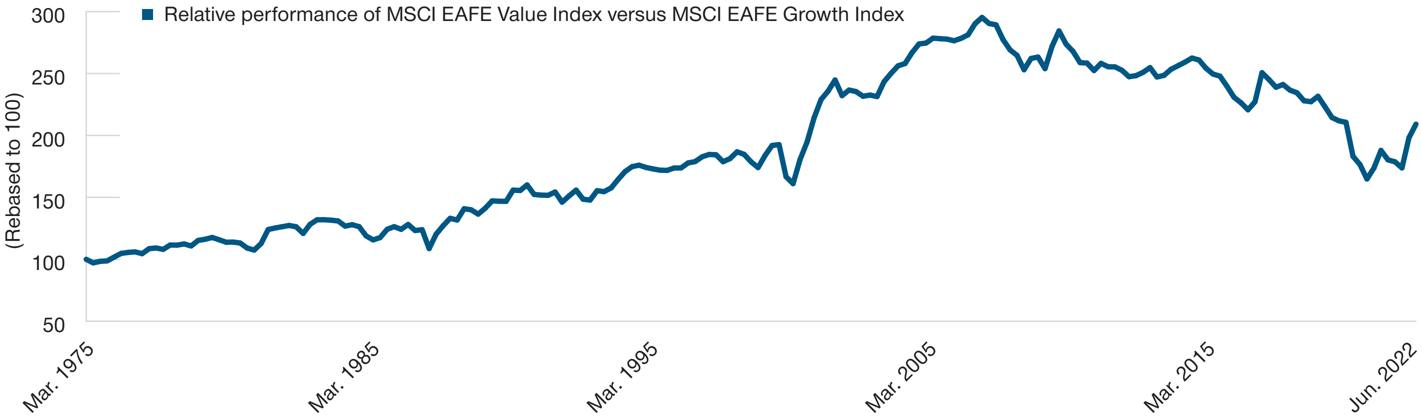


Data from February 3, 1995, through July 31, 2022.
Source: Financial data and analytics provider, FactSet. Copyright 2022 FactSet. All Rights Reserved.

[3] Source: Financial data and analytics provider, FactSet. Copyright 2022 FactSet. All Rights Reserved. As of July 31, 2022. The forward P/E is not a projection of future result. Actual results may vary.

Historical Performance of Value Versus Growth

(Fig. 2) After a decade of growth dominance, the tide has started to turn in favor of value



Past performance is not a reliable indicator of future performance.
Data from March 31, 1975, to June 30, 2022.

But it is also important to remember that value as a factor has historically proven to outperform growth over longer periods of time (Figure 2). The dominance of growth for more than a decade has been particularly unusual but for justifiable reasons.

The GFC in 2008/2009 brought untold damage to financial markets, and unprecedented policy action was required with central banks slashing interest rates and pumping huge amounts of liquidity into the financial system. However, as we move into a more normalized investment environment, this should allow for value to reassert itself once again.

And now, quite clearly, the narrative has changed for value as a factor. Decade-high inflation and the prospect of aggressive monetary tightening has seen investors favor value areas of the market. But although value has outperformed growth on a relative basis year-to-date, it has only moved the needle "slightly" in terms of long-term performance.

The Ukraine conflict and ongoing COVID-19 lockdowns in China have seen markets pull back year-to-date.

Across a broad range of sectors, we are being offered the chance to purchase stocks at depressed valuations. This is particularly evident in international markets, where many areas are looking attractive—from chemicals to financials, and even in technology stocks, which have derated quite significantly.

Assuming the U.S. and the global economy do not fall into a major recession, there seems more limited downside at these valuation levels, creating an attractive risk/reward opportunity.

With hindsight, the pandemic proved to be a great time to buy some cheap stocks, but the market seems intent on giving us another bite of the cherry.

Value Is Also Fighting Back in This New "Disrupted" World

There has been a crop of companies that have been hugely successful in creating giant monopolies. This unique cohort of companies has benefited from extremely low funding costs and huge growth in their customer base. However, we believe the playing field between disruptors and incumbents is becoming more balanced.

> Value can also perform well in a range of different economic environments. We do not necessarily need a new economic upswing for it to outperform.

The idea that today's largest companies—primarily U.S. technology companies—will continue to dominate the next decade should be met with caution. Seldom do the same companies, or even economies (such as Japan in the 1980s) manage to sustain such dominance. The risks to them—including their own disruption and increasing costs of capital and regulation—are real and impacting companies right now.

Long-established brands are also fighting back and adapting to the "new world." They are developing their own capabilities, acquiring or partnering with innovators. At the same time, many traditional business models remain relevant in today's world and have proven to provide durable earnings growth throughout most economic cycles. With these disruptors now having to live in a world of higher interest rates and less liquidity, they may struggle. There is no guarantee that the next wave of start-up companies will deliver on their ambitions nearly as well.

Our Approach and Ability to Perform in Different Types of Economic Environments

Value can also perform well in a range of different economic environments. We do not necessarily need a new economic upswing for it to outperform. Although many parts of the value universe are economically sensitive, such as banks and "high cyclical" industrials, there is also a healthy representation of defensive areas, such as utilities and other traditional industries with strong pricing power.

While disruption and record-low interest rates made value investing more difficult in recent years, the classic value investing model has not fundamentally changed. Investing in high-quality companies that trade below their intrinsic value has continued to prove a successful strategy. Short-term disruption, controversy, or setback in the market can cause mispricing. With stock prices oscillating more than their underlying fundamentals, this often creates opportunities for fundamental investors. We seek to take advantage of these mispricings and other investors' short-term horizons.

Our core approach is based on discounted cash flow, and specifically on a model around normalized economics of a business. Focusing on sustainable levels of margins across a cycle, rather than at peak, ensures we understand the capital intensity of the business. We try to examine what management can do to improve the business, whether that be through improving margins, free cash flow (FCF) conversion, or capital allocation. At the same time, we also consider downside risk scenarios. What is the bear case, and how much is in the price? Can that company survive a longer downturn? Ultimately, it is a sanity check that we perform using the appropriate valuation metrics.

But even within a better valuation backdrop, we believe it is crucial not to simply apply mechanical valuation methodologies such as those embedded in value indices. In many cases, low valuations can simply reflect realities about a poor or deteriorating business model. It is therefore important to research and understand individual companies and challenges to sort the wheat from the chaff.

Also, within the modern economy, many companies are based around intellectual property rather than tangible assets. These often do not fit into many value indices, which rely heavily on tangible book value to define value stocks. These intellectual property-based businesses can also be approached from a value perspective and can be good investments when bought at out-of-favor prices when discounting only limited growth.

“With a more normal playing field restored, we believe value investing can once again provide added value for investors, while offering diversification to other styles and to the market in general.

Encouragingly, while the top-down news may give little room for cheer, we are observing many attractively valued, world-class businesses that currently offer attractive valuations. Plus, the refreshing nature of uncertainty and the recent pullback in stocks is that it makes for a better environment from which to select stocks even while we move through a sticky part of the economic and equity cycle. While perhaps not a deep value cycle, stock-specific opportunities for value investors have broadened.

In today’s market, with high economic uncertainty, we are keen to maintain a portfolio well diversified across economic exposures. Fortunately, we can find attractive valuations in many areas, with financials and increasingly industrials offering notable opportunities within cyclicals. The resilience of health care companies is similarly attractive.

Strong Fundamentals and Near-Term Drivers Provide a Positive Backdrop

Overall, with an increasing recognition that the investment landscape has changed—not least, a challenge to the deflationary mindset—we are looking forward to the future. Many of the headwinds that have restricted performance in the past are fading as the era of permanent deflation has drawn to a close. With a more normal playing field restored, we believe value investing can once again provide added value for investors, while offering diversification to other styles and to the market in general.

Importantly, although value has outperformed since pandemic lows, we believe investors have not missed their opportunity. At current levels, valuations offer a steep discount compared with growth, with international stocks looking more attractive compared with their U.S. counterparts. We believe it is important that investors have a value element in their portfolio, especially as we move through the next stages of the equity cycle.

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