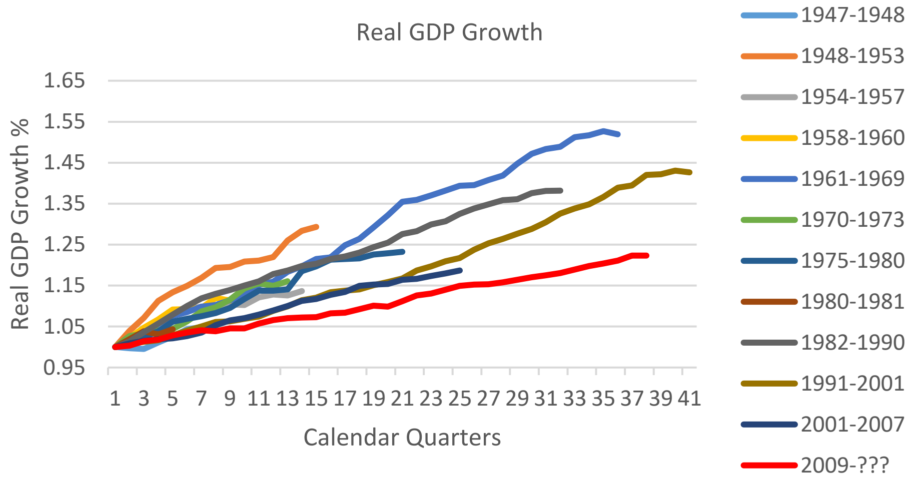
# StrategyInsights
## Value vs Growth Update

Kasim Zafar, CFA

22 Oct 2018

### Executive Summary

The current economic expansion in the US is now the second longest running expansion in the post-war era, as we can see in the chart below. Despite its longevity, it is also the slowest expansion. Therefore, it is perhaps no wonder it is also the expansion with the greatest extremes; in the level of interest rates, the degree of monetary intervention and the degree by which different styles of investing have deviated from each other.




In a research paper written by Norman Cummings, he writes about how the US equity market is expensive based on a series of measures including CAPE and TRCAPE, implying the S&P is substantially overpriced today.

He then goes on to say that for a variety of reasons, he now looks at "real wealth series, derived from MSCI indices", that is to say *he now looks at performance*, "calculated on the basis of capital gains plus the reinvestment of dividends". He then measures the "annual trend, the standard deviation around that trend and the deviation now", including a percentile representation of the deviation.

I must stress again: his analysis *no longer* measures deviations in fundamental value, but rather measures relative performance.

He adjusts these metrics, discounting by UK CPI to get a "real" measure of the deviations. In my opinion, this is a slightly odd way to view global, non-UK regional indices (e.g. US, Japanese or European) and certainly style indices within foreign markets. Furthermore, his observations are then ambiguous by using language like "cheap" and "expensive" that are traditionally associated with fundamental value whereas the data used to derive these observations are based purely on performance and relative performance of a variety of MSCI indices.

In my analysis which follows, I focus on the value and growth style, also using MSCI indices but I expand beyond a simple table and I do not make any inflation adjustment. By looking at the relative return of value vs growth, I show the current drawdown of the value style versus growth is both the longest in duration and now also the deepest, currently sitting at the 0.38% percentile.

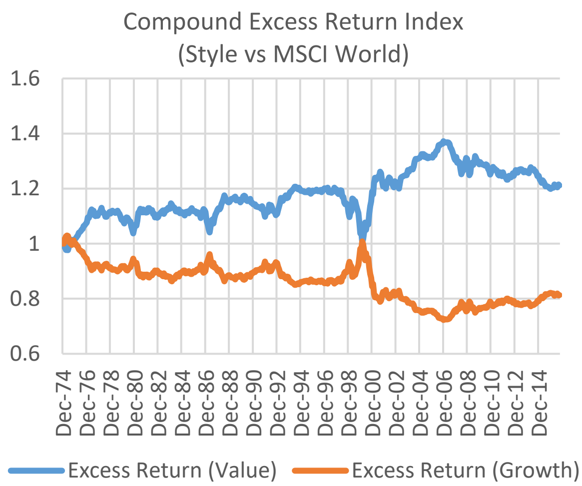
However, I argue this extreme value is driven by structural differences between the US and other equity markets. I demonstrate the value style as being in a long term structural drawdown versus growth, dating back to the mid-1970's. I show the value factor outside the US does provide long term positive excess returns, although here also, the style has been out of favour since the Great Financial Crisis. I postulate on the possible causes for this dichotomy, to be investigated in future research.

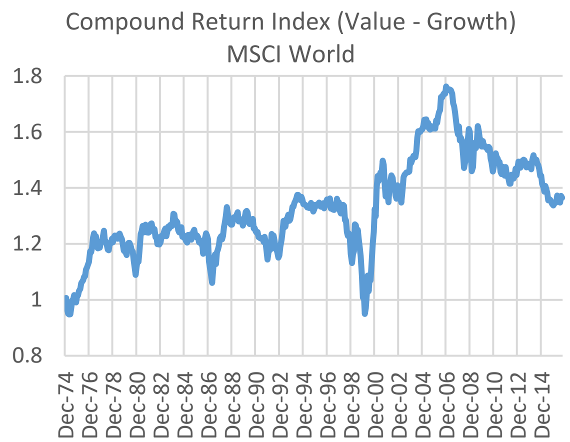
I then use our method of cycle analysis and long term histories of key market variables to understand the environments in which the value style provides outperformance. At that stage, I include the quality factor to the discussion through another MSCI index.

I conclude that a switch to value can be quite costly unless and until we truly enter a recessionary environment. The caveat to this would be if we see some sort of mean-reversion that reverses the last several decades of underperformance of value as a style, in the US markets. I propose an alternative portfolio adjustment, where we should seek to reduce our all-out growth exposures in favour of "quality growth" that has proven robust to changes in macro factors and cycle stages. If the cycle were to extend and were growth to continue its outperformance, therefore, the price of being wrong would be vastly reduced.

## Value vs Growth

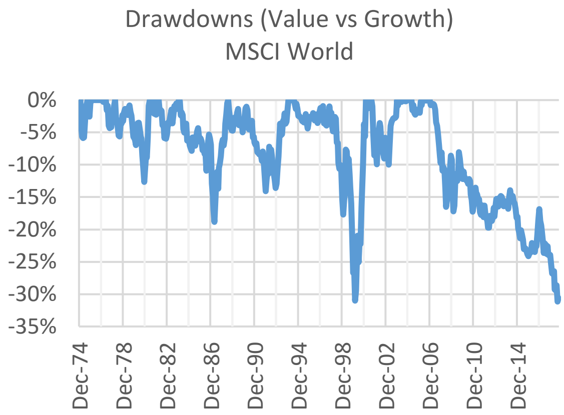
The MSCI World Value and Growth indices start in December 1974. The charts below show the compound excess return of each MSCI World style index versus the MSCI World Index. It shows the story with which we are all familiar: over the long term, value investing outperforms the market.

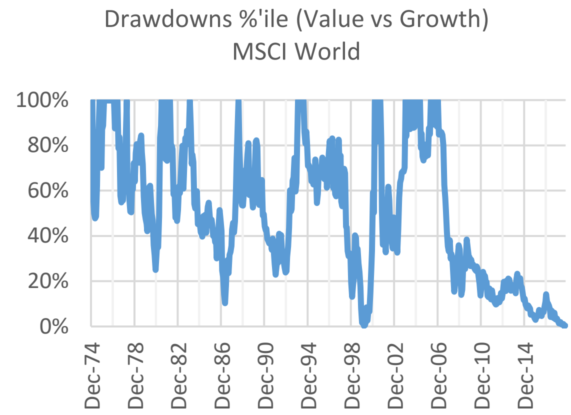



However, as we can see in the chart above right, there are periods when value investing materially underperforms growth. Usually, the style has snapped back quite aggressively. This behaviour is primarily due to the underperformance of value in peak, bubble-like markets when the growth style outperforms before crashing in the subsequent slump.

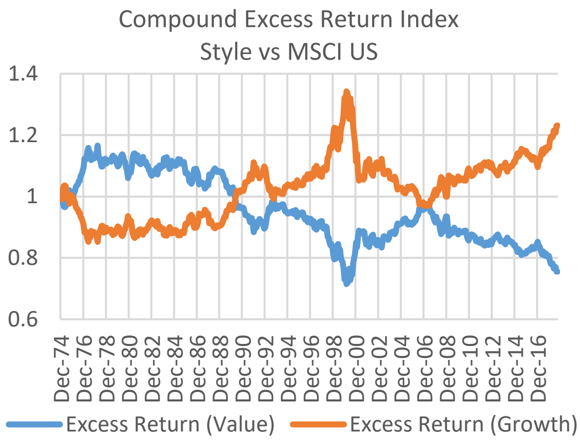
The period since the financial crisis, however, is distinct for both the duration over and extent to which value has underperformed. We can see that in the drawdown and percentile of drawdown charts below left and right respectively. It's hard to argue value isn't looking pretty attractive on this basis. Although we must also note that it has been similarly attractive for a number of years.

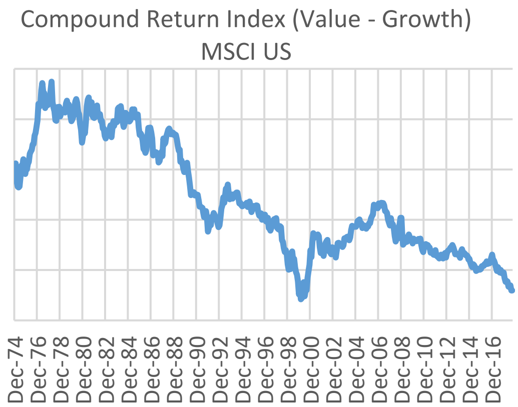


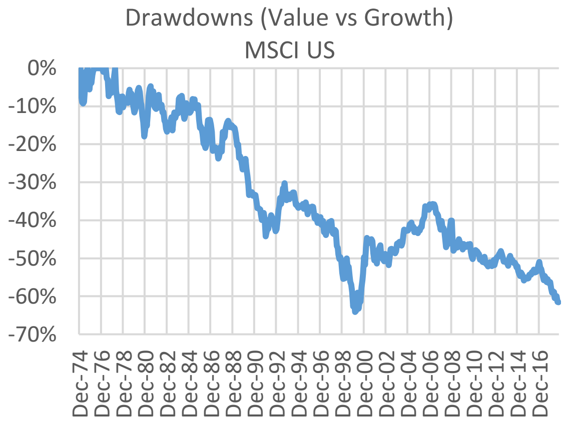



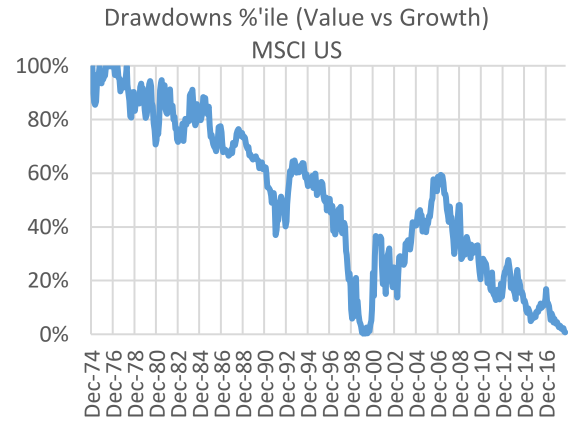

There's just one problem with this picture. As a global developed market index, it is not immediately obvious that using the MSCI World to study style factors would not be representative of each regional component. However, this is highlighted below where I show the same charts again, using the MSCI US Indices (for the broad market, value and growth), i.e. singularly focusing on the equity market of the US.

Please study them carefully. Value has been in a persistent <u>40 year drawdown</u> versus growth in the US market since 1976. There are however, periodic bursts of outperformance and the 2000-2007 bull market when value outperformed.

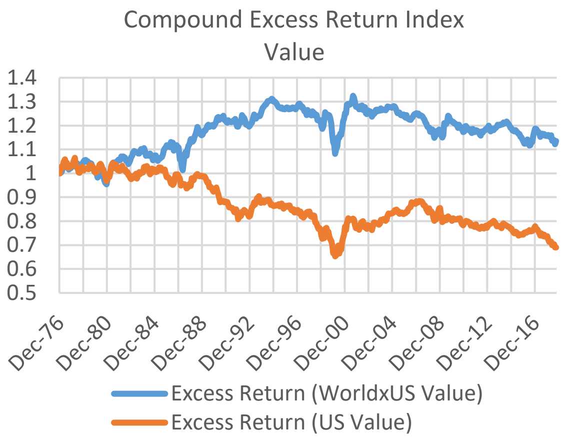


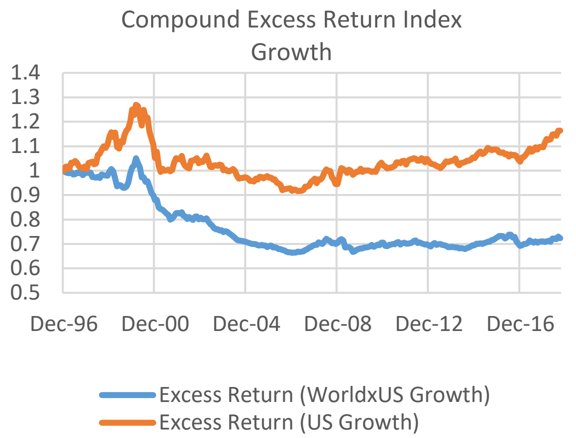



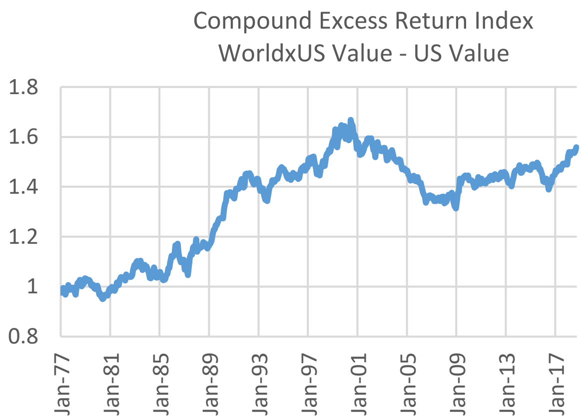



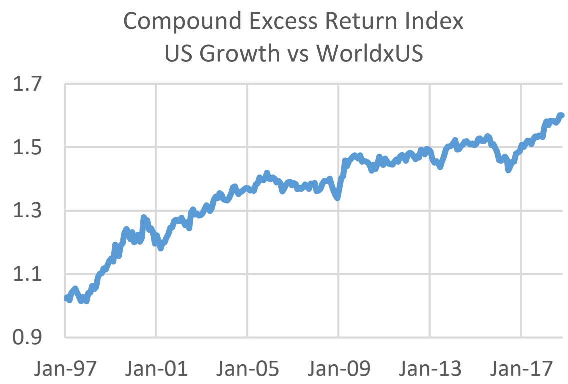




This dichotomy between the MSCI World and MSCI US indices means that an investment opportunity of switching from growth to value is clearly not applicable across each regional subset of the MSCI World index. Indeed, from the analysis so far, there appears to be a significant excess return from the “World ex US Value” factor than for the “US Value” factor. To confirm this, I use the MSCI World ex US indices (for the broad market, value and growth). Albeit the growth index only goes back as far as December 1996.




With the exception of the period from 2000 to 2008, the excess return to value investing appears stronger and more reliable outside the US. Meanwhile, growth investing in the US appears to be much more successful than outside the US (noting the different time scale).

## Drivers for the dichotomy

Research pre-dating these indices (back to Graham & Dodd in 1934) has confirmed the existence of the value factor, studying various value metrics over countless studies. I checked whether there is a structural problem with the MSCI indices. But we see the same drawdown of value versus growth by switching to Russell or S&P indices for US broad market and style component indices, as shown in Appendix 1. So the reason for underperformance of value in the US since 1976 remains a puzzle for now.

Meanwhile, I have tried to identify the cause(s) for the dichotomy in excess return of the value factor between the US and World ex US. I had thought there might be a geographic cause, a possible currency effect, a difference in dividend policy (UK equities) and relative interest rate term structures. Quick analysis of these initial ideas show they are not the sole explanation for the pattern of excess return seen in the charts above. Investigating this further will be a study for a future date.

# Strategy*Insights*
## Value vs Growth Update

In the interim, there are still periods when value outperforms growth in each market. Below I follow our method of cycle analysis and at long term histories of key market variables to understand the environments in which the value style provides outperformance.

## Cyclical Characteristics of Styles

The analyses below extend previous research undertaken on sector performance during different market environments and stages of the business cycle. Below, I discuss the excess return of equity market style factors over rolling 6 month periods conditional on 6 month changes in a variety of factors.

In addition to the value and growth styles, I also include the quality factor which captures the performance of "quality growth" stocks by identifying stocks with the fundamental characteristics of a high return on equity, stable earnings growth and low financial leverage.

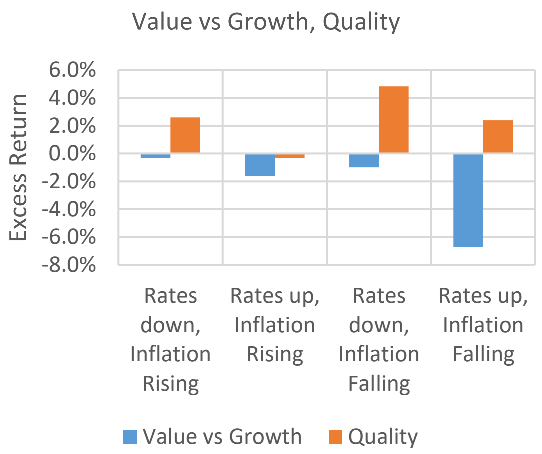
## US Equities

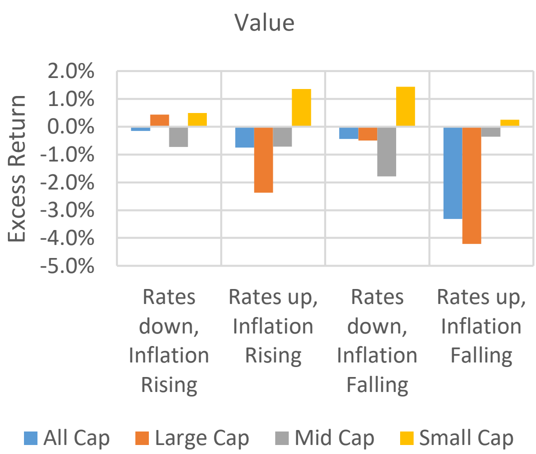
Despite the index based research earlier indicating that value is a difficult style to hold over the long term in the US, there are very clear occasions when growth materially underperforms, which from the time series analysis previously, we know coincides with the market rolling over.

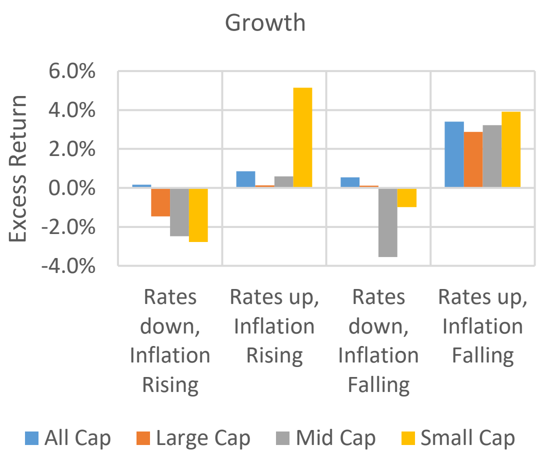
### Rates & Inflation

<u>Observations:</u>

1. Quality, a factor we have not discussed at all so far, has by far the best profile across different rate and inflation environments.
2. Small caps (growth and value) tend to outperform when rates are rising, irrespective of what is happening with inflation. This is intuitive since rates are usually rising when the US economy is healthy enough to absorb them.
3. Counterintuitively, growth seems to outperform best when rates are <u>rising</u>, although the outperformance is greatest when inflation is stable or falling.



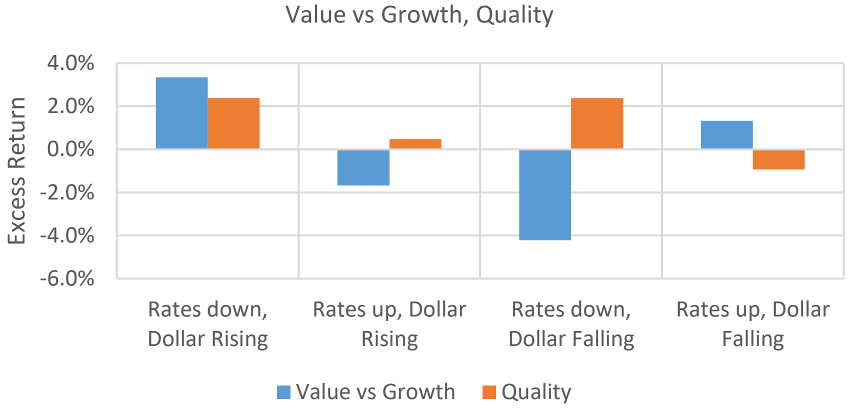



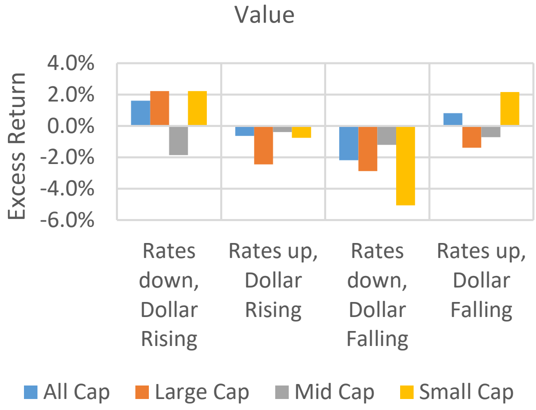



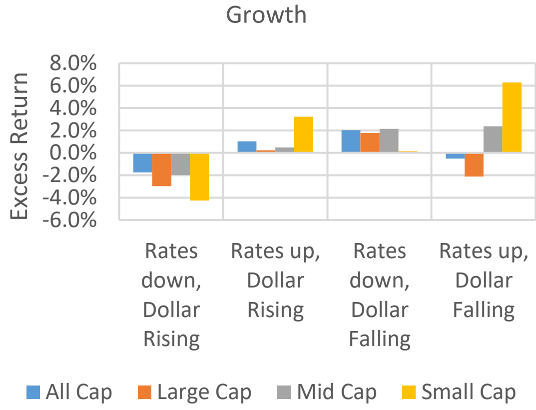
eQ investors

# StrategyInsights
## Value vs Growth Update

### Rates & US dollars



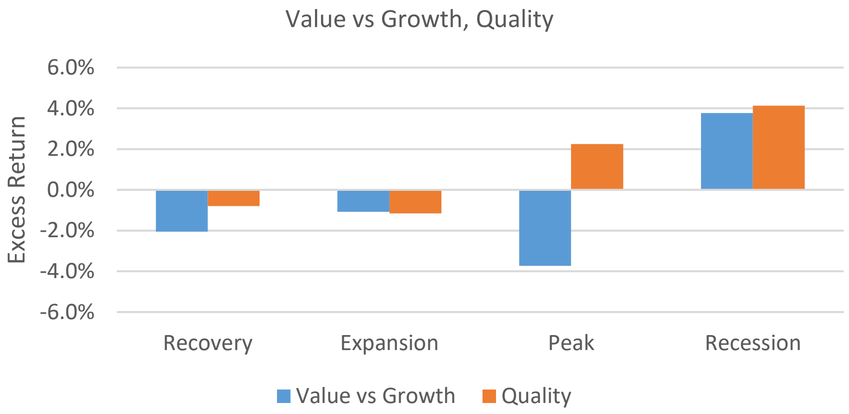



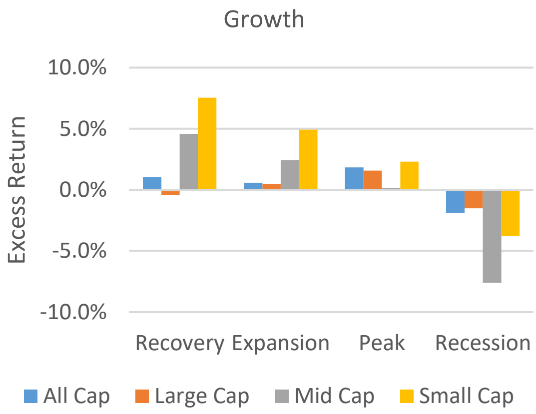

Observations:

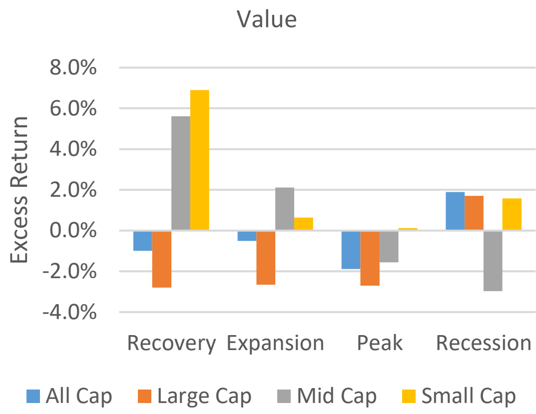
1. Again, we see the quality factor proving robust across a variety of conditions.
2. We also see one of the rare conditions when value has outperformed. Rates are falling and the US dollar is rising in a "flight to safety" environment. Value is the place to seek protection if there are concerns about the market rolling over, which agrees with our qualitative understanding also – just remember to shift back to growth afterwards!
3. Small caps tend to like it when the economy and the US dollar is strong.
4. Rising rates tends not to cause growth too much of a problem, irrespective of what's happening with the direction of the dollar. Meanwhile, value tends to struggle on a relative basis.

# StrategyInsights
## Value vs Growth Update

### Cycle Stage




<u>Observations:</u>

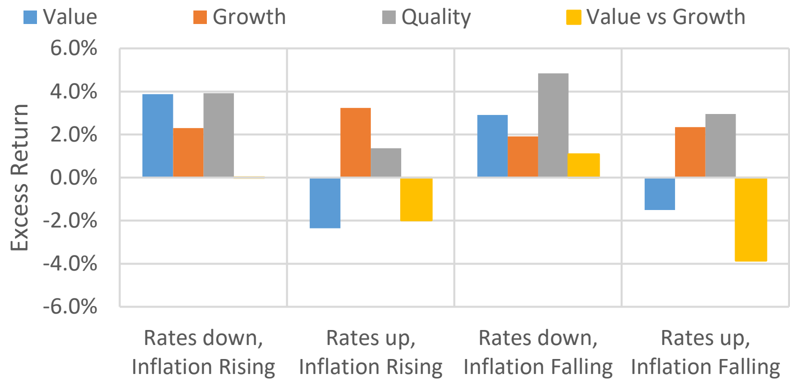
1. Again, we see the quality factor proving robust across a variety of conditions. Although it performs best in the peaking and recession stages of the cycle.
2. We can also see that small/ mid-caps do best in the recovery stage of the cycle, irrespective of their style orientation.
3. As previously demonstrated, growth really craps out in a recession but outperforms at other times.
4. Large cap value really only has a place in recessionary environments.

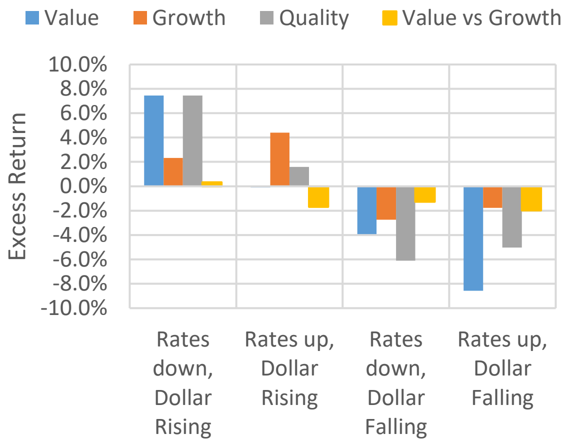
# Strategy*Insights*

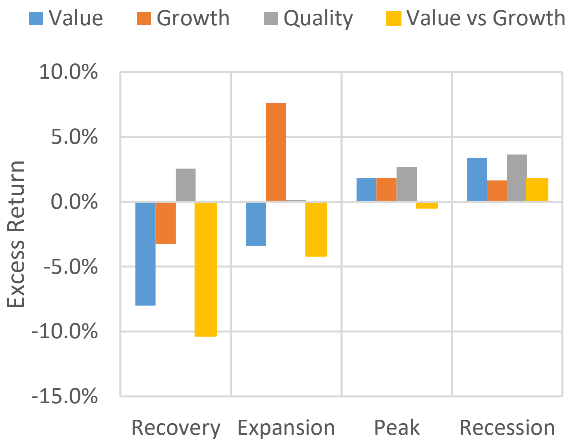
## Value vs Growth Update

### Global ex US Equities

I have started with the Global ex-US Indices to get the maximum history possible (1996). I have kept the analysis factors of inflation, rates and currency for the US to identify what relationships, if any, exist between US monetary policy and foreign equity markets.




Observations:

1. Monetary policy seems to have little direct impact on excess returns for different styles outside of the US. It may well affect the total return outside the US, but the excess returns have little obvious going on there.
2. Value and quality do seem to have some sensitivity to the direction of the dollar, however. They tend to outperform when the dollar is rising (foreign currencies are consequently weak) while they underperform in reverse.
3. Using an OECD G7 indicator for the global cycle stage, which does include the US, we can see the robustness of the quality factor again. The value factor again outperforms best in recessionary environments while growth is best in expansions. The value vs growth measure is less reliable due to the growth index having a much shorter history.

## Conclusion

Considering the observations and conclusions from the paper "Rising yields & the impact on equities", it seems fair to conclude that the best returns from the growth style in US equities is probably behind us.

However, based on the analysis in this paper, a switch to value could be quite costly unless and until we truly enter a recessionary environment in the US. The caveat to this would be if we see some sort of mean-reversion that reverses the last several decades of underperformance of value as a style, in the US markets.

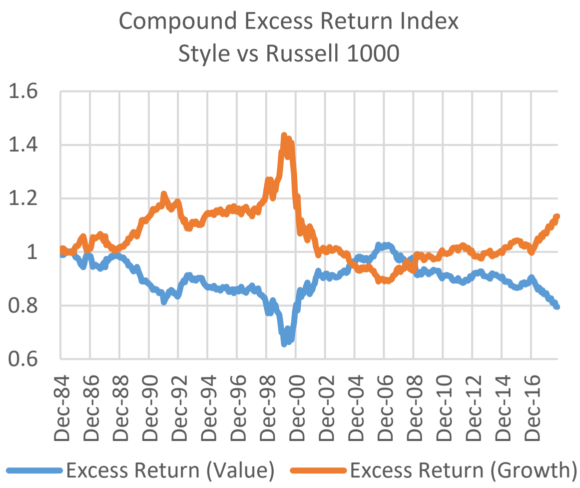
This creates a particular challenge for portfolios since the majority of growth exposure (25% of the 48% in Best Ideas Balanced portfolios) comes mainly from global and thematic funds that have a clear orientation to the US. The remainder is split between the UK (12%) and the rest of the world (12%).

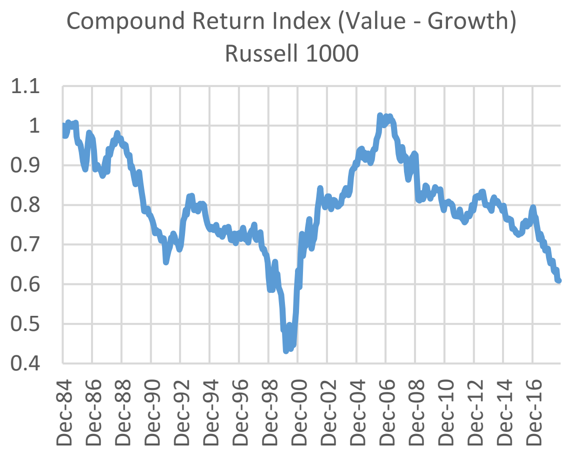
An alternative approach in portfolios is to reduce our all-out growth exposures in favour of "quality growth" that has proven robust to changes in macro factors and cycle stages. Consequently, if the US cycle were to extend and were growth to continue its outperformance (for whatever reason), the price of being wrong would be vastly reduced.

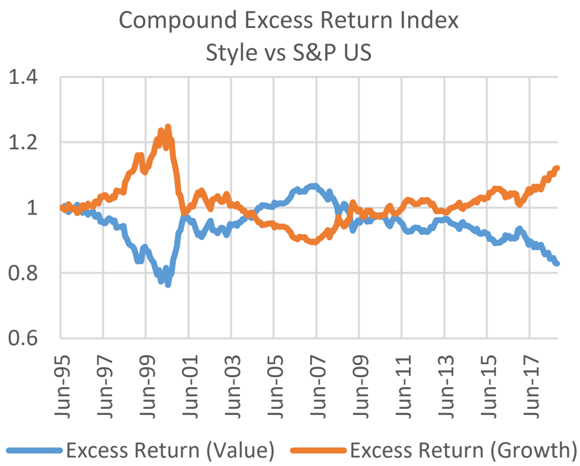
Outside the US, things are less clear. We need to be careful about the direction of the US dollar and based on cycle stages we should favour the quality style again.

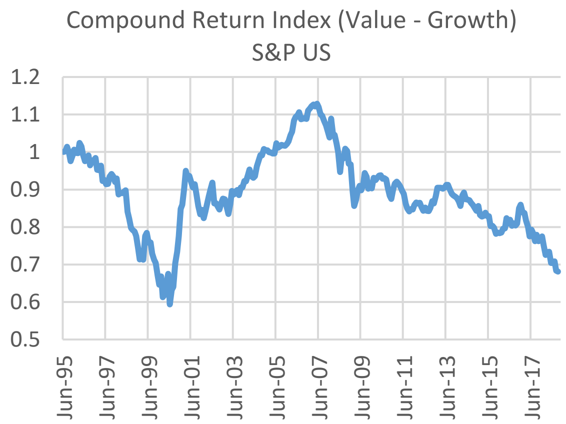
## Appendix 1: Alternative US equity indices

The charts below use alternative indices to the MSCI, but show a similar picture. The indices have different inception dates, but the same characteristic over the same periods are observed, i.e. with the exception of periodic bursts of outperformance, value underperforms in the 1985 – 1999 period, then outperforms from 1999 – 2006 and then underperforms from 2006 to 2018.




EQ Investors, Centennium House, 100 Lower Thames Street, London EC3R 6DL

eqinvestors.co.uk | 020 7488 7110 | enquiries@eqinvestors.co.uk | @eqinvestors | EQ Investors