Key Private Bank

Key Questions

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# Is There Still Value in Value?

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We continue to favor value. Remember, low-quality companies have distinctly outperformed high-quality companies since last summer. We are mindful of retaining higher-quality value positions as we enter future market phases.

US equities have experienced sharp swings over the past several years, with a record-breaking decline in terms of length of time and a similar record-breaking recovery to new all-time highs in 2020 alone. There have been similar shifts within styles of equities, especially in the relative performance of growth and value equities.

From the depths of the Global Financial Crisis through the third quarter of 2020, US growth stocks materially outperformed value equities except for relatively minor reversals in 2013 and 2016. Since the trough of the market in March 2009 to September 2020, the S&P 500 Index generated a total annualized return of 18.0%. The S&P 500 Growth Index led the way, increasing 20.4% on an annualized basis, while the S&P 500 Value Index lagged with a return of 15.2%.

In breaking down the outperformance further, forward earnings growth for growth stocks outpaced value stocks by nearly 2.5% per annum. The remainder of the almost 5% per year outperformance was due to multiple expansion. Up until 2017, the vast majority of growth's outperformance could be explained by stronger earnings. After 2017, multiple expansion drove growth's outperformance, even accelerating in the first two quarters of 2020 as large growth technology stocks benefited from stay-at-home orders.

What were the drivers of multiple expansion for growth stocks compared with the broader market and value stocks? Several explanations have been put forth, with each having some validity. First, a handful of large growth stocks have generated high, sustainable revenue and earnings growth that exceeded expectations. These trends have been extrapolated forward.

Secondly, applying lower interest rates to future cash flows results in higher present values. Because a greater proportion of the value placed on growth stocks is derived from longer-dated cash flows, lower interest rates disproportionately benefit growth stocks more than cyclical or value stocks.

Relatedly, stay-at-home orders acutely benefited tech and growth sectors compared with value sectors. In contrast, certain value sectors such as Energy and Financials have endured strong headwinds in the form of low oil prices and low interest rates. Lastly, sentiment played a role in herding behavior among investors.

Since early September, value (up 28%) has sharply outperformed growth (up 10%). Is there still value in value going forward?

Given several factors, our base case is for value to continue to outperform but at a decelerated pace as the economic cycle transitions from early to mid-cycle. First, earnings growth since September 2020 has favored value with forward earnings increasing 42% compared with 31% for growth. With above-average nominal GDP growth expected over the next 18 months, earnings for value stocks may continue to outpace that of growth equities.

There is a strong probability that the earnings growth gap should at least decrease.

Second, relative valuations are still dislocated compared with long-term history. The discount of value compared to the market is in the bottom third (lower is cheaper) percentile since 1986 and remains below the previous record discount during the Tech Bubble in the late 1990s. As the economy moves to full reopening, the tailwinds for certain growth sectors may become headwinds as consumers shift spending and year-over-year comparisons become tougher. Lastly, energy has benefited from a sharp increase in oil prices, and banking has strengthened with a steeper yield curve. Value may also benefit on a relative basis with increasing inflation.

Investors should note that low-quality companies have sharply outperformed high-quality companies since the summer of 2020. We believe markets may be transitioning to favor more-selective, higher-quality exposures. While we continue to favor value, we are mindful of retaining higher-quality value positions as the market and economic cycles enter the next phases. Over the past several quarters, we have positioned equity portfolios to benefit from a quality, value-led market while still retaining diversification in case an alternative scenario arises.

For more information, please contact your Key Private Bank Advisor.

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