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Value Versus Growth: How Durable is the rally in Value Stocks?

Asset allocation weekly.

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Weighing up the Debate

After a long period in the wilderness for the value style, the prospect of multiple effective vaccines reviving economic activity has seen a sharp rally in value stocks this month. We see the case for value to continue its revival in 2021 as relatively strong.

A Short History of Value Versus Growth Investing

Over the very long-term, professional investors and finance academics have noted the existence of a "value premium". "Cheap" stocks (low price-to-earnings and/or low price-to-book) have tended to deliver superior returns over the long run.

This has been postulated to occur because investors have tended to extrapolate good news (by bidding up the valuation of growth stocks) and extrapolating bad news (by overly discounting value stocks). Academic research has also suggested the value premium may, in fact, be a proxy for the additional risk inherent in investing in value stocks (Fama French 1992).

However, the observed long run tendency for value outperformance has not been evident for some considerable time. Growth has, for the most part, been outperforming value since the end of 2007, with only comparatively fleeting periods of value outperformance.

Growth outperformance has become particularly marked since the beginning of 2017. Moreover, this year the COVID-19 pandemic acted like an accelerant to the outperformance of growth.

Since the start of 2017, the MSCI global growth index has risen 105% compared to 27% for the global value index.

Exhibit 1: Value versus growth relative performance (Global MSCI)

Source: MSCI.

Growth Outperformance Global but US Tech the Epicentre

This well-defined trend of growth stocks outperforming value has been a global phenomenon evident across both developed (DM - including Australia) and emerging markets (EM). The dominance of growth has benefitted the US market disproportionately because of its large weight to the tech sector. In particular, the dominant US mega cap technology companies such as Microsoft, Apple, Alphabet (Google) and Facebook have been leading the global stock market for some time.

The length of this growth outperformance phase (13 years) has been unprecedented. Although it could be suggested that growth outperformance has a precedent in the previous outperformance stretch of value through the 1970s, 80s and much of the 90s.

Growth Outperformance has Widened the Valuation Gap

This extended outperformance from the growth style has seen the valuation dispersion between growth and value also stretch to the widest gap in almost 20 years. The steady fall in interest over the past 20 years has been an important driver in expanding the rating of long duration growth.

If we use sector data to look back 25 years we find that the global IT sector was relatively more expensive back at the peak of the tech bubble in 2000 (see Exhibit 2). Big cap tech valuations are not as clearly in bubble territory, particularly when adjusted for a much lower interest rate structure currently prevailing. However, the conclusion that many long-suffering value stocks are offering potentially attractive relative valuation appeal seems hard to refute.

Value Stocks Have Struggled to Grow Earnings in the Past 10 Years

While the outperformance of growth is partly a story about valuation re-rating, it is also a function of relative earnings delivery. Growth stocks have, on average, delivered vastly superior earnings growth outcomes over the past 10 years relative to value stocks. This combination of falling discount rates and strong earnings growth has been an explosive combination for growth stock multiples, particularly in the well-performing tech space.

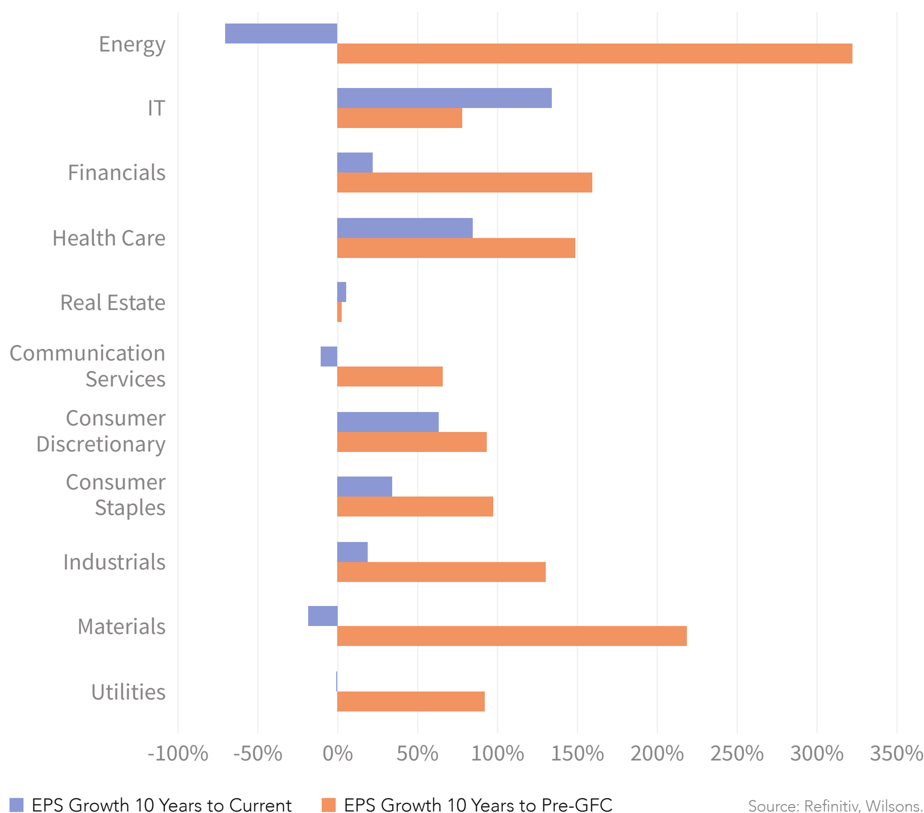
Exhibit 3 shows the earnings performance of value sectors such as financials and energy have been very poor in the past 10 years. Based on global sector data, only the IT sector has been able to deliver better earnings growth over the past 10 years compared to the 10 years leading up to the GFC.

Of course not every growth stock has lived up to the hype, but crucially the highly rated US mega cap companies have delivered genuine earnings growth over the past 10 years and once again in 2020.

Exhibit 2: Value proxy versus IT (growth) - value looks cheap on a relative PE basis

Source: MSCI.

Exhibit 3: Only tech has delivered improved earnings growth in the past 10 years



Source: Refinitiv, Wilsons.

An Earnings Revival for Value stocks?

From an earnings perspective, we do appear to be at an important inflection point, at least cyclically. After the COVID-19-induced earnings recession of 2020, the coming year should usher in a significant bounce back in corporate earnings for many value (recovery) stocks.

Value indices are typically weighted toward cyclical areas such as energy and financials, as well as cyclical industrials and materials. This recovery will take time to build but should extend through 2022. Looking at CY22 relative to CY19 estimates suggests the market may be understating the degree of recovery potential if the world can truly return to "normal" over the next 2 years.

Weighing up the Value Growth Debate

Beyond the prospect of a significant cyclicals recovery, the value growth debate arguably becomes more uncertain again.

Growth advocates point to a number of potential structural supports for the style:

1. Trend or post-recovery global growth conditions are likely to be tepid as they were pre-pandemic (which favours growth). This is likely to be the case because of demographic headwinds and the overhang of large debt burdens.
2. In a slow growth world, only a few outstanding growth businesses will likely prosper with the majority struggling to generate earnings growth.
3. The concept of value is arguable in a world where intangible assets are increasingly important for driving growth and firm value.

In contrast, advocates of the value style would passionately argue that the tide is set to turn for several reasons:

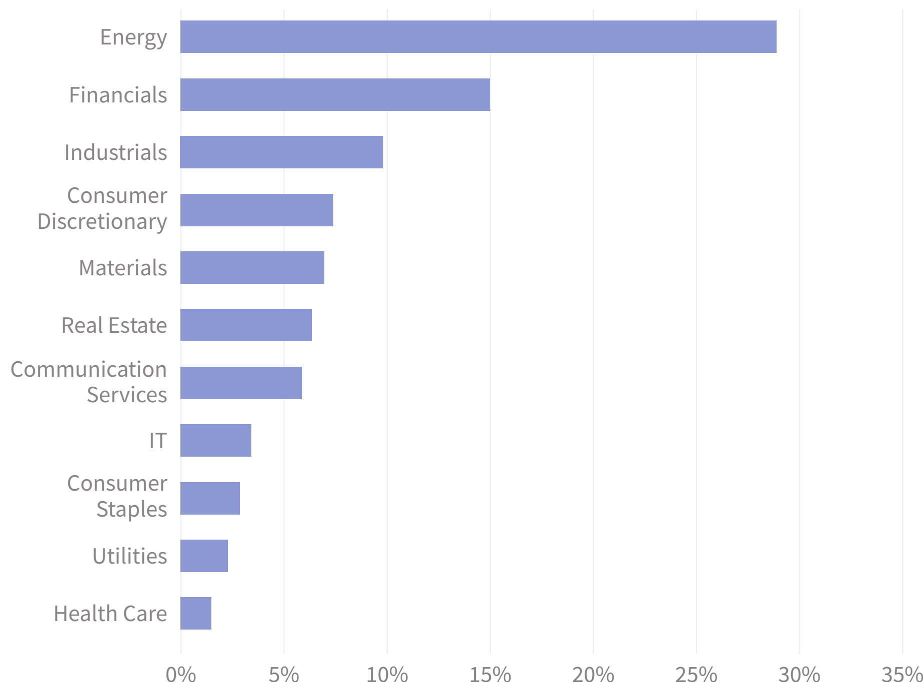
1. A return to more normal economic conditions should see a big lift in value earnings and a sustained rotation to value.
2. The long-running outperformance of growth has pushed relative valuations to stretched levels setting up the potential for a multi-year revival in value.
3. Better growth will also lift bond yields reversing the tailwind that has favoured (long duration) growth in recent years.
4. Mega cap growth (tech) may be subject to increasing regulatory scrutiny, which may crimp future growth prospects.

We see a degree of validity on both sides of the argument, though we do believe we are moving into a significant cyclical rebound phase for the value style. The COVID-19-induced global recession arguably delivered a final blow-off in the performance of growth, driven in particular by the tech sector, which in many cases proved very resilient in the face of the economic shutdown.

Pieces Finally Falling into Place for a Value Revival

With a vaccine driven solution likely to allow the global economic conditions to normalise over the next 1 to 2 years, this earnings recovery will favour many under pressure value/recovery plays. A gradual move up in interest rates will also act as a relative tailwind for value over growth in contrast to recent years. We believe that the sharp pick up in value performance this month is unlikely to be just a one month flash in the pan (see Exhibit 4). Whether this revival can move into a genuine multi-year renaissance in value investing is still open to debate, as we have discussed above. Still, we see the case for value in 2021 at a minimum as relatively strong.

Exhibit 4: Value sectors such as energy and financials have led the global rally this month



Source: Refinitiv, Wilsons.

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