Down … But Not Out

There's Still Hope for Value

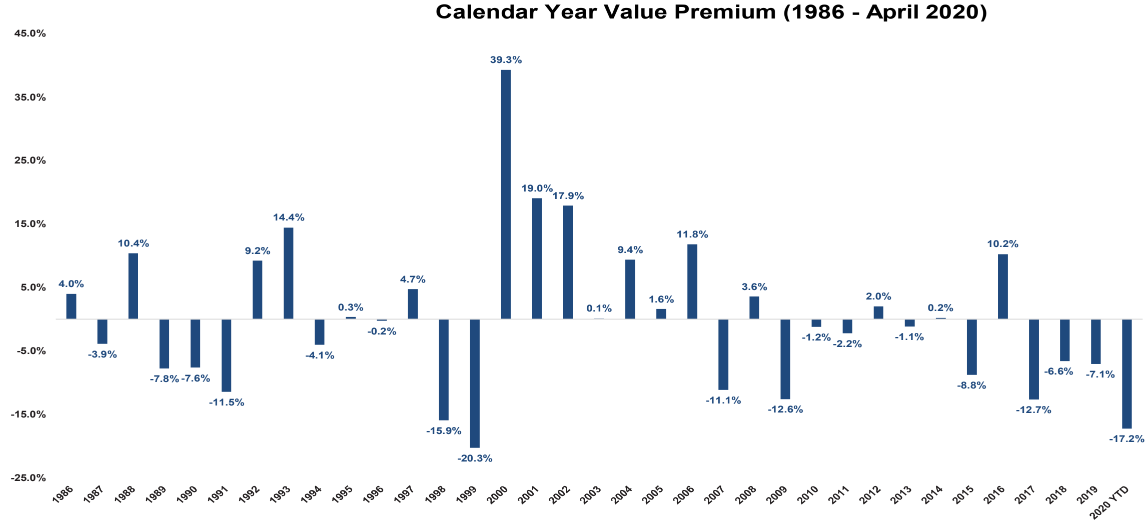
June 2020

- Over the last decade, value stocks trailed their growth peers by a significant margin, and in 2020, that margin has only widened.
- Despite poor performance, we believe the value premium will turn positive at some point in the future. Value has sustained elongated periods of underperformance in the past, but over longer periods, it has generated a positive premium.
- Value stocks continue to have attractive valuations relative to growth stocks on a historical basis. Despite a significant sell-off in 2020, growth stocks continue to look expensive relative to their history.
- Given the unpredictability of the value premium, investors should maintain a diversified portfolio containing both value and growth stocks. Over the long term, we expect this approach will generate superior risk-adjusted returns.

In our prior paper, *Is Value Dead?*, we noted that growth stocks outperformed value stocks over the last decade. While value has endured periods of both underperformance and outperformance relative to growth in the past, the magnitude and duration of value's most recent struggle has been nothing short of unprecedented. Unfortunately, for value investors, this trend not only persisted but actually accelerated in 2020.

Exhibit 1 below depicts the calendar year value premium – defined henceforth as the excess return of the Russell 3000 Value Index over the Russell 3000 Growth Index – every year since 1986. The table displays the average calendar year value premium for various periods of time.

Exhibit 1
Calendar Year Value Premium (1986 - April 2020)



Time Period	Average Calendar Year Value Premium
1986 - 2019	0.18%
1992 - 2019	0.78%
2000 - 2019	1.64%
2009 - 2019	-4.75%
2014 - 2019	-5.98%

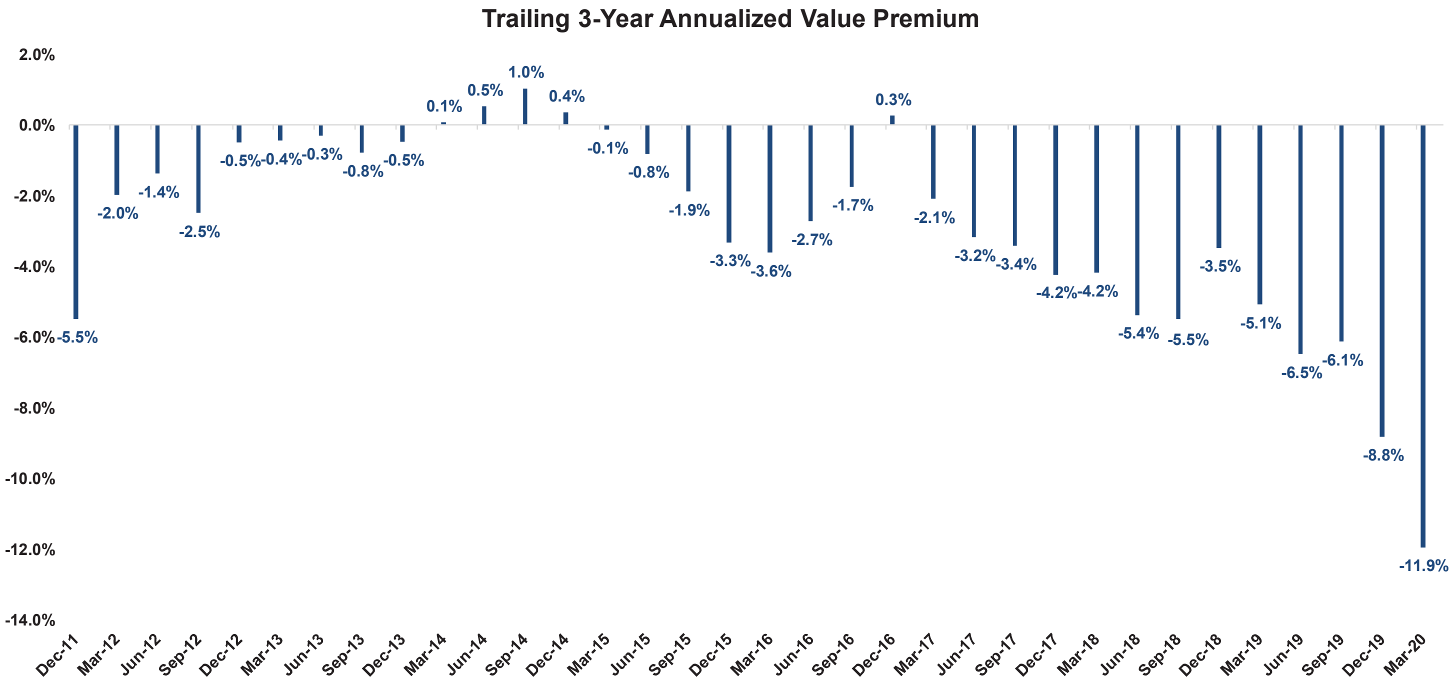
Source: Morningstar and Bloomberg

Source: Morningstar and Bloomberg. Past performance does not indicate future performance.

Through four months of 2020, value underperformed growth by 17.2 percentage points, which represents the worst year for value outside of 1999, the height of the dotcom bubble.

If we evaluate the value premium over longer periods, we observe similar results. In fact, value's struggles become even more pronounced. **Exhibit 2** below depicts the trailing three-year annualized value premium on a quarterly basis over the past 10 years. During the most recent period ending on March 31, 2020, value underperformed growth by 11.9 percentage points per year, which represents the worst rolling three-year period on a quarterly basis in a decade.

Exhibit 2



Source: Morningstar and Bloomberg

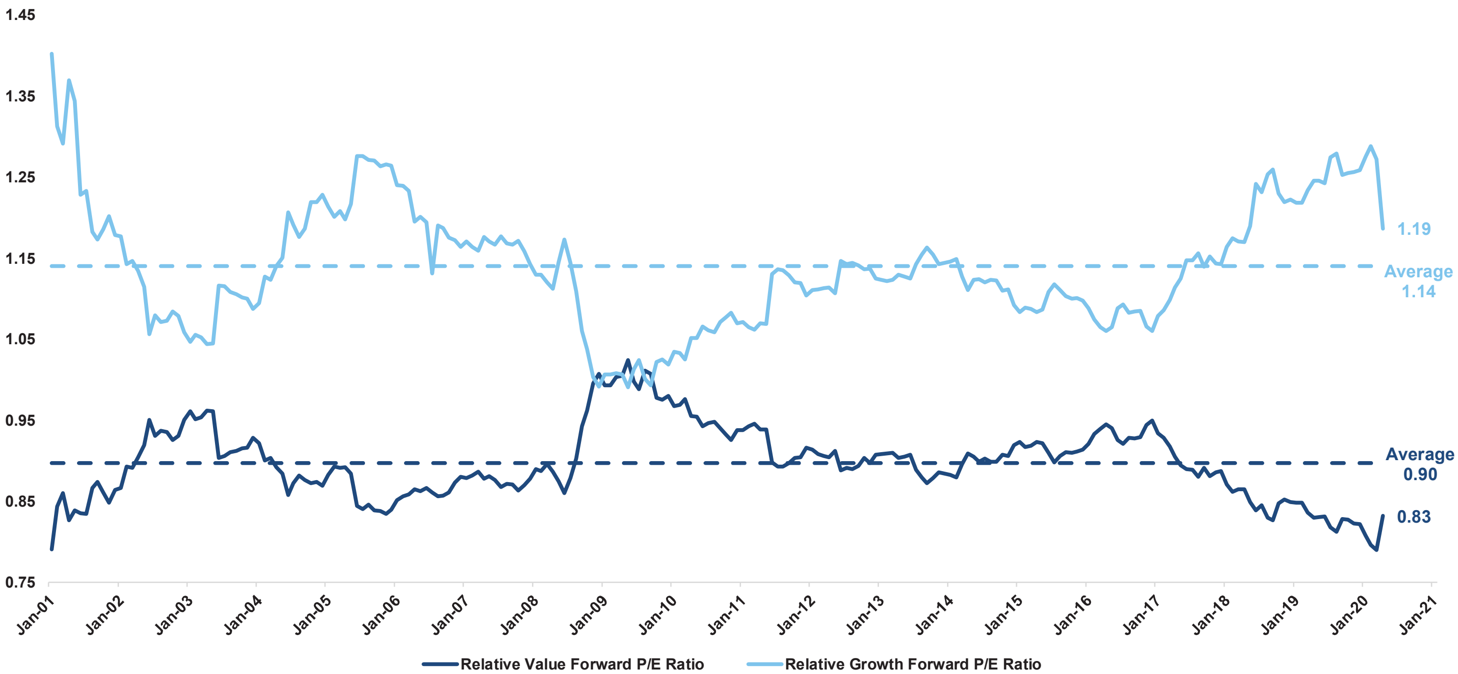
Past performance does not indicate future performance.

Given the underperformance of value, investors are justifiably questioning whether they should continue to allocate to value stocks. We cannot say with certainty that value will return to favor, but we see no fundamental reason to believe the value philosophy has become permanently impaired. In addition, while history does not necessarily repeat itself, it often serves as a good compass, and historically, value experienced sustained periods of both outperformance and underperformance when compared to growth. It is also worth noting that value stocks are cheaper relative to growth stocks than at almost any point in their history, which has lent itself to attractive buying opportunities in the past.

Exhibit 3 plots the relative value and relative growth forward P/E ratios of the Russell 3000 – calculated as the forward P/E ratio of the Russell 3000 Value Index divided by the forward P/E ratio of the Russell 3000 Index and the forward P/E ratio of the Russell 3000 Growth Index divided by the forward P/E ratio of the Russell 3000 Index, respectively. The relative value forward P/E ratio currently registers at 0.83x, or 1.45 standard deviations below its historical mean. This implies value looks cheap based on its historical valuation relative to core.

Exhibit 3

Relative Value and Relative Growth Forward P/E Ratios (January 2001 – April 2020)



Source: Morningstar and Bloomberg

Past performance does not indicate future performance.

In contrast, the relative growth forward P/E is 1.19x, or 0.61 standard deviations above its historical mean. Even after a significant sell-off in the first quarter of 2020, growth stocks look expensive based on their historical valuation relative to core.

As **Exhibit 3** shows, the spread in valuations between value and growth stocks is near record highs. In the past, this coincided with a positive value premium over the next 12 months. **Exhibit 4** displays the relative growth to value forward P/E ratio – defined as the relative growth forward P/E ratio divided by the relative value forward P/E ratio – in relation to its history and compares it with the value premium over the next 12 months. As expected, when value looks cheaper relative to growth, the forward-looking value premium tends to be larger. Alternatively, when value stocks are more expensive relative to growth stocks, the forward-looking value premium tends to be negative. The relative growth to value forward P/E ratio is currently 1.43, or 1.01 standard deviations above its historical mean, which indicates attractive relative valuations for value stocks.

Exhibit 4

Relative Growth to Value Forward P/E Ratio	Average Value Premium Over Next 12 Months	Number of Observations
0.5 Standard Deviations Above the Mean (Value is Cheap)	3.77%	55
1.0 Standard Deviations Above the Mean (Value is Cheaper)	4.85%	28
1.5 Standard Deviations Above the Mean (Value is Cheapest)	9.03%	15
0.5 Standard Deviations Below the Mean (Value is Expensive)	-2.37%	71
1.0 Standard Deviations Below the Mean (Value is More Expensive)	-3.10%	36
1.5 Standard Deviations Below the Mean (Value is Most Expensive)	-2.09%	15

Source: Morningstar and Bloomberg

Based on this data, an investor might strongly consider dynamically adjusting the value exposure within their portfolio. Although doing this seems tempting, investors should keep in mind that doing so poses substantial challenges and risks. For instance, at the end of September 2019, the relative growth to value forward P/E ratio registered at 1.73 standard deviations above its historical mean. Investors expecting to see value outperform growth were rewarded with 19.6 percentage points of underperformance relative to growth through April 2020. Alternatively, **Exhibit 5** highlights the dangers of not maintaining an allocation to value. **Exhibit 5** shows the average quarterly value premium for the best-performing quarters compared to the remaining quarters in the sample. When the value premium turns positive, it tends to do so abruptly, and missing just one or two of the best-performing quarters has the potential to drastically reduce performance.

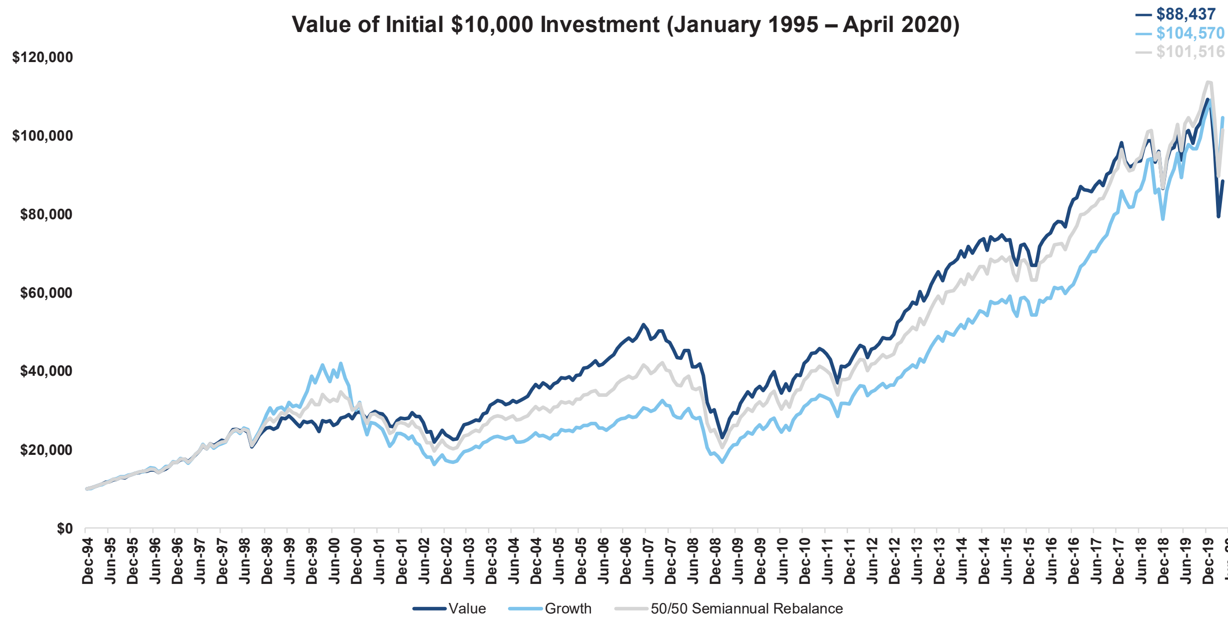
Exhibit 5

Average Quarterly Value Premium		
Number of Quarters Included in "Best"	Best Quarter(s)	Remaining Quarters
1	31.95%	-0.31%
2	25.47%	-0.50%
3	21.60%	-0.64%
4	19.40%	-0.78%
5	17.74%	-0.90%
6	16.05%	-0.99%
7	14.79%	-1.08%
8	13.83%	-1.17%
9	13.04%	-1.25%
10	12.33%	-1.33%

Source: Morningstar and Bloomberg

Maintaining a balanced portfolio – with exposures to both growth and value stocks – has often provided investors with the best risk-adjusted returns. **Exhibit 6** charts the growth of an initial $10,000 investment from January 1995 through April 2020 in the Russell 3000 Value Index, Russell 3000 Growth Index and a portfolio that invests half of its assets in each, rebalanced semi-annually. The performance of value in relation to growth ebbs and flows. For instance, in the scenario below, investors who allocated their entire portfolio in the Russell 3000 Growth Index had the highest returning portfolio from June 1998 through November 2000. However, investors who invested their entire portfolio in the Russell 3000 Value Index had the highest returning portfolio from February 2001 through April 2018. Over the long-term, investors in the balanced portfolio arrived at a similar destination but experienced the smoothest ride.

Exhibit 6



Source: Morningstar and Bloomberg

Past performance does not indicate future performance.

After a prolonged period of underperformance, many investors projected the next change in the market environment would result in value stocks' return to favor. 2020 brought this aforementioned change, as the stock market experienced its first bear market in more than a decade; however, value's underperformance only accelerated. As such, it is justifiable, and even prudent, to question whether value stocks continue to serve a role in portfolios. And yet, investors must remain keenly aware of the fact that this is not the first time value stocks have endured an extended period of underperformance relative to their growth counterparts. We encourage investors to remain disciplined by maintaining a balanced portfolio with exposure to both value and growth stocks across equity asset classes. Although it is impossible to predict when value's performance will shift, current relative valuations suggest that at some point in the future, after years of underperformance, the value premium will turn positive again, and value investors will earn the long-awaited benefits of their patience and discipline.

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