Perspectives

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Value vs. Growth: Where Do We Go from Here?

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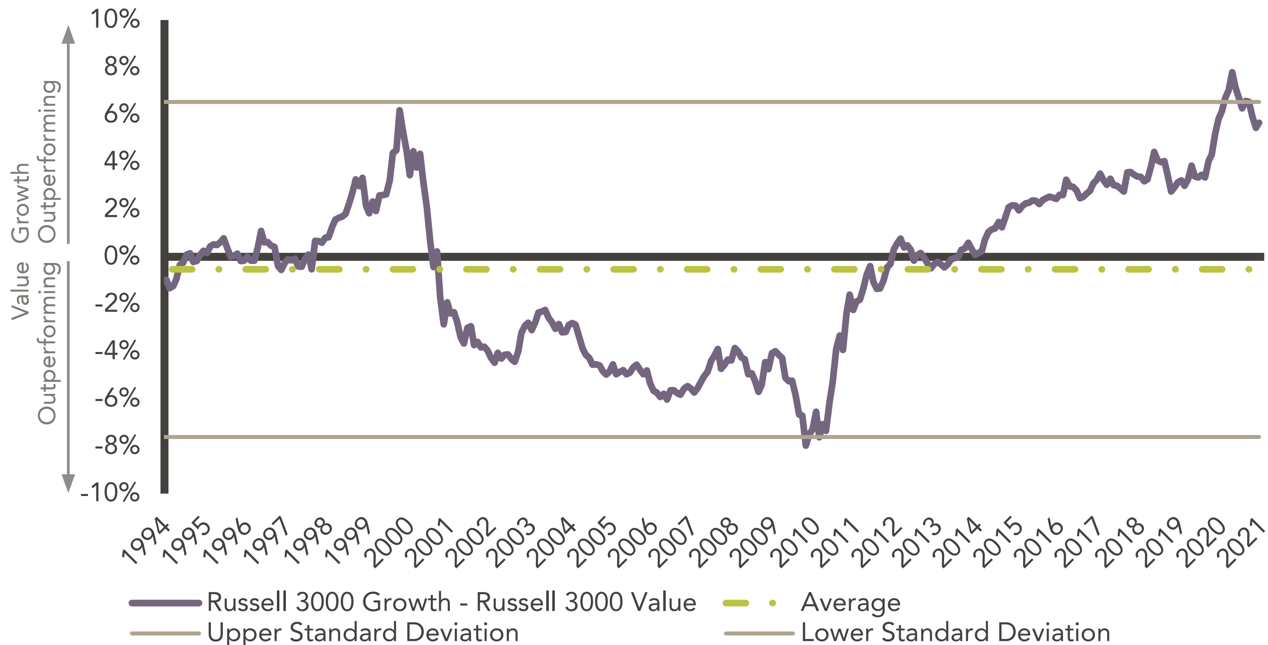
In a reversal of trends that had persisted for several years, value stocks have largely outperformed their growth-oriented peers since the fourth quarter of 2020. Though many factors have contributed to this change in investor sentiment, the resurgence of more cyclical areas of the market is likely being driven by the successful rollout of COVID-19 vaccines, which appears to have ended the pandemic in the United States and allowed the domestic economy to reopen to a significant extent. With equity markets likely pricing in a full economic reopening in the coming months, many investors are wondering if recent trends are sustainable, especially given the headwinds experienced by the value factor during the last decade. The aim of this newsletter is to assess the prospects of value stocks going forward in relation to those of their growth counterparts.

In the years following the Tech Bubble Crash, value segments of the U.S. equity market performed relatively well as investors largely corrected the speculative excesses of the late 1990s. Value leadership began to abate around 2011 in light of secular trends like digitization and cloud migration, along with historically low interest rates as a result of the Global Financial Crisis, which helped give rise to a climate that saw market participants pile into stocks of innovative companies at the expense of more cyclical equities. The onset of the COVID-19 pandemic exacerbated this phenomenon, as growth stocks became somewhat of a safe haven for investors given the economic shutdowns, transitions to remote work, and extremely accommodative monetary policy brought on by the virus outbreak. At the height of this growth-fueled period, annualized 10-year returns for the Russell 3000 Growth index less those of its value counterpart reached nearly 8.0%, a staggering figure when considering the length of the trailing period. Incidentally, this differential is higher than any recorded during the lead-up to the Tech Bubble Crash, and the long-term performance spread between these two indices remains at extremes relative to historical levels despite the recent cyclical rally.

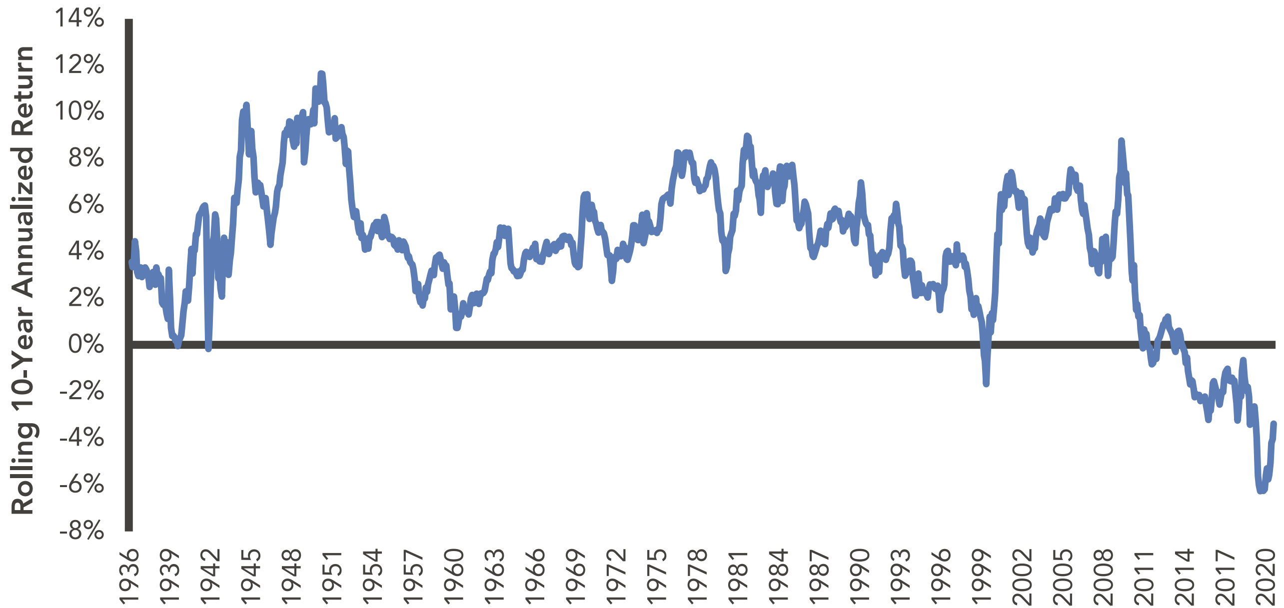
Exhibit 1: Rolling 10-year returns for the Russell 3000 Growth index less those of the Russell 3000 Value index



Source: eVestment as of May 31, 2021

Other relative performance metrics indicate the extent to which recent value struggles are both extreme and aberrational. In the early 1990s, academics Eugene Fama and Kenneth French identified several factors that helped explain certain equity market performance trends, among which was the "HML" factor (a value proxy). Analysis of historical data led Fama and French to conclude that "HML" was a risk premium, meaning that high book-to-price companies should outperform their more expensive peers on average. This follows from the fact that companies with lower price multiples are more likely to be in financial distress, and a higher return is required by equity stakeholders for taking on a higher level of risk. Indeed, going back to the 1930s, the average 10-year annualized return for the HML factor is over 4.1%, indicating that investors are often handsomely rewarded for holding value-oriented companies over extended time horizons. Prior to recent growth leadership, in fact, these returns turned negative only a few times, most notably during the Tech Bubble. In each instance of a negative 10-year annualized return for the HML factor prior to 2014, performance for cheaper companies never fell below -1.7%, and never took more than two quarters to correct itself and turn positive again. In 2014, however, 10-year annualized performance for the HML factor turned negative and has remained below zero through the present day. The magnitude of underperformance for the value factor in recent time is also striking, falling below -6.2% on a 10-year annualized basis in April of 2020. Trailing HML performance has since rebounded given the surge in cyclical stocks of late, but still sits at less than -3.0% as of May 31st, 2021. When determining the viability of the value premium going forward, it is important for investors to avoid recency and availability biases. Using the past as a guide, it is reasonable to expect continued strong performance from cyclical stocks as the pandemic abates given the behavior of the HML factor throughout history. It is also worth pointing out that the value premium surged after periods of extreme struggles like the Great Depression and the Tech Bubble Crash, meaning continued strong performance from cyclical companies in the coming months may be pronounced in nature.

Exhibit 2: Rolling 10-year returns for the HML factor



Source: Kenneth French Data Library as of May 31, 2021

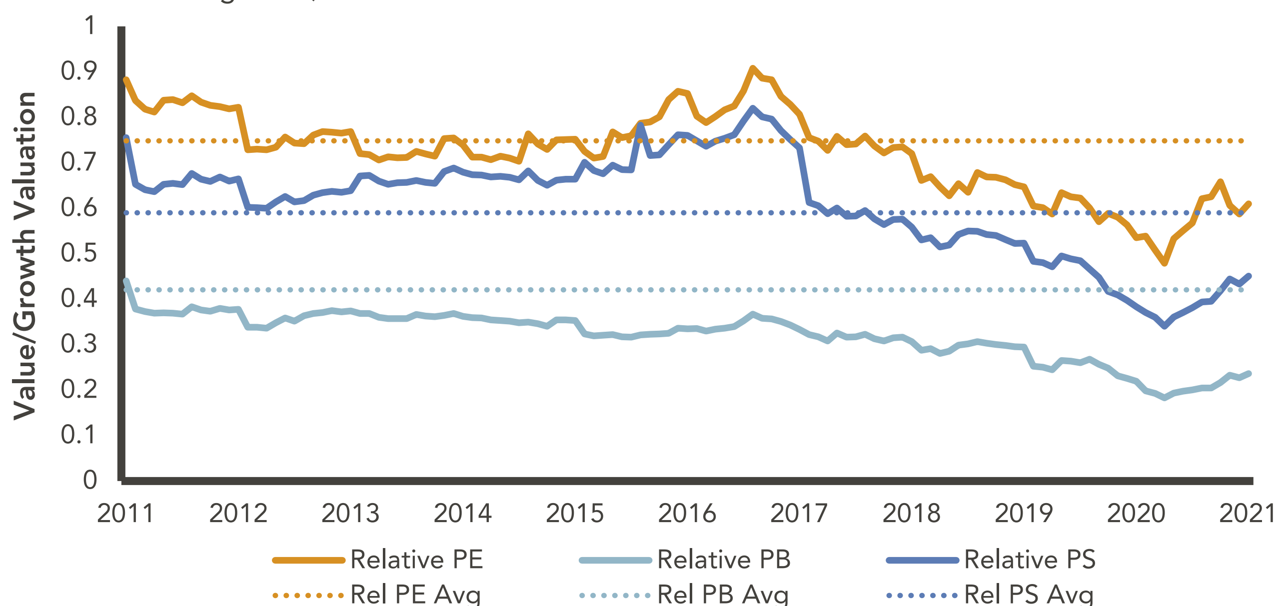
Present-day valuation metrics also indicate the relative attractiveness of value stocks. Though U.S. equity multiples are certainly elevated across the style spectrum, growth companies traded at roughly 44.4 times earnings at the end of May, which constituted a 77.5% premium over the 10-year average for that basket of stocks. Value stocks also trade higher than their 10-year average price-to-earnings figure, but that premium is roughly 33.0% less than that of their growth counterparts. Premiums above historical averages for value stocks based on other price multiples like price-to-book and price-to-sales are also significantly lower than those exhibited by growth companies at present.

Exhibit 3: Valuations for the Russell 3000 Value and Russell 3000 Growth indices

Source: Bloomberg as of May 31, 2021

Though value stocks typically trade at a discount to their more growth-oriented peers by definition, current disparities are extreme relative to recent history. As demonstrated in Exhibit 1, growth leadership has largely persisted since 2011, however current valuations of value stocks relative to the growth space are significantly lower than average, even when solely focusing on the last decade. At the end of May, the price-to-earnings ratio of the Russell 3000 Value index was roughly 0.61x lower than that of the Russell 3000 Growth index, far lower than the average ratio of 0.75x since 2011. Value's main proxy, price-to-book, also demonstrates the relative attractiveness of cyclical stocks. The price-to-book ratio of the Russell 3000 Value index was around 0.23x lower than that of the Russell 3000 Growth index as of May 31st, 2021, whereas the average price-to-book ratio for the two indices was roughly 0.42x since 2011. So, despite high absolute multiples for the value space as a whole, cyclical areas of the market are clearly more attractive than their growth-oriented peers based on several valuation metrics.

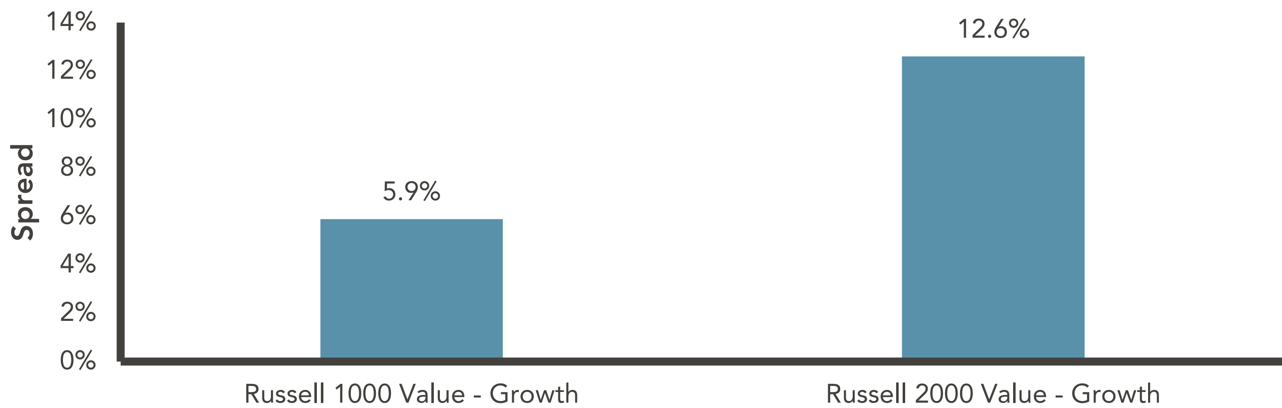
Exhibit 4: Relative valuations for the Russell 3000 Value and Russell 3000 Growth indices (value over growth)



Source: Bloomberg as of May 31, 2021

Relative performance and valuation metrics tell a compelling story in favor of value; however, these data points do not outline what specifically about the current climate may be conducive to continued strong performance of cyclicals. To investigate that question, it may behoove investors to examine value vs. growth dynamics during periods of strong GDP growth. Since 1980, roughly 10 time periods of varying length have seen year-over-year changes in U.S. real GDP of 3.0% or greater (measured on a quarterly basis). During those intervals, the Russell 1000 Value index returned an unannualized average of 50.0%, compared to 44.1% for the Russell 1000 Growth index. The cumulative performance differential during those periods of strong GDP growth was even starker in the small-cap space, as the Russell 2000 Value index averaged a return of 47.5% compared to 34.9% for the Russell 2000 Growth index. The year-over-year change in U.S. GDP was roughly 0.4% in the first quarter of 2021, but experts expect that figure to increase significantly in the coming quarters due to continued economic re-openings (not to mention the fact that year-over-year GDP change calculations for future quarters will begin with periods during which GDP was decimated by COVID-19, which will bias the calculations upward). Should these expectations come to fruition, value stocks would likely continue to perform strongly since they are typically more sensitive to changes in the economic climate than their more growth-oriented peers.

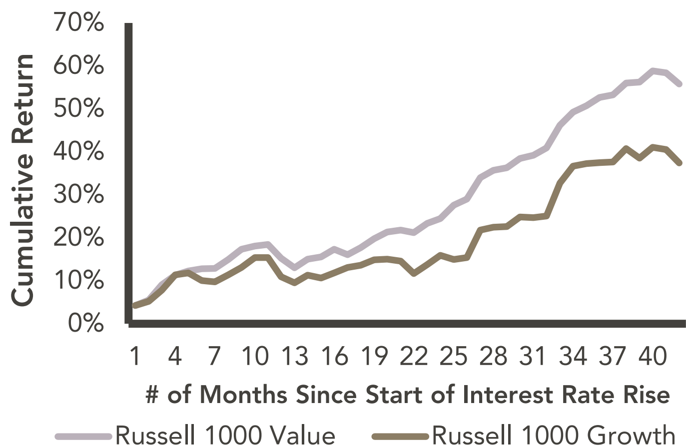
Exhibit 5: Performance spreads during periods of year-over-year real GDP growth of 3% or higher



Source: Bloomberg as of May 31, 2021

Finally, an uptick in the level of real interest rates could be a boon to value stocks while at the same time result in performance headwinds for growth companies. Historically low for over a decade and near zero during most of the COVID-19 pandemic, real rates will likely rise in the near future due to economic growth and concerns over a potential inflation spike. Value-oriented industries like banking often benefit from increasingly restrictive monetary policy due to more attractive net interest margins, as well as the fact that a strengthening economy generally leads to fewer loan defaults. Sectors like Industrials and Energy, both of which are primarily value-biased as well, also typically experience strong performance during periods of rising rates. Growth-oriented sectors like Information Technology, on the other hand, often are negatively impacted by rising rates, since the factors used by investors to discount the far-distant cash flows of more innovative companies have increased (making the present value of their future cash flows lower). History lends credence to these suppositions. Since 1980, there have been seven periods of sustained interest rate increases in the U.S., as measured by the effective federal funds rate. In the twelve months subsequent to the beginning of each of those periods of tightening, the Russell 1000 Value index returned an average of 15.3%, outpacing the Russell 1000 Growth index, which returned an average of 10.9%. The performance spread only increases when the observation period is extended. Two years subsequent to the beginning of each period of rising interest rates, the Russell 1000 Value index outperformed the Russell 1000 Growth index on average by 9.6% on a cumulative basis. Average cumulative outperformance on a three-year basis for the large-cap value index was 15.1%. Since the effective federal funds rate is still close to zero, history indicates that the coming months could see sustained investor interest in value stocks as the Federal Reserve works to implement restrictive policies in light of strong economic growth.

Exhibit 6: Average index performance during or after periods of rising rates



Source: Bloomberg as of May 31, 2021

Though style performance trends are notoriously difficult to predict, the current climate appears to be conducive to the continued strong performance of value-oriented equities due to attractive relative valuations and the prospects of sustained economic growth. Recency bias may lead some investors to believe that value leadership during the last few months is transient, but factor performance over several decades may indicate that cyclical stocks have additional room to run in order to return to levels commensurate with historical averages. Of course, secular trends that have served as tailwinds for growth equities in recent years are likely not going away, and the likelihood of a Tech Bubble-esque reversal for innovative companies is unlikely. It is also important to remember that growth and value are not polar opposites, meaning positive performance from value segments of the U.S. equity market companies does not imply negative returns of the same magnitude for growth stocks. Indeed, both styles could benefit from a "return to normal." In light of these dynamics, allocators should remain diversified across the style spectrum within U.S. equities in order to prudently participate in strong performance of cyclical stocks that could be exhibited in the future.

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