



Conditions Ripe for Value

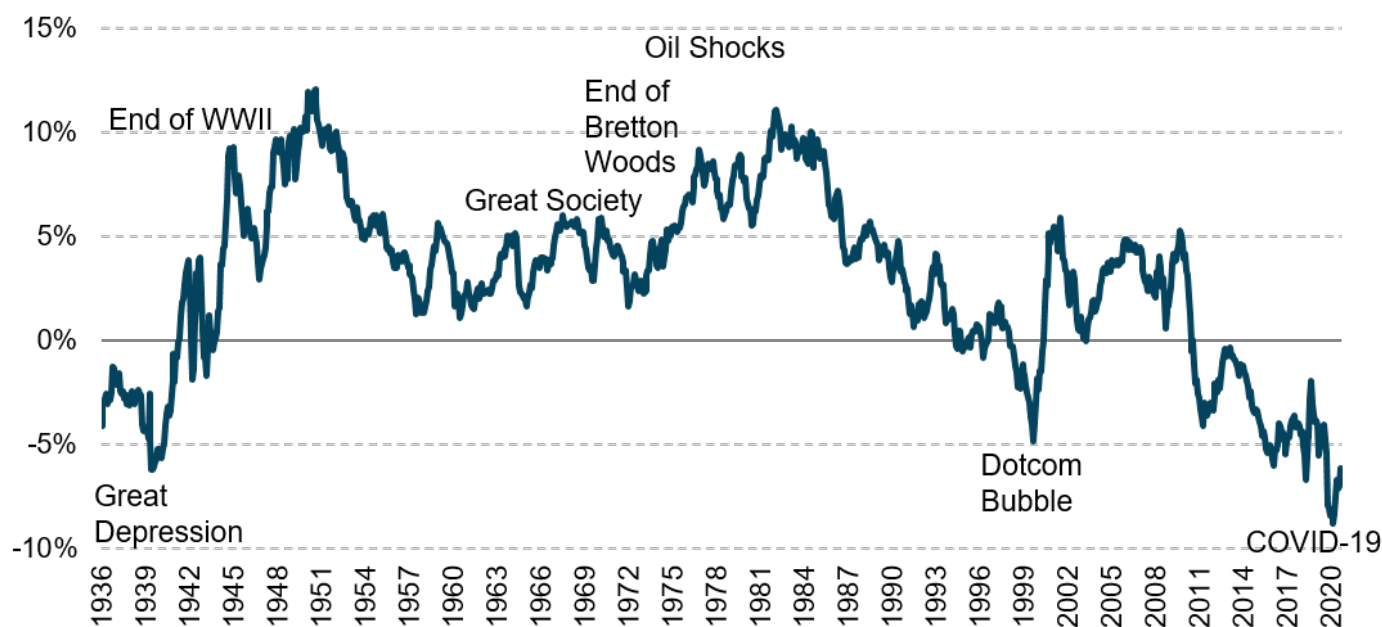
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After the longest, deepest period of value underperformance since the Great Depression, history suggests we are overdue for an extended period during which value outperforms. There is always an “it’s different this time” story as to why the resurgence will or will not happen, but history is on the side of value investors after more than a decade of severe underperformance (see [Chart 1](#)).

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Value vs. Growth Rolling 10-Year Excess Return

%, As of 2/1/2021



Source: Kenneth French Data Library

By some measures, value has underperformed since 2005, and while there has been a rally in recent months, the relative multiples of value stocks are still near all-time lows. While no valuation metric is perfect, the ratio between value stocks and growth stocks has spiked to levels that cannot be justified by differences in accounting approaches (see [Chart 2](#)).



Source: FactSet

Powerful Momentum Backing Value

The outlook for value is positive both from a valuation starting point and a likely economic outlook. Higher interest rates are expected to help sectors with large exposure to value, like financials, and hurt the high-flying momentum stocks where multiples have gone to extremes. There is some evidence that “value” is becoming the “momentum” trade as well, which creates a powerful combination.

Additionally, an economic boom is a scenario where the market may not fully anticipate the prospects for value outperformance, including the potential benefits for more cyclical stocks as both revenues and margins could come in above current expectations with positive operating leverage. Add the possibility of inflation into the mix, and you have a potential ideal situation for value relative to growth, albeit one that may challenge multiples for the market overall. In the case of inflation, however, value stocks would be a much better place to be than bonds, for example.

Inflation Risks Return

Inflation alarms are sounding all over. The question is will it be a temporary surge or a longer-lasting risk? Restating that question, will it be a cyclical move or a secular one? Those who invested through the 1970s are skeptical that inflation can be reined in as easily as most think; those who have never experienced it point to secular forces, like productivity and the unproductive use of capital—meaning capital will be reinvested at increasingly lower returns, reducing growth and inflation—as reasons inflation will naturally fall back. Regardless, this is a “hold your breath” moment as supply chain bottlenecks, raw material and commodity costs, labor expenses, and the prospect of higher taxes to pass through to consumers all combine to set the market on edge and potentially put pressure on prices.

Bank stocks, in particular, do well historically when short rates are stable and longer rates are rising, and

higher-yielding stocks in general do well in periods of inflation. However, it really is easier to point out the problems with growth stocks at current levels: inflation cuts into the present value of future cash flows, and many of those companies rely on a “future” cash flow story.

Other Growth Risks May Be Rising

Concentration risk is tremendous, both in the growth indexes and individual funds, as some funds—most notable the heretofore high-flying ARK ETFs—[have removed concentration caps](#) and are continuing to build positions in their least-liquid, most highly valued exposures. IPO issuance has soared, both through outright new listings and SPACs (special purpose acquisition companies) with increasingly questionable financials. Signs of fraud in the market appear to be at levels unseen since the tech bubble era, evidenced by recent scandals at Wirecard, Greensill, Luckin, Lordstown Motors, and now possibly the family office Archegos. Meanwhile, the SEC and other regulators seem to be asleep. One common factor is that none of these companies were considered “value” stocks. These examples serve as reminders that one of the behavioral defenses against fraud and overpriced stocks is the question: “what happens to the price if the story I am being told does not happen?” A margin of safety is critical but often does not exist in growth or glamour investing.

Conditions Set for Value Outperformance

Putting the two together—valuations and the environment—the conditions look very positive, in our view, for a sustained period of value outperformance. The past few months could be only the beginning, giving investors time to rotate into the space.

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