RBC Global Asset Management

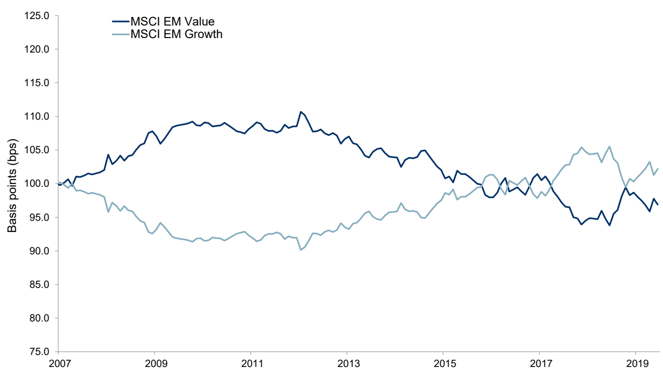
Out of style: Why Value is due a rebound

The RBC Emerging Markets Equity team

Value stocks have been out of favour globally since 2007 in what seems like the longest period of underperformance in recent history. The Value premium has been widely researched and explained using data series dating back almost 100 years. Despite this, many commentators have argued that this time it is different and for structural reasons the historic dominance of the Value style will not resume any time soon. In the meantime Growth stocks have performed extremely well and this trend is expected to continue as we enter a period of potentially slower economic growth.

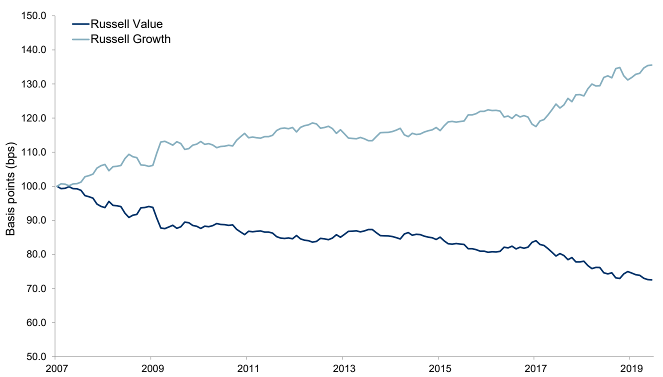
In this document we will analyse the similarities between the Value style's underperformance in both developed and emerging markets (EM), review in detail the reasons for such underperformance, and outline our expectations in the short and long term for a rebound in Value at the expense of Growth.

Exhibit 1: Relative performance of MSCI EM style indexes



Source: MSCI, Bloomberg, RBC Global Asset Management, July 2019.

Exhibit 2: Relative performance of Russell 3000 style indexes



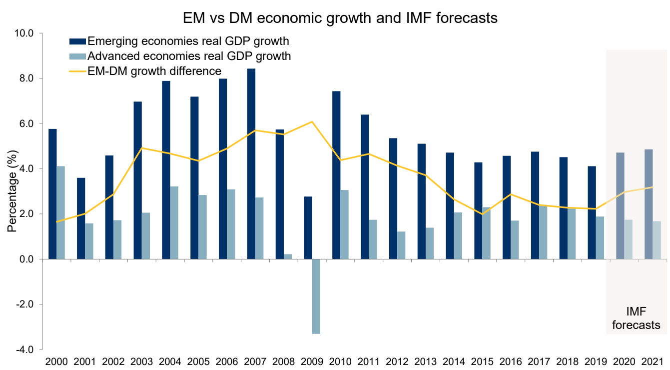
Source: MSCI, Bloomberg, RBC Global Asset Management, July 2019.

Value performance

The track record for equity returns in EM is much shorter than for the U.S. but style returns have been very similar over the past 20 years. After strong performance for Value in both markets in the noughties, a dramatic shift occurred around the time of the Global Financial Crisis (GFC).

Exhibits 1 and 2 highlight the style returns between Value and Growth in the U.S. and EM since 2007. In both cases Value has underperformed Growth over the period although Value began its underperformance much earlier in the U.S. compared to EM: in 2007 compared to 2012. The main explanation for this is probably that EM economies were still growing very strongly immediately after the GFC compared to developed market (DM) economies, mainly thanks to a huge stimulus from China. For a short period of time it appeared that EM economies had decoupled from DM economies and in 2009 we actually saw an acceleration of the growth differential between EM and DM. This peaked in 2009 with only a gradual decrease in the acceleration of the differential from 2012. (See exhibit 3.)

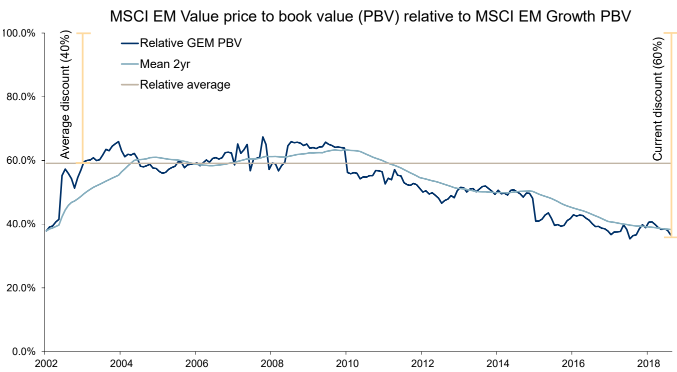
Exhibit 3: Economic growth differential



Source: IMF, April 2019.

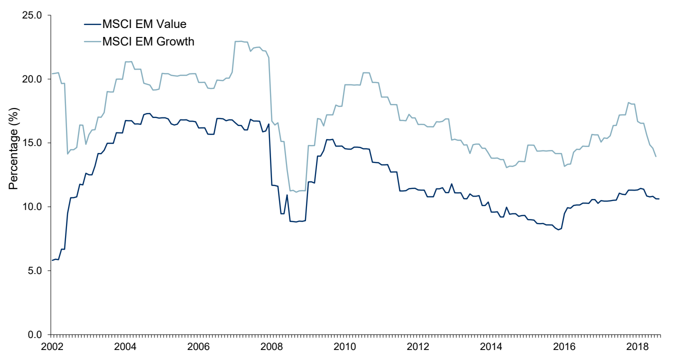
The consequence of this extended period of poor performance for Value is the large discount at which Value stocks trade compared to their Growth counterparts. The average discount over the past 17 years has been 40% and is now approximately 60% - the highest ever (see exhibit 4). The widening and extreme level of the discount does not seem justified by underlying fundamentals as exhibit 5 below highlights: the differential of returns on equity (ROEs) between Growth and Value stocks has actually narrowed recently. In fact Value stocks have seen a faster increase in ROE compared to Growth stocks and the differential has narrowed to around 26%, similar to the long-term average and much lower than the bottom in 2016 at 37%.

Exhibit 4: Relative valuation



Source: MSCI, RBC Global Asset Management, June 2019.

Exhibit 5: ROE differential



Source: MSCI, RBC Global Asset Management, June 2019.

Yet, apart from a small - and very short - rebound in Value stocks globally at the end of 2016, and for EM at the end of 2018, the underperformance of the Value style has been constant despite improving fundamentals. Why has this been the case?

Explanations for the underperformance of Value

The common explanation for Value's underperformance is very similar to that of 1997 to 1999 during the technology bubble: this time it is different - mean reversion is unlikely to happen and the dominance of Growth is here to stay as we are in a new era. We have identified below the key factors that have contributed to the poor performance of Value stocks.

The technological revolution[1]. The world is going through a fifth technological revolution with the rise of the internet disrupting many industries.

The leaders are either new entrants with no legacy business, such as Tencent or Alibaba, or existing companies who have adapted and embraced new technologies. The profits for these companies are very high whereas companies who have been slow to embrace change have been left behind with little prospect of improving their situation in the short term. As a result, the relative returns (high or low) of these companies have remained constant with Growth stocks leading the way for a long period of time. This phenomenon has not only affected IT stocks. For example, internet disruption has also hurt the autos sector. A rise in car sharing (aided by car-pooling apps) and improved taxi apps such as Uber, have reduced the need to own a car perhaps contributing to the weakness in car sales. Offline consumer sectors are competing with online stores which offer unlimited shelf space and immediate price comparison, which can drive down prices and enable brands to build – and fade – much more quickly. The financial sector has also been affected with the rise of fintech leading to a contraction in fees for many traditional players. A study by J.P. Morgan showed that Asian stocks in the highest quintile ROEs have, on average, been there for 45 months; the longest time since records began in 2002 and more than double the 20-month average for the full period.2

The rise of intangibles. This is adding to complexity in portfolio management as it can make it difficult to value a stock. Brands are built quickly and market values are inflated by the value of that brand. How do we value such a stock? What is a cheap stock? Is next year's price to earnings relevant to a company still returning negative profits but with a globally well-known name? Is book value a good way of measuring the value of a stock even though it doesn't include intangibles? The last time we had these discussions was in 1999.

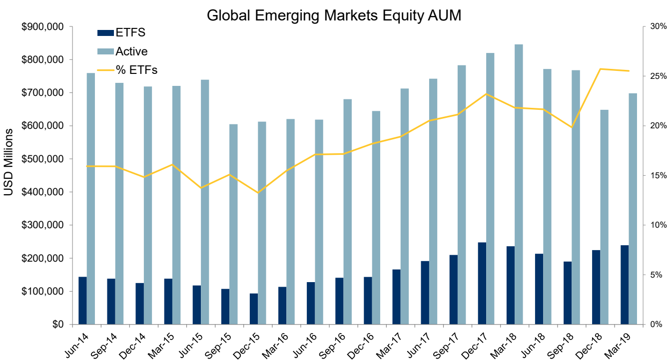
Interest rates are very low globally. This has been the case for most of the past 10 years. Low interest rates usually favour Growth stocks as discount rates drop and future growth looks more attractively valued. Low rates also pushed bond investors into Low Volatility and Quality stocks as investors sought out returns from equities without taking excessive risks; this pushed valuations for those names.

Asset management industry changes. Dramatic changes in the asset management industry may also have affected the performance of Value stocks. Increased demand for cheaper passive products has caused a huge rise in passive investments in recent years. It is estimated that 50% of assets under management for U.S. equities are now passive (McKinsey, 2018). In EM ETFs now represent 25% of global EM equity assets compared to 16% in 2014 (exhibit 6). ETFs tend to be trend-following strategies, so as money is added the outperformance of Growth and Quality names is reinforced as is the underperformance of Value. On top of this a semi-active variation of passive products, Smart Beta, has effectively replaced the large traditional Value-biased quant funds. According to Morningstar, the peak in the number of launches of traditional passive funds occurred in 2015. Smart Beta funds tend to rotate between styles using models which are often based on low volatility, and they have been largely underweight Value stocks in recent years and have favoured Quality and Growth. Some of the funds have even excluded Value as a factor as it is believed to be ineffective now.

The rise of private equity (PE). In 2017 and 2018 PE funds raised close to USD400bn each year compared to USD75bn inflows for EM equity funds and outflows from U.S. equity funds. More money in PE may potentially result in a greater focus on Quality and low volatility stocks within equity portfolios as the risk has largely been used in the PE portfolios; this may come at the expense of Value stocks.

The rise of ESG. Currently it is difficult to measure the number of portfolios managed with an ESG focus but anecdotally we have seen a large increase in demand for products including environment, social and governance criteria in their investment process. By definition those portfolios will have a large emphasis on high quality companies and may tend to avoid Value names which are traditionally of lower quality.

Exhibit 6: The rise of multi-factor passive strategies



Source: eVestment, RBC Global Asset Management, June 2019.

A difficult environment. Despite uninterrupted expansion, the economic environment has been difficult throughout the past 10 years. It is true that we haven't had a downturn in 10 years: the U.S. economic expansion has been the longest ever and in July 2019 broke the previous 120-month record of 1991-2001. However cumulative GDP growth during the period was only 25%, well below previous expansions. The last 10 years have not felt like a period of economic growth. Interest rates have remained fairly low, political events, such as Brexit, and weak economic conditions throughout Europe have worried investors. More recently the trade dispute between China and the U.S. has caused heightened concern about the end of globalisation and its benefits. Typically, during periods of economic expansion Value stocks do well as growth opportunities are abundant so there is no need to overpay for them. Also riskier companies, such as those with mature business models and less-robust balance sheets, look more attractive as fears of punishing economic conditions diminish. The past 10 years, however, have been challenging and investors have focused on Quality and Growth names. They ignored Value stocks. More recently (the last three years!) we have been in a late-cycle environment and traditionally Growth outperforms during this part of the cycle.

The consequence of this difficult environment is that we have seen reduced flows into the asset class, adding to the underperformance of Value. We have found that during periods of strong inflows where there is a pick-up in risk appetite, investors tend to favour laggards and riskier names with higher beta. In this type of environment Value stocks should be well placed to outperform Growth and Quality stocks. However, although emerging markets have returned nearly 40% since 2011, flows into the asset class have been limited. While assets under management (AUM) have remained broadly stable during the period, the inflows since 2016 have not made up for the very large outflows between 2012 and 2015. The majority of the inflows were concentrated in 2017 which was a record year for EM returns. Despite the strong inflows and performance, 2017 was not a good year for Value as could have been expected. In fact, 2017 was by far the best year for Growth performance since EM style indexes began. The discrepancy in EM style performance in 2017 can be attributed to the Information Technology (I.T.) sector and its relative under- and over- representation in the EM Value and Growth indices respectively. During 2017 the I.T. sector became one of the largest in EM, outpacing Financials for the first time. By being underweight I.T. relative to the broader index and the Growth index in particular, EM Value lost out on a significant bulk of the 2017 gains. Fast forward to 2019, it has already been one of the worst years for Value with Value stocks lagging Growth stocks by almost 6% in only 7 months. After a very strong January, during which Value outperformed both the market and Growth stocks, there have been constant outflows from the asset class and record inflows into EM bonds as investors worry that we may finally see the end of the cycle.

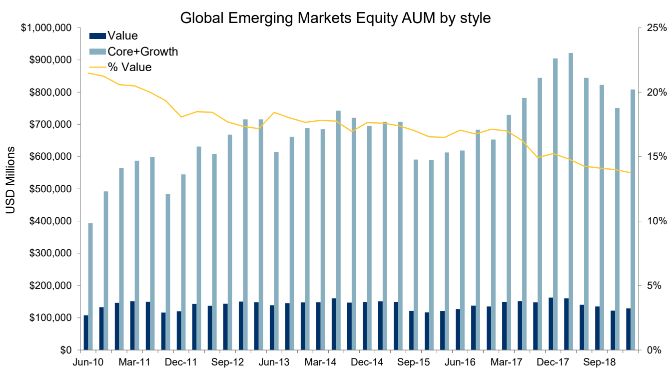
Why a rebound is possible in the short term

Value, as a style, is the most out of favour it has been since at least 2010. In July 2019 a Bank of America survey found that only 2% of fund managers expect Value to outperform Growth in the coming 12 months, the lowest level since 2010, and down from 40% only a few months ago. This is because a slowdown in global economic growth is anticipated and, historically, in such an environment Growth stocks typically outperform Value stocks.

Soft landing. Considering the current positioning and the very strong recent performance of Growth stocks, in the event of a soft landing due to the co-ordinated and proactive actions of global central banks rather than a recession, we could see a rapid reversal of the Growth trade and therefore Value stocks could rebound very quickly. This will be true if the economy's reacceleration is strong or if if the U.S. dollar starts to weaken compared to EM currencies.

Short squeeze. It is also very possible that in the next two years we could see investors returning to Value stocks if there is a short squeeze. The timing of this will probably be when the last active Value investors have given up. Exhibit 7 shows that only 14% of EM equity assets are managed with a Value bias (and we can argue that after years of underperformance many have adopted a relative rather than a deep Value approach). Anecdotally, we hear of an acceleration of outflows as strategies with a Value or Dividend focus are shut down and assets reallocated to Growth or Thematic products. We also hear that fund selectors are struggling to find "good" and large enough Value strategies in which to invest. When the trend starts to reverse we can expect to see a large rotation as the negative impact of passive and Smart Beta strategies in previous years will this time accelerate the comeback of Value.

Exhibit 7: Value strategies are out of favour



Source: eVestment, RBC Global Asset Management, June 2019.

Longer term Value performance

Mean reversion. In the economy and capital markets, mean reversion is generally a powerful moderating force. The length and intensity of the current period does not contradict this view. The work by our colleagues at O'Shaughnessy Asset Management ("Value is Dead, Long Live Value", July 2019) has shown that over the past 100 years there have been periods when Value has underperformed for a very long time (for instance between 1926 and 1941) as disruptions occurred, but Value outperformance has always resumed. It is likely that the fifth technological revolution will enter its maturity phase when technology is widespread and barriers to entry have fallen due to lower costs and easy adoptions.

It used to take decades to build a brand or to build a manufacturing empire but now, with the internet, a new leader can sometimes emerge in only a few months as often an internet connection and a few software engineers are all that is needed to monetize a good idea. Does this mean that an online brand can also disappear as quickly as it emerged? The intangibles that are valued so highly can also become worthless overnight if a new entrant disrupts with a new product. Incumbents benefited from the first mover advantage but plenty of cheap money is currently invested in start-ups that are attempting to be the next Facebook or Uber.

Regulation. It can be argued that some players are already too big to be challenged. Regulators are increasingly alarmed by the 'winner takes all' consequence of new technologies and the potentially negative impact on consumers (without even mentioning the potential harm to society from social media and artificial intelligence). In Europe and the U.S. calls for a break-up of the leading internet-based technology firms are gaining more traction. It is interesting to compare this with the lack of similar campaigns for dominant hardware companies such as Apple or Microsoft. If we were to see anti-monopolistic actions it is likely that the attractiveness of traditional industries would increase.

Low interest rates. These are clearly preventing better performance from Value stocks, and for Value to perform well for longer we need to see the end of quantitative easing. Capital (and labour) intensive firms are out of favour because of low growth, notably due to a lack of investment from the private sector. No premium is being applied to those with a large tangible asset base, suggesting the market assumes this can be quickly recreated or rebuilt. However, this is not necessarily the reality; the price distortions have been created by low interest rates for too long.

Reset. For Value to do better over the long-term, we probably need to see some sort of paradigm shift in markets. Value has frequently performed well after a reset. This could be caused by a recession or a shift in the dominant technology sector.

Concluding remarks

While the past decade or so has been a challenging time for Value stocks globally, we see several catalysts that could drive a re-rating in the near term. In particular, the extreme valuation discount and underweight investor positioning in Value stocks could catch Growth-heavy investors off-guard in the event of a correction. From current absolute and relative valuation levels, the rewards for investors in Value stocks could be substantial.

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Laurence is a portfolio manager and deputy head of the Emerging Markets Equity team at RBC GAM. Prior to joining the firm in 2013, Laurence headed the emerging markets team of a leading UK asset manager. In this role, Laurence was responsible for managing Asian and global emerging market income funds; developing quantitative stock selection and environmental analysis models. Laurence began her investment career as a quantitative analyst at a major financial services company, where she supported European and global equity portfolio management by developing quantitative models to assist in the portfolio construction and security selection process.

Source: [1] A technological revolution is a period in which one or more technologies is replaced by another technology in a short period of time. The fifth technological era is marked by the convergence of technology and humans. [2]JP Morgan Asia Equity Strategy, 28 June 2019.

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