Investment Team Corner

In conversation with Brent Fredberg, member of Brandes' Global Large-Cap Investment Committee and an analyst in the Technology Group

In the past year, the financial landscape has been marked by rising interest rates and growing buzz around technological innovations, particularly in artificial intelligence (AI). To delve into what these developments could mean for value investors, we spoke with Brent Fredberg, a technology analyst and member of Brandes' Global Large-Cap Investment Committee. Brent sheds light on navigating today's interest rate environment, parallels to the 1990s tech bubble that he is witnessing, and the sustainability of value's recent performance. Brent has 29 years of experience and has been with Brandes for 24 years.

Interest rates have risen and are expected to remain at an elevated level for an extended period. How does this interest rate environment impact your investment strategies?

There has been a lot of rhetoric surrounding "higher-for-longer" interest rates following the Federal Reserve's historic rate increase, where we have observed the 10-year Treasury yield rising from about 1% a few years ago to roughly 4-4.5% today. And while inflation is coming down from recent peak levels, there is the potential for structurally higher inflation than we experienced over the past decade due to the reshoring of manufacturing, the escalating costs of clean energy, and the substantial Treasury debt issuance required given the fiscal and monetary stimulus during Covid-19. These factors can create inflationary pressures that counterbalance the productivity gains typically achieved through technology and AI advancements.

Historically, the performance of global value stocks has positively correlated with high or rising interest rate environments. This correlation arises in part because the higher the interest rate and discount rate, the more challenging it can be for longer-duration growth stocks (those whose market value depends on more distant future cash flows), as these discount rates affect the present value of their future cash flows.

In the past, we have talked about this theme of "Goliath wins" as it regards the banks, with larger, scaled banks being advantaged in several ways versus smaller banks. In today's environment, we are also concentrating on "balance sheets win." This approach means we are prioritizing companies with what we consider robust financial health and strong balance sheets. In this interest rate environment, companies with heavy debt burdens tend to face increased pressure as they refinance their debt at higher rates. Therefore, we are being more selective, trying to avoid companies that appear "cheap" but have financial structures that could pose significant risks, particularly if an economic downturn occurs.

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Investing in the technology sector has been one of the most popular themes this year. This trend began with the success of the so-called "Magnificent Seven"—a group of U.S. tech stocks that have contributed notably to the S&P 500's returns over the past decade—and then expanded into widespread exuberance over AI. Given this background, do you think the tech sector is in a bubble?

While it may surprise some to hear this from a value perspective, I do not believe the tech sector is in a bubble per se, although I think it is fair to say tech valuations in general appear quite full. I was a tech analyst at Brandes during the height of the tech bubble in 1999, and today's tech sentiment and valuations do not appear quite as excessive as back then. With that said, there are some parallels with the late '90s. Firstly, similar to that period, tech valuations are at a significantly higher premium compared to the broad market than we are used to seeing. Secondly, we have experienced aggressive interest rate increases by the Fed. And finally, there is a dominant narrative exciting the market—in the '90s, it was about the internet changing the world, and today it is about cloud computing and AI.

Despite tech generally being expensive, the sector's valuation is bifurcated. We have been able to find a number of opportunities to invest in some of these secular themes, such as AI, in ways that are lower-profile, less popular, and appear to be better values from our perspective. For example, AI requires a very large amount of memory semiconductors (e.g., DRAM chips) to do its processing, so Brandes has invested in a number of leading DRAM manufacturers across the world. We also own a Taiwanese foundry producing AI chips, a European software company using AI to enhance customer decision-making, and an IT services company helping customers transition to the cloud and incorporate AI technologies. I would not paint all of tech with the same brush, even though, in general, the sector seems suboptimally priced for performance from this point.

After a long drought, U.S. value stocks outperformed growth stocks over the past three years. However, this year has seen a reversal, with growth outperforming once again. Does this mean that the value run is over?

As a firm, we do not think the value run is over. Historically, since the 1970s, shifts between growth and value regimes have lasted many years. On average, value regimes have lasted about six to eight years, and we are just three years into this current value period.[1] Nevertheless, it is not uncommon to have extended periods of growth outperformance during these multi-year value regimes.

For example, after the late '90s tech bubble, from 2000 to 2002, a stronger period for U.S. value stocks relative to growth, there were six periods during that time when the Russell 1000 Growth outperformed the Russell 1000 Value by over 10 percentage points, three of which exceeded 20 points. Despite this, the value index outperformed over the subsequent four years. From that perspective alone, we do not find the recent trend overly concerning.

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Also, there are also several potential catalysts for value that exist today, but one that we talked about earlier is this interest rate environment, and a return to what we consider a more legitimate cost of capital. Interest rates do not need to remain at these levels, but instead just a more normal interest rate environment, unlike the abnormally low and negative real rates of the past decade, helps remind the market that valuations matter.

Most importantly, the valuation gap between value and growth is very wide, near historic levels. If you look at a composite of various metrics (e.g., price to earnings, price to book, price to cash flow, and enterprise value to EBITDA), value is less expensive relative to growth than it has been in 50 years, with the exception of the Nifty-Fifty era (late '60s and early '70s) and the late '90s tech bubble. And not only does value appear to us to be quite attractively priced relative to growth, it also looks reasonably valued on an absolute basis. For these reasons, we do not think the value run is over. Instead, we think value provides an attractive opportunity in today's environment and could potentially help mitigate some risks that may exist in the rest of one's portfolio.

[1] Source: MSCI via FactSet. MSCI World Value Index vs. MSCI World Growth Index, 3/31/1975 to 9/30/2023. The inception date for the MSCI World Value Index and World Growth Index is December 8, 1997. Performance prior to this date is the result of back-testing performed by MSCI. There may be frequent material differences between back-tested performance and actual results.

Cash Flow: The amount of cash generated minus the amount of cash used by a company in a given period.

Price/Earnings: Price per share divided by earnings per share.

Price/Book: Price per share divided by book value per share.

Price/Cash Flow: Price per share divided by cash flow per share.

Enterprise Value/EBITDA: Market capitalization plus debt, minority interest, and preferred shares, minus total cash and cash equivalents, divided by earnings before interest, taxes, depreciation, and amortization.

Nifty Fifty: A popular name in the 1960s and 70s for a group of the largest U.S. companies.

The Russell 1000 Growth Index with gross dividends measures performance of the large cap growth segment of the U.S. equity universe. Securities are categorized as growth or value based on their relative book-to-price ratios, historical sales growth, and expected earnings growth.

The Russell 1000 Value Index with gross dividends measures performance of the large cap segment of the U.S. equity universe. Securities are categorized as growth or value based on their relative book-to-price ratios, historical sales growth, and expected earnings growth.

The S&P 500 Index with gross dividends measures equity performance of 500 of the top companies in leading industries of the U.S. economy.

The MSCI World Value Index captures large and mid cap securities across developed market countries exhibiting value style characteristics, defined using book value to price, 12-month forward earnings to price, and dividend yield.

The MSCI World Growth Index captures large and mid cap securities across developed market countries exhibiting growth style characteristics, defined using long-term forward earnings per share (EPS) growth rate, short-term forward EPS growth rate, current internal growth rate, long-term historical EPS growth trend, and long-term historical sales per share growth trend.