Is the Value Run Over? – When "All Else Equal" Is Rarely True

Before we dive into the topic of where we currently stand in the style leadership rotation, it might be helpful to start the discussion with where we stood two years ago. At that time, investors were understandably reluctant to allocate to value stocks given that value had underperformed growth in a meaningful way for a meaningful period (over a decade). Then came "Pfizer Monday" in November 2020, which became a catalyst for a value resurgence across most major markets. The outlook was positive, and in our **thought piece**, we highlighted some potential tailwinds for value-led environment, including:

1. **Economic recovery potential**
2. **Inflation**
3. **Valuation spreads compared to previous strong value cycles**

Entering 2022, we were optimistic that these factors would continue to reinforce the value-led period going forward. However, the world has changed significantly in the past few months. Geopolitical concerns, triggered by the Russia/Ukraine conflict, have dimmed investor hope of economic growth while deepening worries about inflation. There are so many moving parts and ever-changing news flow, it is easy to get lost in the myriad of topical questions. Although it would be impossible to predict the outcomes of current world events and their impact on investment portfolios, we believe there are a number of factors that remain supportive of sustained value leadership.

Economic Recovery and Rising Interest Rates

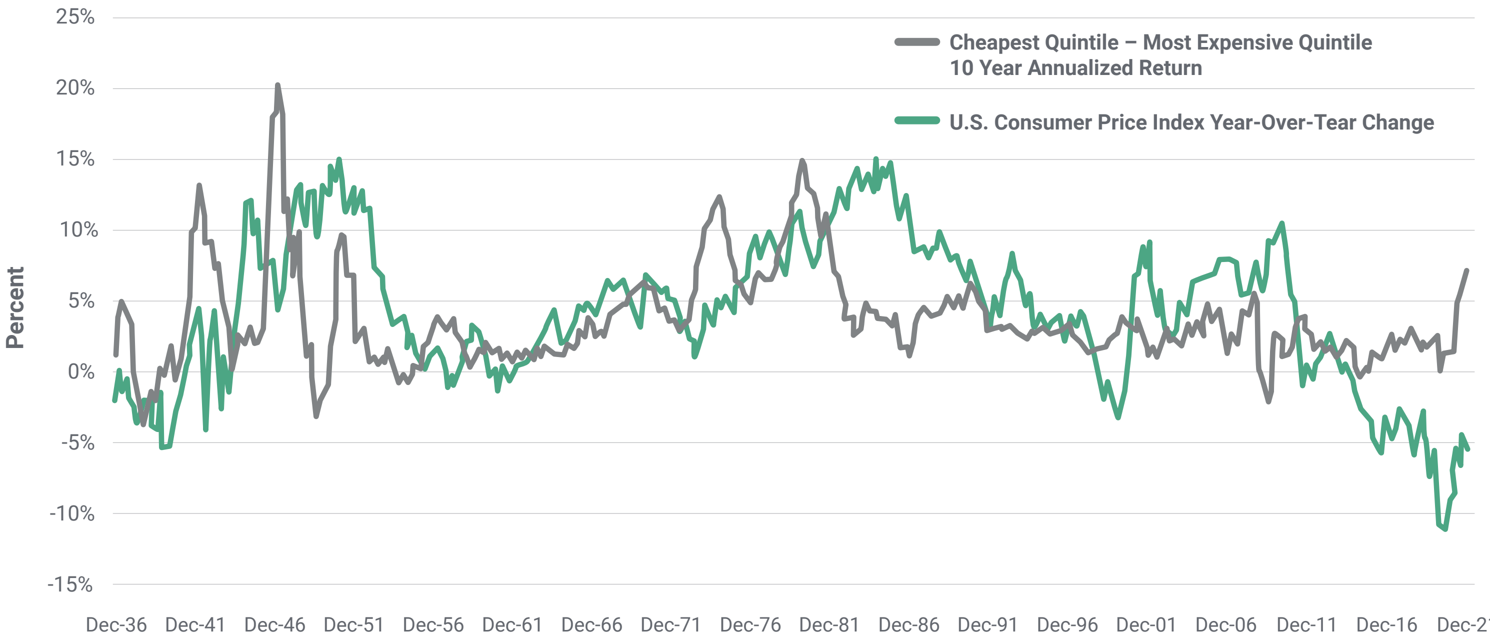
Historically, the "ideal" conditions for value tend to involve solid economic growth and increasing interest rates. The global markets had experienced the exact opposite after the Great Financial Crisis: the most tepid economic growth since World War II, as well as low and declining interest rates. In the past couple of years, we started to see those factors reverse, which contributed to several bouts of value outperformance relative to growth (i.e., late 2020, late 2021, early 2022). Optimism about an economic recovery in an eventual post-COVID world appeared to improve investor sentiment. Additionally, the potential negative impact of rising interest rates on the present values of long-duration assets may have compelled investors to favor value stocks over growth (growth stocks have tended to be long-duration assets as their cash flows are usually projected to occur in further future than value stocks).

Impact of Inflation

Inflation has also historically been good for value. As the following chart highlights, value outperformance and inflation have been positively correlated.

Inflation and U.S. Value Have Been Correlated for More than 85 Years

Inflation Increases as a Potential Catalyst



JUNE 30, 1936 TO DECEMBER 31, 2021 | Source: BLS, Ken French Data Library. Ken French universe includes all listed US stocks. Cheapest quintile represents the 20% of the universe with the highest book to market ratio. Most expensive quintile represents the 20% of the universe with the lowest book to market ratio. Past performance is not a guarantee of future results. Annualized 10-year return of cheapest quintile is subtracted from the annualized 10-year return of most expensive quintile. Values above zero indicate the cheapest quintile outperformed.

The reasons for the positive correlation are multifold:

Financials

- Largest component of many value indices
- May benefit from net interest margin expansions during periods of steepening yield curve
- Higher interest rates may also boost the returns of their short-term investments

Cyclical Stocks

- A big component of value stocks (including financials, industrials, energy, etc.) tends to be economically sensitive
- Rising inflation and interest rates have tended to occur during periods of economic strengthening, which had boded well for value stocks

Discount Rate

- The present value of a growth stock is largely driven by cash flows from a distant future (long duration)
- Rising inflation/interest rates drive up the discount rate used in company valuations, making long-duration growth stocks worth incrementally less compared to value stocks with more immediate expected cash flows (short duration)

Investor Sentiment

- During uncertain times (e.g., trade war, pandemic) investors are likely willing to pay a premium for the prospect visibility provided by growth stocks
- As the economy strengthens—and inflation rises—investors typically become more comfortable investing in economically sensitive value stocks

To put the outperformance potential into context, the following table highlights asset class returns during the 12 inflationary periods that have occurred since 1940. In these periods, value stocks have outperformed the general market (S&P 500) more often than their growth counterparts, and with greater magnitude of outperformance as well.

Asset Class Returns During 12 Inflationary Periods Since 1940

Large Cap and Value Stocks Have Performed the Best

Returns During Inflationary Periods	Value	Growth	Large	Small	S&P 500	LT Treasury Bonds	Gold
% Positive	83%	75%	75%	67%	67%	75%	58%
% Outperform S&P 500	92%	50%	83%	58%	n.a.	50%	58%
Average Return	9.2%	2.6%	5.9%	3.8%	2.0%	3.3%	3.9%

12 Inflationary Periods Based on CPI: 2/29/40–5/31/42, 6/30/44–3/31/47, 6/30/44–3/31/47, 7/31/50–7/31/53, 9/30/55–3/31/57, 9/30/60–2/29/64, 1/31/66–11/30/70, 1/31/73–2/28/75, 11/30/77–6/30/80, 6/30/83–5/31/84, 2/28/87–2/28/91, 11/30/03–9/30/06, 10/31/10–1/31/12.

Source: Bank of America "The Thundering Word" March 11, 2021, based on data from Bloomberg, Dartmouth University Data Library, FactSet, BoFA US Equity & Quant Strategy. Inflation based on core CPI since 1958 and CPI since 1937. Value and Growth based on Fama-French High Book/Price and Low Book/Price factors. L-T Treasury Bonds based on Ibbotson 15+ Maturity Government Bond Index. Small and Large Size based on Fama-French Small and Big factors.

Where We Are Now

The world's events in the past few months have had a binary effect: on one hand, it deflated hope of a sustained economic recovery—replacing it with concerns about a slowdown or even recession; on the other hand, it amplified worries about continued inflation. The term "stagflation" (a period marked by low economic growth and high inflation) resurfaced.

Amid this environment, our clients and prospects have asked: Wouldn't slower economic growth be "bad" for value? Is the value run over?

The short answer to the first question is: yes, low economic growth has tended to be a headwind for value—all else being equal. However, "all else" is hardly ever equal. In fact, two of the best periods for value's performance relative to growth were in the 1970s post-Nifty Fifty era (when the term stagflation was first widely used) and during the post-tech bubble market correction in the early 2000s.

Stagflation – Value's Performance in the 1970's

U.S. Value Performance Relative to U.S. Growth, Inflation, and Gross Domestic Product (GDP) Growth by Decade

Decade	Value Stock Performance	U.S. Inflation	Real U.S. GDP Growth
1930's	-5.5%	-2.0%	0.9%
1940's	11.9%	5.4%	5.9%
1950's	2.1%	2.2%	4.5%
1960's	3.1%	2.5%	4.4%
1970's	11.2%	7.4%	2.6%
1980's	8.2%	5.1%	2.8%
1990's	-3.2%	2.9%	2.6%
2000's	9.5%	2.5%	1.6%
2010's	-5.6%	1.8%	2.2%

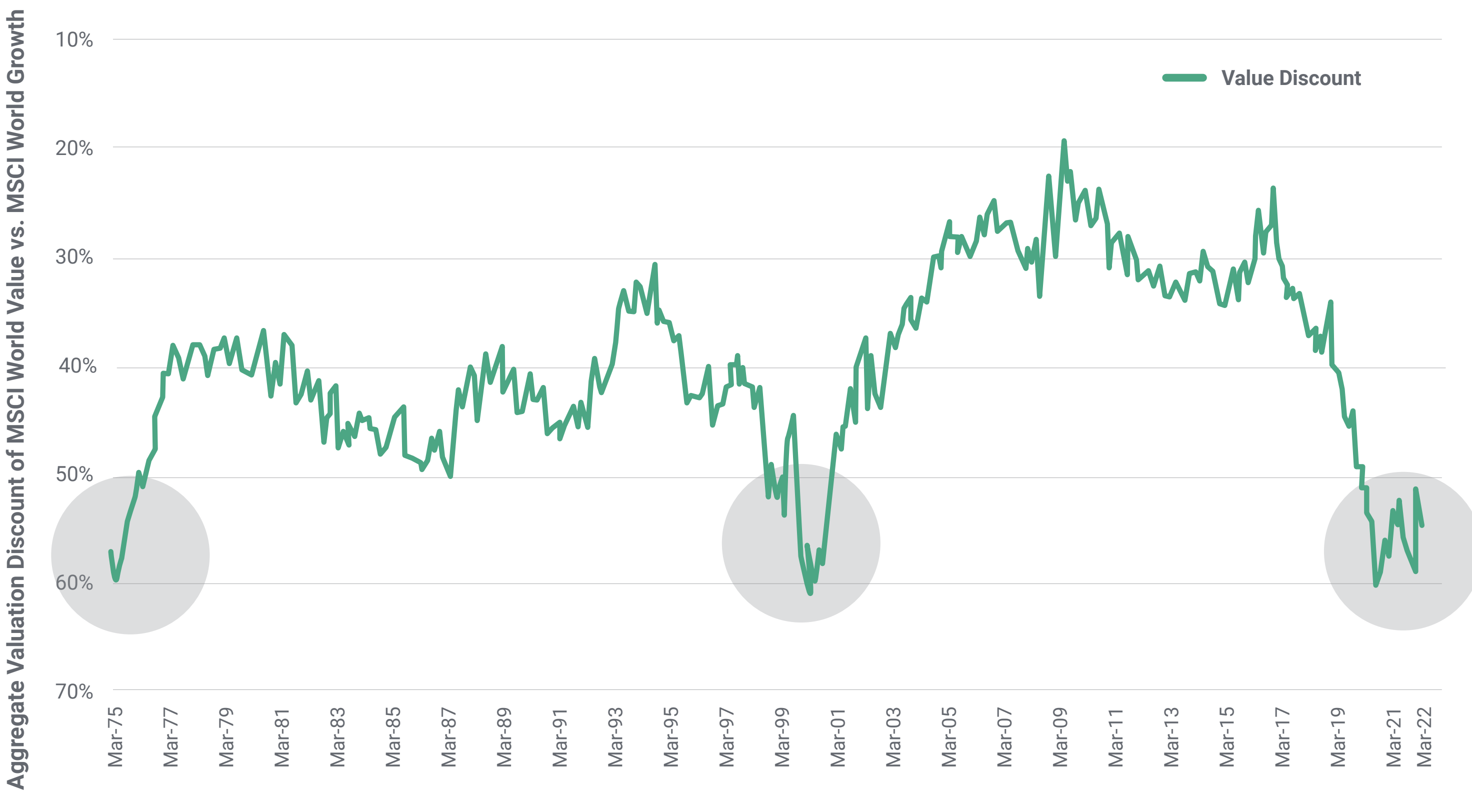
DECEMBER 31, 1929 TO DECEMBER 31, 2019 | Source: BLS, BEA, Ken French Data Library. Value Relative Performance is cheapest quintile of Ken French Data Library based on book to price relative to most expensive quintile. Includes all NYSE, AMEX and Nasdaq stocks. Inflation is measured by Consumer Price Index. Past performance is not a guarantee of future results.

These two periods shared common factors that culminated in a very favorable environment for value: the general market had been in a state of elevated valuations and the valuation spreads between value and growth were at historic levels

We observe the same attributes in today's environment. Even after value's overall outperformance relative to growth in the past 18 months, valuation spreads remain historically high. The general market also continues to exhibit what we consider elevated valuations.

Global Value Stocks' Relative Valuation

Valuation Relative to Growth Stocks



DECEMBER 31, 1974 TO MARCH 31, 2022 | Source: MSCI via FactSet. For each fundamental ratio (Price/Book, Price/Earnings, Price/Cash Flow, Forward Price/Earnings, Enterprise Value/Sales, Enterprise Value/Earnings Before Interest, Taxes, Depreciation, and Amortization), we calculate the average ratio of the MSCI World Value Index and divide it by the average ratio of the MSCI World Growth Index to determine the relative valuation. Aggregate valuation discount based upon the average of each individual metric's valuation discount of the value index relative to growth. Please note that all indices are unmanaged and are not available for direct investment.

Furthermore, despite concerns about slower economic growth, post-COVID recovery potential persists, as do other market characteristics that have tended to be favorable for value—namely rising inflation and interest rates. In our opinion, these factors outweigh the prospect of slower economic growth, and we are as bullish on value as we have been in over a decade.

Book-to-Market Ratio: Book value per share divided by price per share.

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

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

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

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

Forward Price/Earnings: Price per share divided by earnings per share expected over the next 12 months or fiscal year.

Enterprise Value: Market capitalization plus debt, minority interest and preferred shares, minus total cash and cash equivalents.

Enterprise Value/Sales: Enterprise value per share divided by annual sales per share.

Enterprise Value/EBITDA: Enterprise value divided by earnings before interest, taxes, depreciation and amortization.

The MSCI World Index with net dividends captures large and mid cap representation of developed markets.

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 with gross dividends 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.

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.