

The Staying Power of the Value Run

The last decade has been a challenging one for value investors. Prior to the fourth quarter of 2020, value stocks (MSCI World Value) had been experiencing their longest and most pronounced underperformance period on record relative to growth stocks (MSCI World Growth). Many wondered about the “death of value investing” and allocators were running for the exits.

However, “Pfizer Monday” (November 9, 2020, when Pfizer and BioNTech announced the successful outcome of their COVID-19 vaccine trial) triggered a shift. Since that date through May 31, 2021, MSCI World Value outperformed MSCI World Growth by 18%.¹ While the rotation was remarkable and naturally encouraging for disciplined value investors, many remained skeptical. We’ve seen this story before, such as in the fourth quarter of 2018 and the fourth quarter of 2016, when value stocks outperformed growth. Both times, the outperformance turned out to be false hope and did not last. As such, it was understandable that amid the most recent value rally, a question arises: *Is this time different?*

While we cannot forecast the future, several factors have led us to believe that the current pro-value cycle has more staying power than the previous “false hope” periods, including:

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

Economic Recovery Potential

Pfizer Monday catalyzed hope for a global economic recovery, ushering in a performance regime change analogous to previous economic recoveries. As the following table illustrates, U.S. value stocks have outperformed the general market in every single economic recovery since 1929.

Value Led Following the Last 14 Recessions

Relative Price Performance of the Fama-French Value Factor Stock Universe (High Book Value to Market Cap) vs. S&P 500 During/After U.S. Economic Resessions

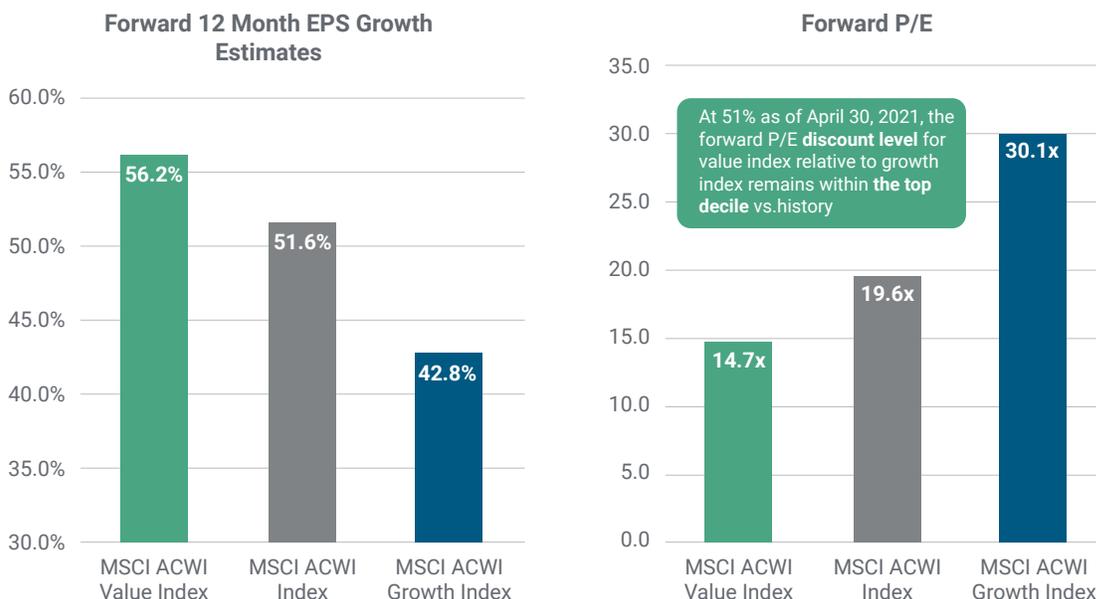
U.S. GDP Growth Peak to Trough	U.S. Value Stock Performance vs. S&P 500	Value Outperformed S&P 500
Aug '29 / Mar '33	78.3%	May '32 - Aug '32
May '37 / Jun '38	27.2%	May '40 - May '41
Feb '45 / Oct '45	11.1%	Aug '45 - Nov '45
Nov '48 / Oct '49	29.7%	Mar '50 - Jan '51
Jul '53 / May '54	21.5%	Dec '53 - Dec '54
Aug '57 / Apr '58	26.1%	Dec '57 - Dec '58
April '60 / Feb '61	9.8%	Jun '60 - May '61
Dec '69 / Nov '70	9.0%	Dec '69 - Aug '70
Nov '73 / Mar '75	14.7%	Nov '74 - Nov '75
Jan '80 / Jul '80	28.3%	Nov '80 - Nov '81
Jul '81 / Nov '82	16.8%	Jun '83 - Jun '84
Jul '90 / Mar '91	18.1%	Dec '91 - Jun '92
Mar '01 / Nov '01	10.3%	Oct '01 - Jun '02
Dec '07 / Jun '09	25.9%	Feb '09 - April '10

Source: Bank of America “US Equity Strategy In Pictures” June 8, 2020. U.S. gross domestic product peaks and troughs according to National Bureau of Economic Research. Value universe performance minus S&P 500 Index performance. Positive results indicate value outperformance but do not necessarily indicate positive absolute performance. Fama-French Value Factor stock universe includes NYSE, AMEX and NASDAQ listed firms. High Book Value to Market Cap is the top 30% of the universe based on book equity to market cap. Relative performance shown in middle column was achieved during respective period in right column. All performance periods begin/end on last day of month (e.g., May 31, 1932 to Aug 31, 1932, etc.). Past performance is not a guarantee of future results. One cannot invest directly in an index.

¹ Source: MSCI via FactSet 11/8/2020 to 5/31/2021.

Coming out of this recession, the 2021 global economic growth is expected to experience its strongest post-recession pace in 80 years.² Since value stocks tend to be economically sensitive, their earnings are forecasted to increase even more than their growth counterparts, while still trading at what we consider an attractive valuation level (see chart below). *This means that investors may feel less inclined to pay a premium to pursue earnings growth potential, adding further to value's potential, in our opinion.*

Consensus Earnings and Valuations More Attractive for MSCI ACWI Value vs. MSCI ACWI Growth



AS OF 4/30/21. Source: MSCI via FactSet. EPS: Earnings per share. P/E: Price/Earnings. Forward P/E decile history represented by the period June 20, 2003 to March 31, 2021.

Inflation

Global monetary and fiscal stimulus has been significant in the past 18 months, dwarfing that during the global financial crisis. In the United States, the M2 money supply—considered one of future inflation indicators—grew 24% year-over-year as of March 31, 2021, nearly double that during the financial crisis.³ In Europe, the European Central Bank has retained its aggressive monetary stimulus package to prop up the economy.⁴

Stimulus and quantitative easing of this magnitude have generally brought on inflation, and we are now seeing signs of it in global markets. The 10-year yield increased since the beginning of the year and the 10-year inflation expectation in the bond market briefly surpassed 2.5% in mid May, near its highest level in a decade.⁵ We believe potentially higher inflation is another possible catalyst for value stocks. As the following chart highlights, *value had been among the strongest performing asset classes in periods of rising inflation.*

² Source: The World Bank; "Global Economic Prospects," published June 2021.

³ Source: The Federal Reserve's H.6 Statistical Release, June 22, 2021; comparing M2 supply change between the period March 2020 to March 2021 and the period December 2007 to June 2009. M2 money supply includes M1 (i.e., cash and checking deposits) and easily convertible near money such as savings deposits and money market securities.

⁴ Source: The Wall Street Journal, "As Covid-19 Vaccines Lag, Europe Keeps Cheap Money Flowing," published 4/22/21.

⁵ Source: U.S. Department of the Treasury as of 5/31/21 (10-yr treasury yield); Federal Reserve Bank of St. Louis via FRED Economic Data as of 6/30/21 (daily 10-yr breakeven inflation rate).

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.

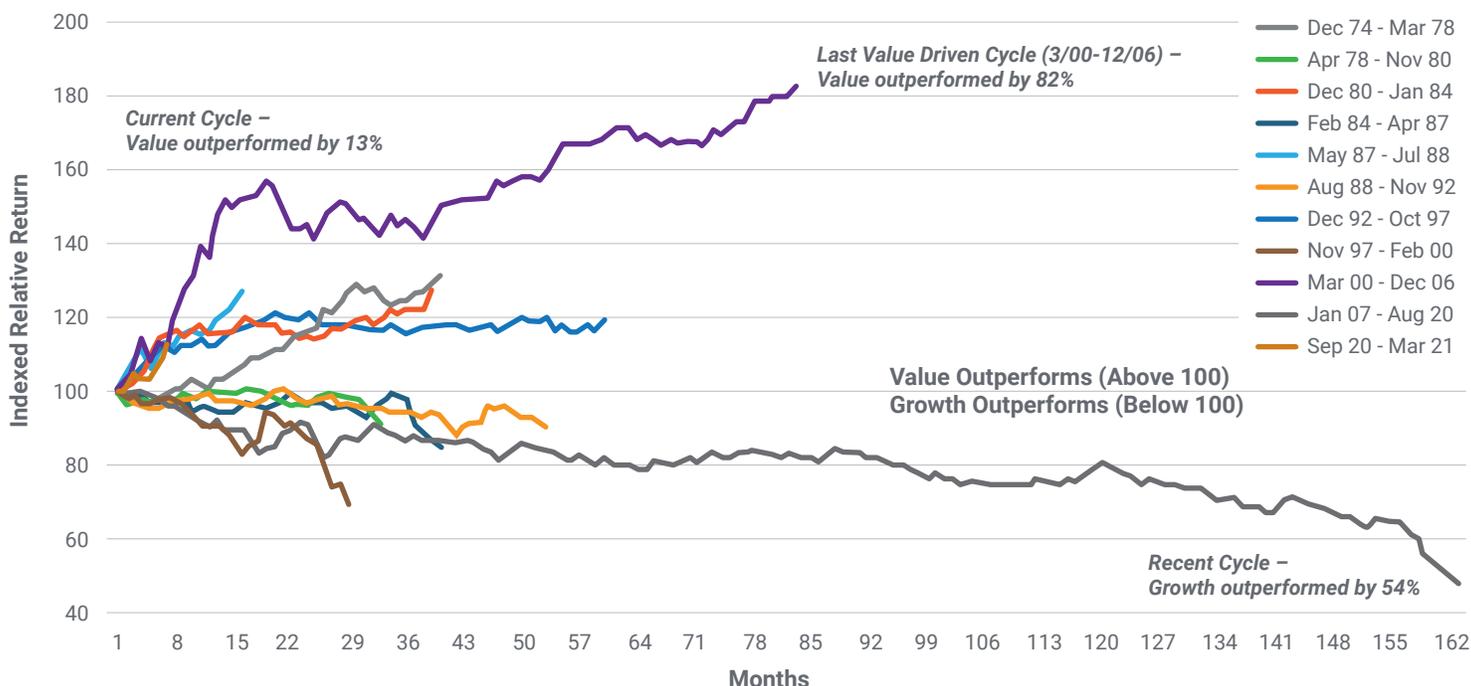
Source: Bank of America "The Thundering Word" March 11, 2021, based on data from Bloomberg, Dartmouth University Data Library, FactSet, BoFA US Equity & Quant Strategy. Inflation based on core CPI since 1958 and CPI since 1937. Value and Growth based on Fama-French High Book/Price and Low Book/Price 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.

Valuation Spreads Compared to Previous Strong Value Cycles

Just as the latest growth-led environment has been the longest and most pronounced in favor of growth stocks, it was preceded by the longest and most pronounced value stocks-led environment.

Longest and Most Pronounced Period of Value Underperformance

MSCI World Value/Growth Cycles - Indexed (100) Relative Return



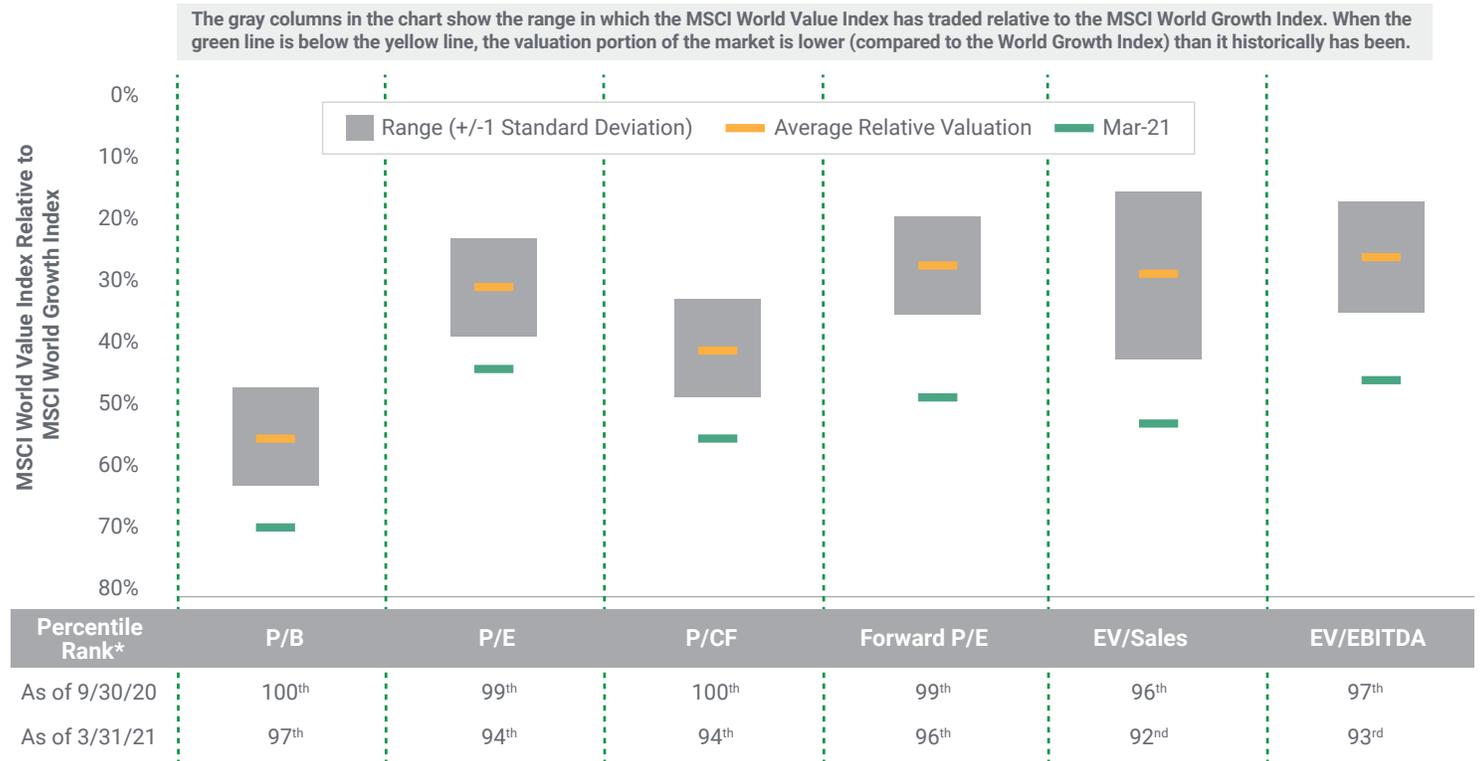
DECEMBER 31, 1974 TO MARCH 31, 2021; RELATIVE RETURN OF MSCI WORLD VALUE INDEX VS MSCI WORLD GROWTH INDEX (100 INDEXED AT THE START OF EACH PEAK-TO-TROUGH CYCLE) | Data is indexed to a common starting point at the start of each relative performance cycle to facilitate comparison of figures with different magnitudes. Source: MSCI via FactSet. It is possible for one index to outperform another and still experience negative absolute performance. Index performance does not reflect Brandes investment performance.

A common trait between the current value cycle and those of the past? Valuation spreads. Leading into the current value cycle (as of September 30, 2020), MSCI World Value traded at extremely high discount levels (100th or 99th percentile compared to history) to MSCI World Growth based on such measures as price-to-earnings and price-to-cash flow. The last time valuation spreads were as wide was during the tech bubble of the late 1990s, which was subsequently followed by the strongest value cycle on record (see chart above). Prior to that, the only other time in the last 70 years when we've observed this level of valuation dispersion was during the Nifty Fifty of the late 1960s and early 1970s, after which value had a multi-year outperformance relative to growth.

Even after their strong returns over the past eight months, value stocks continue to trade at significant discount levels (top decile rank compared to history) to growth stocks, indicating to us that there may be still room for value's current run to go.

Global Value Stocks' Relative Valuation

Valuation Relative to Growth Stocks vs. History



* 100th is the least expensive

RELATIVE VALUE BASED ON VARIOUS FUNDAMENTAL RATIOS, DECEMBER 31, 1974 TO MARCH 31, 2021* | Source: MSCI via FactSet. *Forward P/E data begins at 6/30/2003, EV/Sales begins at 3/31/2000, EV/EBITDA begins 3/31/2000. For each fundamental ratio (P/B-Price/Book, P/E-Price/Earnings, P/CF-Price/Cash Flow, Forward P/E-Forward Price/Earnings, EV/Sales-Enterprise Value/Sales, EV/EBITDA-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.

Is this value-led environment enduring? That question is impossible to answer with certainty, but we believe the overarching catalysts we discussed, combined with a litany of others (e.g., potentially tighter regulations for large-cap tech companies, which make up a significant portion of many growth indexes; value stocks becoming momentum stocks, which could give the value rally another boost) give us more confidence about the staying power of value run this time around.

Book Value: Assets minus liabilities. Also known as shareholders' equity.

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

EV/Sales: Compares the enterprise value of a company to its annual sales.

EV/EBITDA: Measures the value of a business. It compares a company's value, including debt and liabilities, to its true cash earnings, less noncash expenses.

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

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.

Past performance is not a guarantee of future results. It is not possible to invest directly in an index. The declaration and payment of shareholder dividends are solely at the discretion of the issuer and are subject to change at any time.

The S&P 500 Index measures equity performance of 500 of the top companies in leading industries of the U.S. economy. **The MSCI ACWI** with net dividends captures large and mid cap representation of developed and emerging markets. **The MSCI ACWI Value Index** captures large and mid cap securities across developed and emerging markets exhibiting value style characteristics, defined using book value to price, 12-month forward earnings to price and dividend yield. **The MSCI ACWI Growth Index** captures large and mid cap securities across developed and emerging markets 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 MSCI World Value Index** with gross dividends 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 Ibbotson 15+ Maturity Government Bond Index** is an unweighted index which measures the performance of long-term U.S. Treasury Bonds.

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