Value managers out of style but value still matters

Key points

- *The significant underperformance of the value style has been compounded by the economic implications of the COVID-19 pandemic.*
- *Valuations spreads between value stocks and growth stocks are now extreme by most historical stands.*
- *However, it's important not to lose sight of the merits of good value investing, which continues to evolve.*
- *A number of potential catalysts for an inflection in style leadership add further weight to the importance of strategic style rebalancing.*

The post-GFC has generally been a very challenging one for value managers, particularly in recent years, however; investors should be wary of abandoning the style, according to Frontier Advisors.

The economic intuition of value investing has not diminished despite an extended period of underperformance and if anything the opportunity for value managers has only increased. Valuation spreads between growth stocks and value stocks have reached extreme levels, while value can offer an important hedge against excessive price momentum in markets and potential leverage to an economic recovery, said Frontier Advisors Senior Consultant James Gunn at the Frontier conference.

"Rebalancing to value right now probably seems fairly counter-intuitive given we're in the midst of this unprecedented economic shutdown and health crisis," he said. "However, we do believe that now is the wrong time to be taking a large active bet against value. From our perspective, value will always matter in the long term."

Why value is underperforming

There's are many reasons ascribed to value's extended underperformance versus both growth and other factors. The relatively lacklustre post-GFC economic recovery and now COVID have put a scarcity premium on growth attributes and the longer duration cash flows of growth stocks, given collapsing interest rates and ongoing deflationary pressures. The related search for yield and geopolitical sources of volatility have also seen a bidding-up of defensives and low volatility stocks. Significant growth in passive forms of investing has arguably also been a relative headwind for the value style, exacerbating momentum in outperforming styles.

Market leadership has become increasingly concentrated to mega-cap growth stocks, particularly tech, where the application of traditional accounting-based valuation metrics can be problematic in the case of capital-light business models.

"A number of the higher quality US techs stocks in particular are clearly growing their top line significantly, improving their market position, reinvesting and above all, throwing off enormous amounts of cash, said Gunn." However, value and other parts of the market left behind appear well overdue for a rebound. Value stocks in particular are looking as "cheap" as they have been on most measures since the tech bubble of 1999-2000.

MSCI Style and Factor Returns to 30 June 2020

	1 Year (%)	2 Years (% p.a.)	3 Years (% p.a.)	5 Years (% p.a.)	7 Years (% p.a.)	10 Years (% p.a.)
MSCI World Growth	19.8	16.9	18.3	13.9	17.0	15.2
MSCI World Value	-9.6	-0.4	2.8	4.5	8.6	9.1
MSCI World Enhanced Value	-9.3	-3.8	1.7	2.6	8.5	8.5
MSCI World Quality	16.8	16.9	17.6	14.3	17.0	15.7
MSCI World Min. Volatility	0.5	9.8	10.3	10.2	13.1	12.5
MSCI World Small Cap Index	-3.4	-0.5	5.7	6.6	11.3	11.7
MSCI World Momentum	13.5	14.3	18.3	14.6	17.1	16.9

Source: MSCI, eVestment. All indexes are shown net of dividends (in AUD)

With most value managers struggling to beat their benchmarks in recent years, some of the better performing value managers have naturally been accused of style drift. However, Gunn said that rather than drifting towards growth, most value managers are looking as value as they have for some time.

"But value is really just going through a natural and necessary evolution, he said. Many value managers are incorporating a greater emphasis on quality attributes, as well as longer-term perspectives in response to the increased risks of technology-driven disruption, secular issues like climate change and the evolving nature of business models. This justifiable adaptation has been an important input in maintaining our forward-looking conviction in the style."

Catalysts may bring value back in fashion

While value has continued to underperform during the COVID-19 crisis, Gunn noted a number of potential triggers for a rebound in the style:

- The extreme dispersion in valuation spreads, setting the scene for mean reversal.
- COVID-19 is more effectively contained or a vaccine is quickly developed.
- Inflationary expectations unexpectedly rise, pushing up bond yields.
- Growth stocks fail to deliver on expectations and are de-rated.
- The momentum trade in tech stocks is unwound.
- A sell-off in longer-duration expensive defensives.
- Trade tensions ease, prompting renewed hopes for globalisation.

Gunn said asset owners overweight growth within their equities portfolios (either by intent or otherwise) have clearly benefitted from strong outperformance in recent years. However, we’re becoming increasing cognisant of the risks of this positioning relative to underlying strategic style objectives.

Key questions the panellists answered

- *(38.40m) How much has passive money fuelled the growth style?*
- *(40.20m) How has manager behaviour been affected by reporting against benchmarks?*
- *(42.15m) Should the underperformance of value managers change the way we think about building portfolios?*