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Investments

Growth & Value

Thinking differently about growth versus value

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Executive summary

- Value and growth are often sectoral investments, as growth stocks are dominated by technology and consumer discretionary, and value tends to reflect financials, industrials and materials.
- Over the past four decades, the difference in returns have only slightly favoured growth.
- Each style has periods in the economic cycle in which they will outperform and attempting to time these shifts is extremely difficult.
- Investors are best served through diversification and should therefore consider including both value and growth styles in their portfolios.

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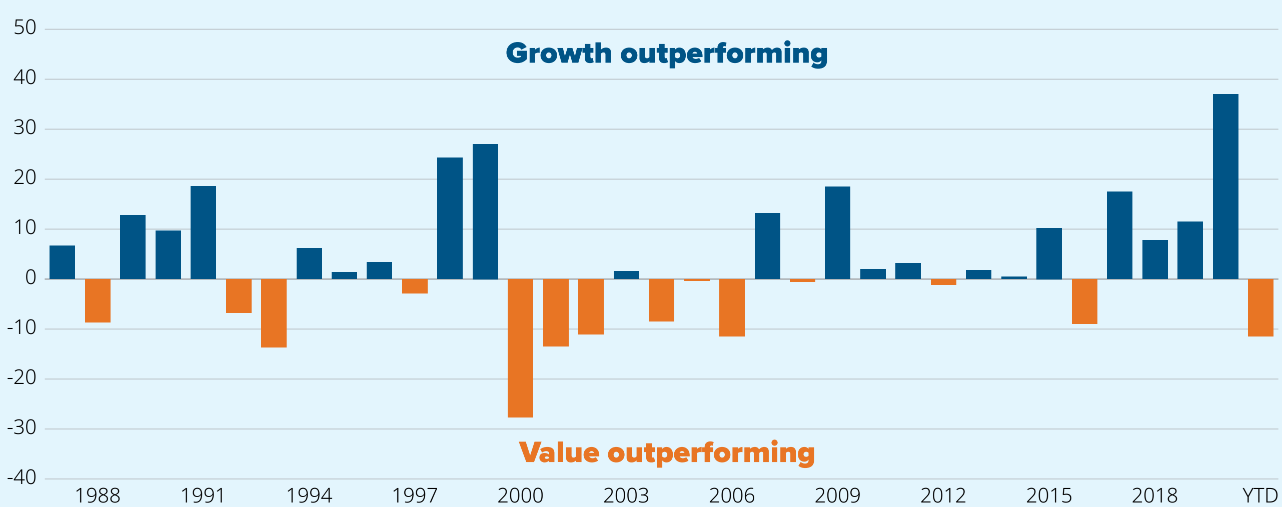
On growth and value

After a prolonged period of outperformance of growth stocks dating back to the Great Financial Crisis in 2008, there are finally strong signs that the tide is turning in favour of value stocks. Following the swift and steep equity downturn caused by the global pandemic, growth stocks reversed course and surged to lofty heights, cementing their run of outperformance for the past decade. But this trend cracked with favourable clinical trial results for COVID-19 vaccines and investors began to look to a future that involved a global re-opening for economies worldwide.

Value and growth in reference to investment styles have become entrenched in our investing vernacular. The truth is that while “value” and “growth” are a tidy way to organize stocks in a given universe, investing with this binary lens for your portfolio may lead to missed opportunities to maximize risk adjusted returns. Holdings within each style do not have to be viewed as mutually exclusive.

Although there are conventions to define growth and value stocks, there are no hard and fast rules. In very simple terms, growth investors are seeking companies with strong revenue or earnings growth, while value investors focus on companies that appear to be undervalued on one or more valuation metric, with price to book value the most common. Value stocks can also display additional characteristics such as low price to earnings, high dividend yield and high leverage. From a sector standpoint, growth investments tend to naturally cluster in sectors with secular tailwinds, like information technology or consumer discretionary. Value, as a style, can be more dispersed as mispricing can happen in any sector of the market, but often can be seen in more cyclical sectors like energy, materials, industrials and financials.

Historical outperformance of growth and value (%)



Source: Morningstar Direct as of May 31, 2021.
Growth as represented by Russell 1000 Growth PR USD. Value as represented by Russell 1000 Value PR USD.

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Investing in growth

Growth stocks represent companies that exhibit generally higher growth rates in sales and earnings than the expected economic growth rate (as measured by GDP). They garner premium valuations because investors expect share price appreciation commensurate with the superior growth rate of the business. Often these stocks don't pay dividends because their best use of capital is reinvestment in the business, rather than a return to shareholders. Growth stocks can range from companies that are currently profitable with strong balance sheets and growing earnings/free cash flow, to speculative "emerging" growth companies which have the potential to achieve high earnings growth but are years away from reaching profitability. All else being equal, companies with higher growth rates should be expected to trade at higher price multiples than companies with lower growth rates.

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Key attributes of a growth portfolio:

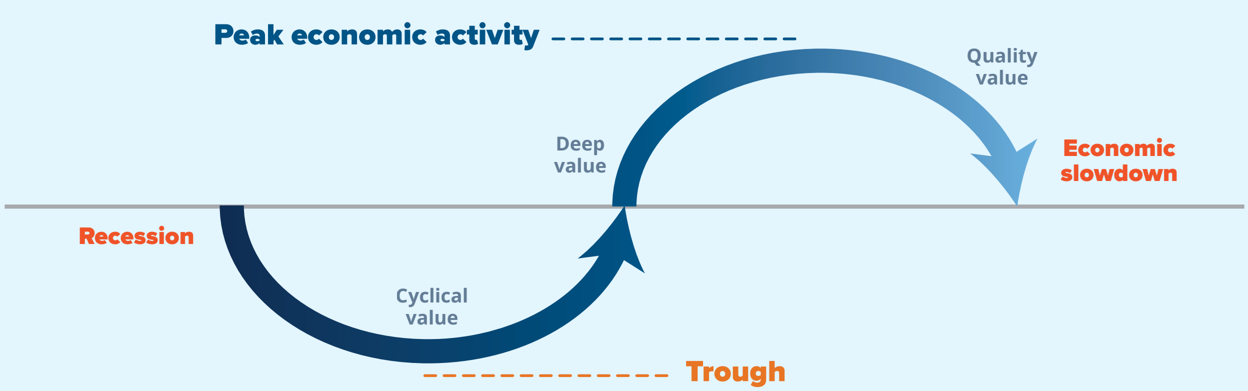
- The portfolio will hold a collection of companies with price multiples of earnings and sales that are higher than the broader market. Investors are willing to pay high prices with the expectation of selling them at even higher prices as the companies grow their way into their present-day valuations.
- Companies in the portfolio will benefit from tailwinds of a secular growth trend that can fuel the company's growth without relying on a strong economic growth backdrop.
- Growth stocks can be viewed as long duration equities when the majority of positive earnings are expected far into the future. In this case, the value of the company is projected to be the net present value of these future cash flows and thus interest rate sensitivity of the stock price can be high, despite the fact that the business itself may not be interest sensitive.
- Portfolio holdings can experience sharp drops in price on negative news about the company, where tangible book value support does not exist.
- Most of the investment return for the portfolio is generated by capital appreciation.

Investing in value

Value stocks by definition trade at lower multiples of earnings or book value than growth stocks and typically lower than market averages. The value group often includes companies that are out of favour or those that have been affected by lower economic activity. The lack of momentum or investor interest may also help perpetuate deep "bargain" prices. Value stocks may take longer to achieve their potential for share price appreciation.

There are also different types of value stocks. For example, a cyclical value stock is inexpensive because of the headwind of a weak economic cycle. These stocks can provide outsized returns in a short period of time when the economic cycle turns in their favour – commodity-based companies would be examples of cyclical value stocks. Deep value stocks often trade at a discount to intrinsic value because the business is of low quality and thus requires patience by the investor to wait for a catalyst to drive the share price to fair value. Deep value investing originated with Benjamin Graham, who was known as the father of value investing. A third type of value investing is quality value, where the company is not necessarily a broken business but still may trade at a discount to fair value due to poor market sentiment or mispriced fundamentals. The three types of value stocks perform differently at various points of the economic cycle:

Typical value investing phases over the economic cycle



Key attributes of a value portfolio:

- The portfolio manager will select from a universe of companies that trade at a discount to intrinsic value, often defined as the book value or replacement value of the assets; typically, little value will be given to intangible assets on a company's balance sheet.
- The portfolio may hold companies in any of the three value styles: cyclical value, deep value and quality value.
- While patience may be required to realize the potential value of the companies in a value portfolio, often the appreciation potential of the holdings are catalyst-driven through take-outs or activist shareholders, where fair value can be realized quickly but unpredictably.
- Portfolio returns can still be generated through the portfolio's dividend yield, which is typically higher than average.

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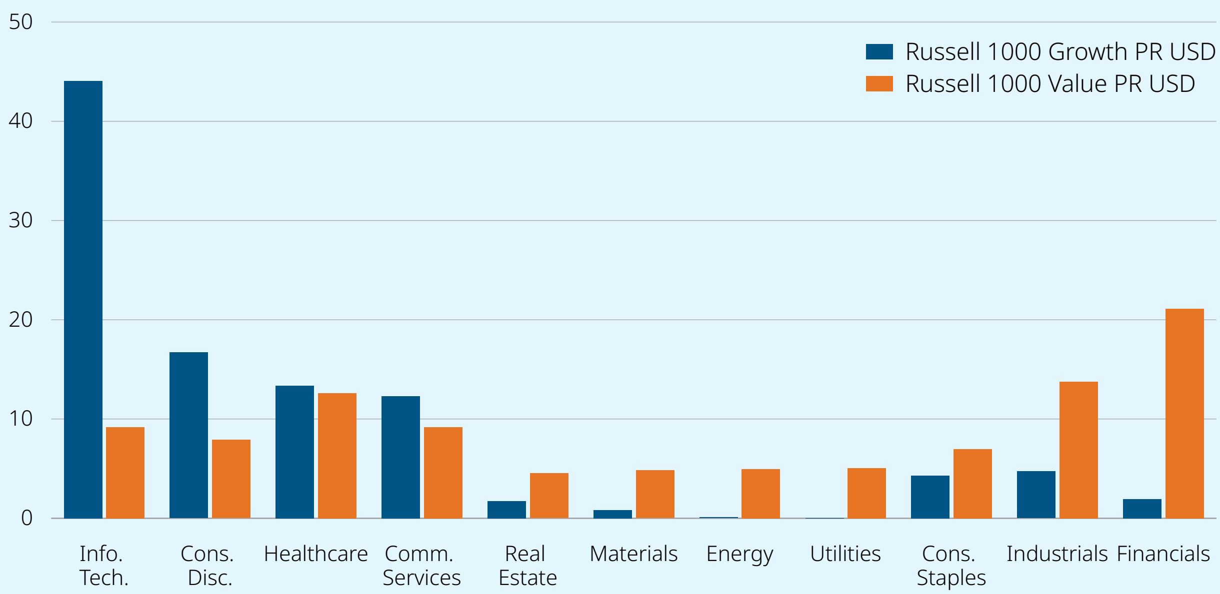
A sector bet in disguise

To emphasize the opportunity for diversification, it is important to recognize the different sector weights for growth and value indices. Unsurprisingly, the growth indices skew towards technology, consumer discretionary and healthcare. Conversely, the value index has outsized representation in financials, energy and industrials.

This lines up perfectly with the "sector story" nature of the periods of relative growth and value strength; for example, the technology run-up in the late 1990s versus the commodity super-bull market before the Great Financial Crisis. It is reasonable to assume that, if we are heading into a period of strong growth or value style performance, then we should expect to see very different relative sector performance going forward. A strong growth period should see strength in the technology, consumer discretionary, and/or health care sectors, while a strong value period will be characterized by outperformance of financials and/or energy.

How growth and value are spread across sectors (%)



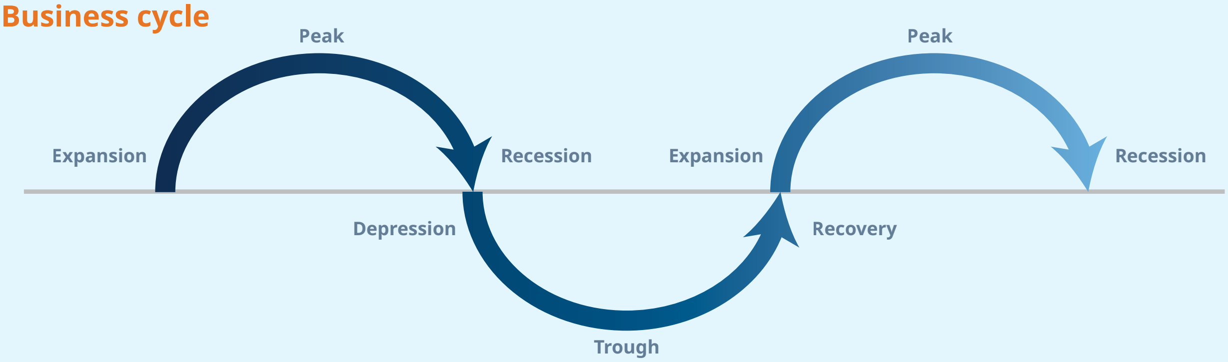
Source: Morningstar Direct as of April 30, 2021.

The economic cycle and portfolio positioning

When thinking about the role of value and growth in the context of the economic cycle, investors may have the opportunity to position their portfolios to take advantage of the various stages of the economic cycle.

The illustration below highlights the factors that perform best at various stages of the economic cycle. For example, when the economy is in an expansion phase, the companies hardest hit by the downturn (typically value stocks), tend to be the top performers. When the economy has passed its peak and starts to move into a downturn, growth becomes scarce; growth stocks become more desirable to investors, as they tend to be the only companies offering price appreciation.

Business cycle



Recession	Trough	Recovery (early-cycle)	Expansion (mid-cycle)	Peak (late-cycle)
Positive GDP to negative GDP – economy contracts	EPS and price/ earnings (P/E) typically grind towards lowest levels	Inflection from negative-to-positive GDP – economy expands	Period of EPS growth and broadening market leadership	Period of peak earnings, slowing growth and tight credit
Period of earnings per share (EPS) contraction	Lower-quality, deep cyclical companies begin to outperform higher-quality, defensive companies	Period of sharp recovery and growth of P/E multiples	Lower valued, higher quality assets take over from riskier assets; defensive, stable assets continue to underperform	Defensive, high quality, growth-oriented companies outperform
Interest rates typically lowered to stimulate growth		Deep cyclical, low-quality companies lead markets while higher-quality, defensive companies lag	Typically, a longer part of the business cycle	Typically, an 'overheating' economy and above-trend interest rates

The problem, of course, is that it is impossible to predict the future. Accurately rotating between value and growth ahead of the market through an economic cycle is extraordinarily difficult and can be highly risky.

Understanding the "cyclical vs. defensive" underlying positions of individual value and growth funds may lead to more informed decisions and provide more actionable investment ideas. In addition, it is also worth being aware of the idea that value and growth are not inherently in conflict and that over time, each style will perform well for your portfolios, but not necessarily at the same time.

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How about value *and* growth?

Investors have three different strategies to invest with growth and value factors in mind:

Pick one style and stick with it.

Try to time the rotation from one style to the other.

Diversify your portfolio through the utilization of both styles.

Given the significant differences in rates of return between growth and value styles over different periods, it is understandable that advisors are curious about the path forward. Because value and growth portfolios are characterised by different factors, these complementary styles of investing can help with portfolio diversification when used together by smoothing out returns over long time horizons and removing the potential of market timing pitfalls.

Looking back in history, since 1979 the annual equivalent total return for the Russell Value Index is 10%. This compares to an 11% total return for the Russell Growth Index. But excluding the pandemic backdrop of 2020, the two indices returned almost the same amount to investors, so over very long periods, it hasn't really paid to favour one over the other. But the added diversification of holding both could have reduced portfolio volatility due to the different eras that favoured value over growth and growth over value.

Ultimately, no one can truly know what the future holds and therefore, the golden rule of investing – to maintain diversification in your portfolio – can be partly achieved through growth and value style diversification. Allocations to growth AND value offers the potential to generate strong returns through both capital appreciation and dividend yield throughout different types of economic cycle, regardless of which style of investing is in vogue at the moment.

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