# Value stocks are overdue for a comeback

**Mary Mathers,** MBA, CFA
Senior Investment Director
Mackenzie Cundill Team

## No one rings a bell when it's time to switch investment styles

The old Wall Street adage is "no one rings a bell at the top," meaning that a market change is never "announced" but instead can happen swiftly without warning. Like a flock of birds that change direction, Mr. Market (as the father of value investing, Ben Graham, referred to the stock market) can abruptly switch from favouring one style, such as growth, to another, such as value.

This paper explains growth and value investing styles and outlines the reasons we believe the current global economic backdrop favours value investing success. Well diversified portfolios should consider a mix of styles, in our view.

### What is growth investing?

Growth investors look for companies that exhibit much higher growth rates in sales and earnings than the economy's growth rate. These companies tend to do well when economic growth is muted and inflation and interest rates are low because, in a low growth environment, investors tend to reach for high growth rates. As a result, other types of investments, such as dividend stocks or value stocks, often fall out of favour. Growth companies tend to be valued on expectations for the future, such as the potential dominance of an industry and supernormal earnings growth rates. Their stocks generally don't produce dividends because they are reinvesting every dollar in the business to grow it faster. Their valuations tend to be on the very high end of the scale.

### What is value investing?

Value investors look for companies where they believe the business is worth more than the price Mr. Market assigns it. Warren Buffett, one of the greatest value investors of all time is one of the richest people on earth and a student of Ben Graham. He believes that most people cannot predict the next fashion trend,[1] so he stays away from businesses that require an accurate forecast of the future – that is, growth stocks. Value investors seek bargains from the discard pile caused by market mispricing, with the expectation that catalysts will drive the share price back up to what the company is really worth.

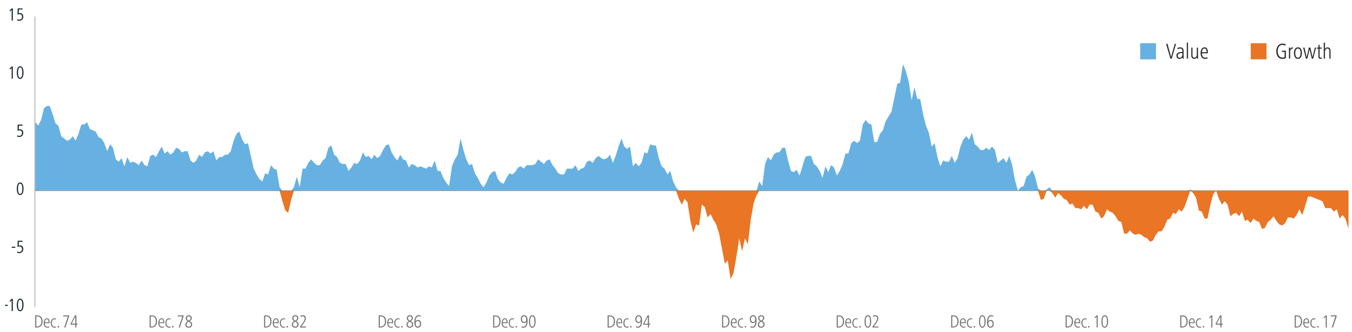
[1] www.businessinsider.com/warren-buffett-best-investing-advice-for-beginners-2017-11#4-only-make-investments-that-you-understand-4

## The ups and downs of value and growth stocks

As Chart 1 reveals, value and growth styles are highly cyclical and offset one another. Trends in which one is up and the other is down can last for years, but when they reverse the outperformance is significant. In the chart, orange shading indicates periods during which growth outperformed value, and blue shading indicates periods during which value outperformed growth. For the past decade, since the financial crisis of 2008–2009, the growth style has outperformed value. This is coincident with a long period of low economic growth, low inflation and low interest rates. Over a longer period of time since 1975, the chart shows a clear dominance of value over growth style.

We think the situation could change in favour of value stocks because global interest rates are rising and inflation is also coming back. We believe that these ingredients tend to help value stocks do well.

### Chart 1 – Value vs Growth*




Source: Morningstar Direct,
* Value = MSCI World Value index, Growth = MSCI World Growth Index, relative returns

## Value tends to outperform growth during rising interest rate cycles

In Chart 2, the grey bars are years when the Federal Reserve Bank in the United States raised interest rates (tightening monetary policy). When the blue line is falling, value stocks are outperforming growth stocks. When the blue line is rising, growth stocks are outperforming value stocks. During the mid- to late 1970s, interest rates rose substantially to curb rampant inflation, and value stocks dramatically outperformed growth stocks from 1975 to 1989. The dot.com bubble of 1998–2000 is evident, with a steep outperformance of growth stocks compared to value stocks, then the swift reversal of this trend with the rise in rates in that period, and finally the bursting of the bubble. Notice that during the most recent gray period, growth has been outperforming despite a tightening cycle that began in late 2015. *"The four most dangerous words in investing: 'this time it's different.'" – Sir John Templeton*. We believe value outperformance is overdue given what we see as an anomalous pattern over the past tightening cycle compared to history.

### Chart 2


Source: Scotiabank GBM Portfolio Strategy, MSCI

## Why value goes up with rates

Value stocks tend to do well when interest rates and economic growth are rising in tandem. Suddenly, previously slow-growing companies become very attractive since their earnings start to accelerate. Value stocks can be companies that are more sensitive to the economic cycle and that do better when the economy is improving. These may include banks, energy companies and industrial companies that grow along with the economy. For banks and industrials, a slow-growth economy means a slow-growth company, but a faster-growing economy means a faster-growing company. Meanwhile, energy companies tend to do well later in the economic cycle as commodity prices rise with increasing demand thanks to a strengthening economy.

Why take a closer look at value now? We see plenty of evidence that the global economy is on a strong footing, with solid job growth, corporate profitability, low unemployment levels, strong consumer and business confidence, increasing capital expenditures on plants and equipment, steady wage gains, and both rising inflation and interest rates. We believe, these are all tailwinds supportive of value stocks.

## Summary

We believe that investors should consider adding value stocks to their portfolios, since no one rings a bell when it's time to switch investment styles. We see evidence of tailwinds that have historically helped value stocks do well. Mackenzie Investments offers domestic and global value investing solutions.

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