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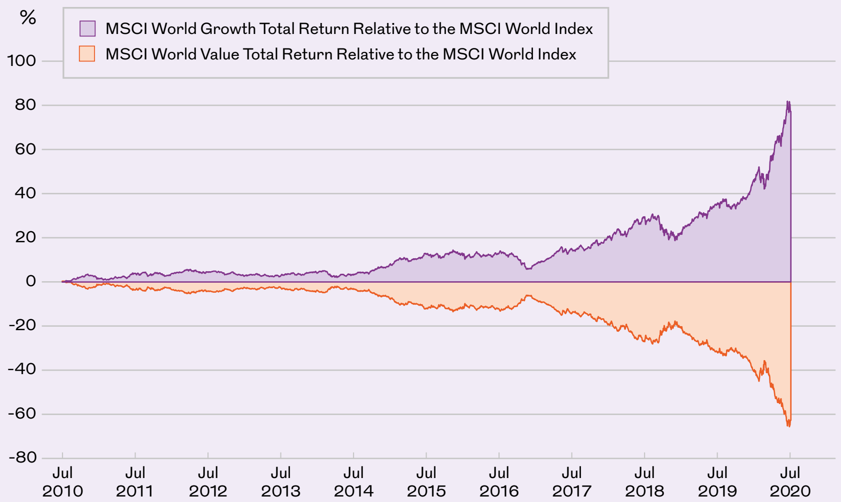
Value versus growth: a new perspective

The battle between 'growth' and 'value' stocks has captivated investors for much of the past century. Yet over the past decade it has become a decidedly one-sided fixture. Growth stocks have massively outperformed, and this has accelerated during the COVID-19 crisis. This explains why the US S&P 500 and NASDAQ indices, which heavily feature growth stocks in the healthcare and technology sectors, have so drastically outperformed the relatively value-dominated UK FTSE All-Share Index.

The upshot of this remarkable divergence is that it would appear that it has never been more expensive to choose growth over value than it is today; even adjusting for differences in profitability levels and a low discount rate environment. This raises a critically important dilemma for investors. Should we tilt our portfolios towards growth stocks, assuming that the superiority of growth is here to stay? Or has the time finally come for value, with the relative expensiveness of growth having become so stretched that a sharp snapback is inevitable?

We have sought to answer these questions recently, and have used our proprietary models to provide a fresh perspective on this perennial debate. In this article we address:

Figure 1: A decade of 'growth' outperformance



Source: MSCI as at 27 July 2020

1. The reasons behind the impressive performance of growth stocks this past decade
2. Whether the underlying drivers will remain in place in the future
3. An attractive solution for investors navigating the current market environment

Has the market gone mad?

The divergent performance between growth and value stocks appears quite mystifying when looked at with traditional analytical tools. Technology giants like Amazon appear to be priced for perfection and yet keep outperforming. Our analytical tools tell a different story. Considering the informational inadequacies of traditional accounting data, a world awash with capital and discount rate sensitivity, we find the historic outperformance of growth to be much more logical than it first appears.

Mismeasurement

Financial statements prepared according to regional accounting standards overlook a tremendous amount of real economic value. In fact, we estimate that approximately 40% of the real value in the corporate economy is not captured by traditional accounting data. This really matters for companies like Amazon because research and development, intangible assets and network effects that have been generated organically are critically important for their success, but are ignored by conventional balance sheets. Such glaring omissions lead to distorted perceptions of company fundamentals and valuation differentials.

To overcome this measurement problem we use an Economic Return Framework to convert reported accounts into measures

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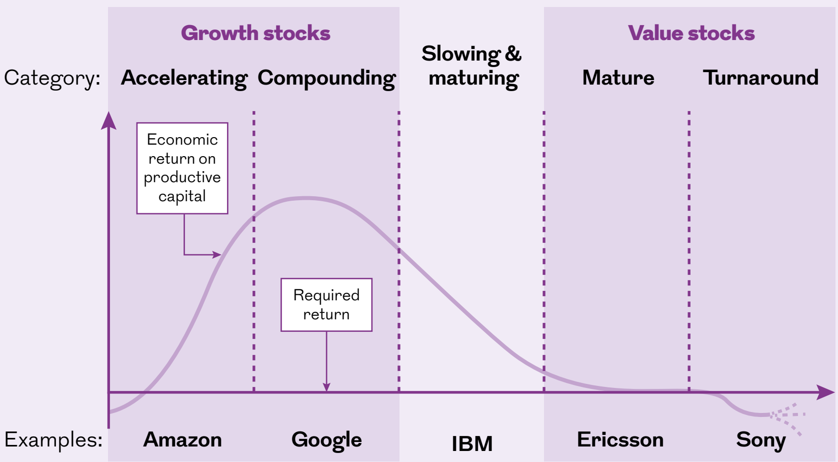
of earnings and corporate value that more appropriately capture the economic reality of a business. This framework enables us to fairly compare companies across regions, sectors and time, as well as to capture hidden assets neglected by standard accounting data. So while normal balance sheet analysis suggests that Amazon trades on an exorbitant 21x price-to-book ratio, as at the end of June 2020, we determine the price-to-book, including hidden assets like R&D, to be more like 7x.

A world awash with capital

We employ a Corporate Life Cycle framework that rests on the observation that the forces of innovation, disruption and competition result in all companies tending to follow a particular trajectory in their growth and returns on capital over time. In our framework growth stocks are located in the 'accelerating' (Amazon) and 'compounding' (Google) stages, while value stocks are in the 'mature' (Ericsson) and 'turnaround' (Sony) stages.

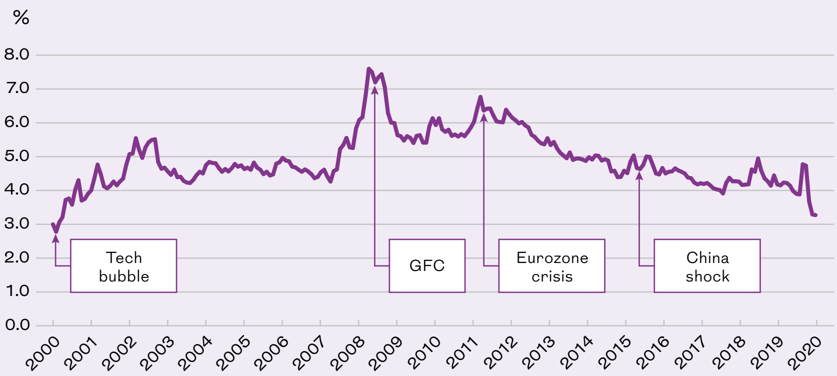
In a world with too much capital chasing too few assets, early Life Cycle businesses have benefitted from exceptional levels of public and private funding in the hope that innovation and disruption will create wealth through growth and higher returns on capital. Excess funding for these business models directly impacts the returns of later Life Cycle value stocks because they increase the amount of competition and disruption that those value stocks must contend with, accelerating the progression of returns along the Life Cycle. So while the fundamentals of growth stocks have become stronger over the past decade, the exact opposite has happened to value stocks. The rise of Tesla above incumbent auto manufacturers is a great example of this.

Figure 2: The Corporate Life Cycle



Source: RLAM, for illustrative purposes only.

Figure 3: The global discount rate over the past 20 years



Past performance is not a reliable indicator of future results.

Source: CS Holt as at 30 June 2020

Discount rates

Share prices reflect expected future cashflows discounted back to present value by an investor discount rate. They show what businesses are expected to earn in the future, adjusted for the cost of financing that business activity. Due to their nature, expectations for the cashflows of growth stocks need to be extrapolated further into the future. This means these stocks have a longer duration than value stocks, making them more sensitive to changes in the discount rate. This is beneficial when the rate is falling but detrimental when it is rising.

As part of our process we calculate a market-implied global equity discount rate, which is a function of interest rates and bond yields. It has fallen steadily over the past decade, with the rate of decline recently accelerating during the COVID-19 pandemic. The reduction of global equity discount rates has been a tailwind for the performance of growth stocks. You can see in figure 3 that the period of falling discount rates maps neatly onto the period in which growth stocks have outperformed.

Is it all about to change?

We have shown that there are sensible reasons for the divergence in the performance of growth and value stocks. Hidden earnings drivers, improving cashflows and greater sensitivity to the considerable reduction in the global discount rate are key factors. The next step is to assess whether these underlying drivers will remain in place in the future, and whether the superiority of growth is already in the price.

The two primary catalysts for a sharp reversal in the relative performance of growth versus value stocks would be a cyclical recovery or rising bond yields. Cyclical recoveries usually take place during periods of economic strength. Yet we are currently in the middle of a deep global recession and the effects of lockdowns, social distancing measures and widespread unemployment on demand and supply reduce the likelihood of a sharp rebound in economic growth as measures are relaxed.

At the same time, the responses from governments and central banks in dealing with the pandemic have been extraordinary. Monetary policies have never been so accommodative, and that should remain the case as long as economic growth remains depressed. It is therefore likely that government bond yields will remain bounded in the near term. Neither a long-term cyclical recovery nor rising bond yields appear probable, so a reversal of the growth outperformance is not our base case.

Nevertheless, it would be foolish to dismiss the possibility entirely, given the risks it entails. The discount rate cannot keep falling forever. The past decade has been highly unusual, with the unprecedented interventions from central banks resulting in interest rates becoming disconnected from the real economy. This artificial situation could quickly change if there is a shift in the views of policymakers towards these supportive monetary policies.

The risks are severe given how stretched the relative expensiveness of growth has become. Even adjusting for the mismeasurement from relying purely on accounting data, we find that the price-to-book and price-to-earnings differentials are close to their 20-year highs and our global market-implied discount rate shows the lowest expected future returns from growth stocks since the dot-com bubble.

While it is conceivable that the drivers of growth stocks will remain broadly in place, the dangers of a harsh market correction to reduce the divergence between value and growth make it prudent that investors avoid betting too heavily on either outcome. Fortunately, we have formulated an approach that has proved successful in both scenarios, although it has benefited more when value has outperformed.

Value exposure without the traps

The RLAM Global Select Fund is designed to provide a high amount of stock-specific risk with differentiated stock holdings balanced across sectors, regions and our Corporate Life Cycle. It offers a very different approach to traditional growth and value exposures because the fund invests across the Life Cycle (from early stage growth through to deep value) but targets superior valuation metrics for holdings relative to their Life Cycle category.

Traditional value funds get their exposure to value by effectively biasing their portfolios towards the minority of companies in the late stages of the Life Cycle. The problem is that many of these companies in the 'mature' and 'turnaround' stages are possibly structurally impaired. They are potential traps for investors. Our focus on value across the Life Cycle, rather than by overweighting one part of the Life Cycle, is the first way that we achieve 'value without the traps'.

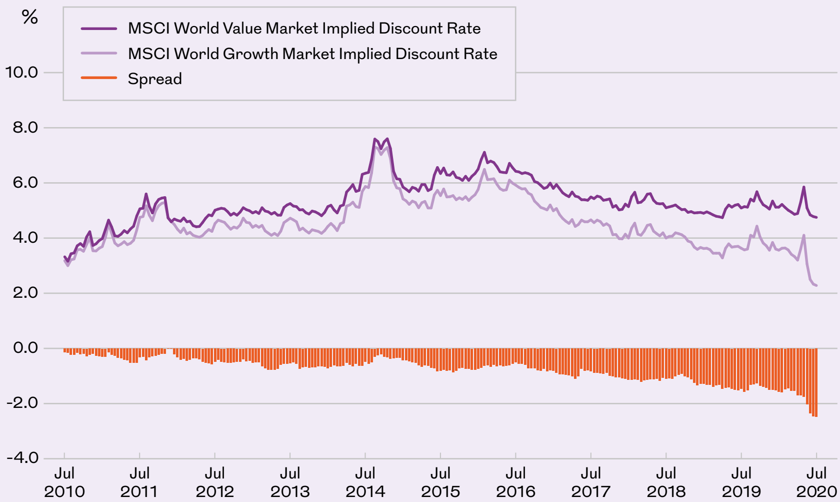
The second way is through the stock selection process itself. We identify companies with attractive, forward-looking, wealth creation prospects, especially compared to peers in the same stage of the Life Cycle – our wealth creation test. Only companies that pass the wealth creation test are considered as potential holdings; the traps that fail it are discarded. This helps us find 'value without the traps' at the stock-specific level.

This differentiated investment approach gives our clients a **selective value** exposure. Our Economic Return Framework captures hidden assets and identifies attractive valuations across the Corporate Life Cycle; our wealth creation test helps avoid stock-specific value traps; and our portfolio construction discipline across the growth/value continuum provides balance. This gives clients not only 'value without the traps', but also exposure to exciting early Life Cycle growth companies.

Our long-term track record shows that our portfolio returns have been primarily driven by idiosyncratic stock selection. Smaller residual factors show consistent value/valuation style tilt. In combination, these have helped the fund to outperform in every year featuring flat-to-rising discount rates and value outperforming growth.

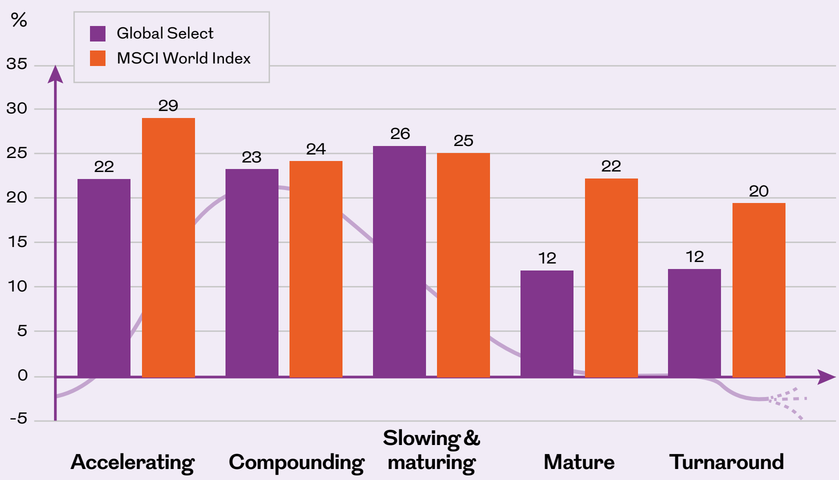
These characteristics make the RLAM Global Select Fund an ideal solution to today's momentous value versus growth debate.

Figure 4: The lowest implied future returns from growth stocks in 20 years



Source: RLAM, Factset, CS HOLT, 27 July 2020

Figure 5: Valuation exposure without being a value fund



Source: RLAM as at 27 July 2020

Contact us

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The views expressed are the author's own and do not constitute investment advice.

For more information on the fund or the risks of investing, please refer to the fund factsheet, Prospectus or Key Investor Information Document (KIID), available via the relevant Fund Information page on www.rlam.co.uk

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