

## THE COMEBACK KID?

### Why there's still value in a value allocation

#### Key Takeaways

- Following over a decade of outperformance, growth stocks' recent melt-up is so sharp that it appears unsustainable.
- With the economic recovery backstopped by monetary and fiscal stimulus, value stocks should finally have the expansionary backdrop needed to come into investors' favor.
- Meanwhile, growth stocks have hurdles on the horizon, such as greater regulation of technology companies and higher taxes
- Because of these factors, the current environment presents a relatively attractive entry point for value stocks.



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Value bulls have been underdogs of the investing world since the Financial Crisis of 2008. As with a down-on-its-luck sports team, whenever value stocks would outperform their growth counterparts for even a week, diehard fans of value would proclaim that the “losing streak” to growth stocks was over. However, none of those predictions have turned out to be right. More recently, value investors claimed that since value underperformed growth by 20% during the first quarter’s downturn in 2020, it was bound to rebound. Yet in the rally from March 23 through June 30, value has lagged growth by 9.21%.

Is it time to finally throw in the towel on value investing? While we have so far shied away from overweighting value in the Portfolio Optimization Portfolios, we find it prudent to have both styles in our portfolios as each has the potential to outperform the other under the right set of macroeconomic conditions. And right now, the tide may finally be shifting in favor of value stocks.

Before we dig into why value may be ready for a turnaround, let’s examine the economic backdrop behind its long losing streak to growth.

A key tenet to remember: Typically, value outperformed growth during expansions because of strong economic growth, which benefits all equities and makes expensive growth stocks lose their luster. Yet over the recent 11-year bull market—the longest on record—the economy did not experience the kind of rapid growth that has usually made investors consider shedding pricey growth names for less expensive value stocks. Ironically, lackluster growth in the economy could have been the biggest contributor to the expansion’s length. There were few economic excesses as we saw leading up to the dot-com bust or the housing crisis to feed a downturn. Instead, what stopped the expansion was largely unforeseeable: a global pandemic.

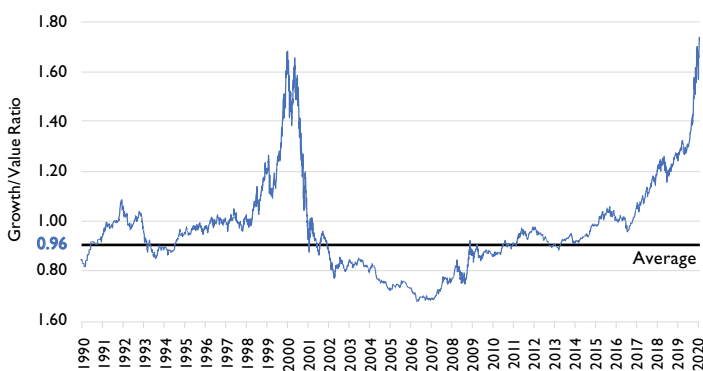
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The global pandemic only amplified many structural trends that benefited technology, the dominant sector within the growth style over the last decade. Facebook, Apple, Netflix, Microsoft, Amazon and Google (FANMAG) saw strong revenue growth before the current crisis. Quarantines only heightened demand for their products and services as consumers took their shopping and entertainment online, and corporations accelerated plans to boost efficiency by doing more business in the cloud.

With this backdrop, it is no surprise that FANMAG's fundamentals have been head-and-shoulders above the S&P 500® index. Through May 2020, FANMAG's trailing 12-month sales at 15% were nearly five times those of the rest of the S&P 500 at 3.1%. Furthermore, its net margins were more than double the broader index at 17.8% versus 7.8%, respectively. All good for growth investing.

During the Covid-19 crisis, the biggest value sectors only encountered further headwinds. The energy industry was hit with a double whammy of a massive drop in demand, as cars remained in garages, and a temporary spike in supply due to additional oil pumped by Saudi Arabia and Russia. Financials, meanwhile, faced even lower margins amid record low interest rates.

**Historical Growth/Value Ratio**



Source: Morningstar® Inc., as of 6/30/20.

All this explains why value stocks trailed growth for so long, but why do we think investors should consider keeping value in their portfolios or adding an allotment if they don't have one? First, growth's recent run is so strong that it appears unsustainable:

The chart is a ratio of the Russell 1000® Growth to Russell 1000® Value indices. When the ratio rises, growth stocks outperform value stocks—and when it falls, value stocks outperform growth stocks. At 1.74, the current level is higher than the 1.68 hit in 2000, right before the dot-com bust. Importantly, both peaks were hit after near-vertical ascension. Historically in markets, such moves are often symmetrical—sharp spikes followed by deep plunges.

Besides the historical technical perspective, several fundamental factors make us more optimistic for value stocks going forward:

- **Economic Rebound:** Lockdowns imposed in the first quarter will likely make the first half of 2020 one of the most severe but, crucially, also the shortest economic contractions on record. The reopening of the economy has flipped the momentum of key labor, consumer, and business confidence indicators from negative to positive. Markets care more about the trend—where the economy is heading instead of where it is right now. The relatively quick pace of this expansion should provide the sort of economic growth needed for value stocks to rebound from their depressed valuations.

- **The Second Wave Can be Surfied:** Although June saw a resurgence of coronavirus cases in certain states, we do not expect statewide lockdowns to return en masse and reverse the economy's emerging ascent. Instead, we may see stricter social distancing enforcement and localized measures, including reducing restaurant capacity, closing bars, and requiring residents of the highest-risk counties to temporarily shelter-in-place.

- **Spurging on Stimulus:** At over 13% of U.S. gross domestic product, the CARES Act dwarves previous stimulus packages, and ongoing bipartisan talks look to inject even more to keep the economic recovery on track. Should the coronavirus situation worsen, the size of additional stimulus is likely to increase proportionately. With the expansion backstopped by monetary and fiscal stimulus, a rebound in value should be sustainable.

*Performance data quoted represents past performance, which does not guarantee future results.*

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• **An Unlikely Ally:** Joe Biden, whose popularity is surging even in conservative polls, has recently unveiled a proposal to raise corporate taxes from 21% to 28% in a partial rollback of 2017's tax reform. This will be most detrimental to growth sectors such as IT and healthcare, which saw their effective tax rates more than halved by the 2017 reform and used repatriated cash to buoy their stocks through buybacks. On the other hand, value sectors such as financials and consumer staples saw far more modest benefits. While a Biden win and higher taxes will dent nearly all corporate earnings, growth equities will likely experience the most pain.

• **Tech Regulation is Coming:** Whichever candidate wins the election in November, he will likely seek greater regulation of tech companies based on campaign comments. The only difference will be whether Washington's regulatory wrath is fueled by perceived anti-conservative bias or antitrust and privacy concerns. Whatever the case, increased tech regulation does not bode well for growth stocks.

All this sets up both the near and longer-term catalysts for underdog value stocks to break their losing streak and take the style championship back from growth. For investors who have shied away from value in the past, the current environment presents a relatively attractive entry point.

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The **Russell 1000 Growth Index** measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-value ratios and higher forecasted growth values.

The **Russell 1000 Value Index** measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The **S&P 500 index** is a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the U.S. stock market.

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All indexes are unmanaged and cannot be invested in directly. Further, they hold no cash and incur no expenses.

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