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US Value Stocks: No. It's not "different this time."

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Snapshot

- When a group of stocks delivers sustained outperformance, investors want to believe that the ride will never end.
- The latest example involves the massive performance gap between growth and value stocks in the US.
- We've seen this story before. It always ends the same way. We fully expect the performance gap to close.

Every time a group of stocks delivers sustained outperformance, there's a tendency to want to believe that the world has changed forever and that "it's different this time." We saw this during the tech bubble from 1998-2000 and during the 1960s and 1970s with the "Nifty Fifty[1]," to name just a few of the many examples throughout history. The tech bubble implosion in 2000 and the bear market of 1973-74 both demonstrated that the world had not changed. Today, the spectacular rise in growth stocks that began in 2009—and which has accelerated since 2017—has led some investors to believe that growth stocks will rise forever and that value stocks will never recover. We don't believe it.

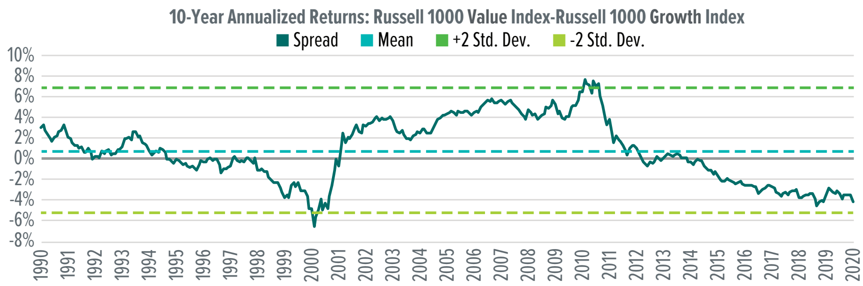
We believe in reversion to the mean

"Reversion to the mean" is a fancy investment phrase used to explain the idea that stock prices and returns will eventually return to their historical averages. Low prices won't stay low forever. High prices won't stay high forever. Looking at the spread between growth and value, we can't help but think of reversion to the mean.

Relative to growth, value has performed so poorly over the past decade that only about 5 percent of previous ten-year periods have been worse. Yet, even with the past decade of significant underperformance, value has outperformed growth—on average—over all rolling 10-year periods over the last 30 years, which is why we maintain exposure to value stocks as part of our portfolio construction process.

We continue to believe the current performance gap between value and growth represents what may be the most attractive investment environment for value stocks that we have seen in nearly 20 years, as seen in Exhibit 1.

Exhibit 1: A Decades-Wide Gap



Source: Russell, SEI
Data spans 31/1/1980-31/1/2020, Past performance is not a reliable indicator of future results.

[1] Nifty Fifty was a designation for 50 US large-cap stocks in the 1960s and 1970s that were generally viewed as sound growth stocks to buy and hold.

Periods in which value underperforms have historically been followed by outperformance. Value has rebounded and outperformed growth over the following three years in more than 80% of these scenarios since 1927, as Exhibit 2 highlights.

Exhibit 2: Nowhere Near the Mean

Value-Growth Relative Returns			
	Trailing Three Years Annualized Return (%)	Following Year Return (%)	Next Three Years Annualized Return (%)
1939	-12.0	-0.8	9.7
2019	-11.8	?	?
1940	-11.0	11.1	22.8
1999	-10.0	39.7	21.5
1991	-9.6	24.3	13.6
1980	-9.4	25.0	19.7
2009	-7.9	-5.3	-1.6
2011	-7.7	9.8	3.1
1932	-6.1	28.5	0.8
1931	-5.6	10.2	0.9
2010	-4.7	-8.4	0.7
2000	-4.6	19.5	10.6
1941	-3.8	19.9	24.4
1953	-3.6	26.2	9.5
2015	-3.4	22.9	-1.3
1930	-2.7	-14.3	6.6
1981	-2.6	13.6	18.0
2012	-1.6	1.5	-3.4
2017	-1.5	-9.2	?
1992	-1.3	18.9	7.5
2018	-1.3	-12.2	?
1957	-0.9	13.2	3.1
1967	-0.8	18.5	9.3
1969	-0.8	22.3	3.4
1971	-0.7	1.8	9.6
2008	-0.6	-9.3	-7.7
1990	-0.3	-14.4	8.1
Average		**9.7**	**7.9**

Source: Ken French's cap-weighted US equity data since 1927, contrasting the cheapest 30% of the market with the most expensive 30% of the market.
https://mba.tuck.Dartmouth.edu/pages/faculty/ken.French/data_library.html
Data spans 1/1/1927-31/12/2019

When Will Value Shine?

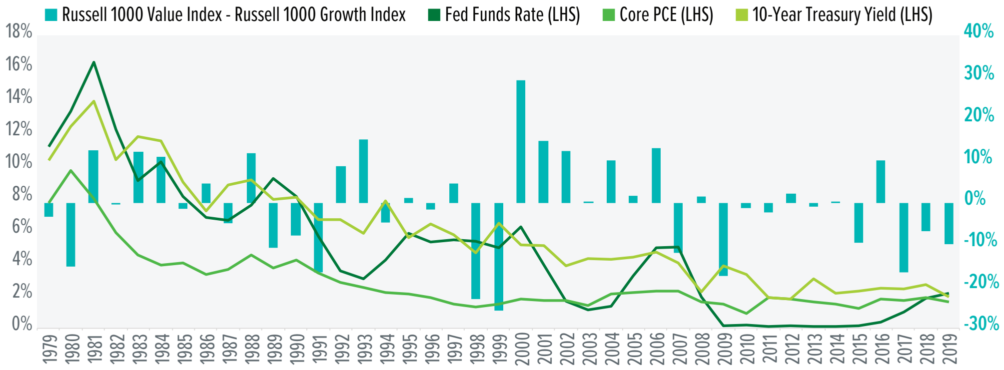
To the great disappointment of anxious value investors, there's no easy answer to this question. Looking at historical data does not give us a clear answer. Looking back to the 1980s, the US started the decade in a high interest-rate environment with corresponding high rates of inflation. For much of the 1980s, 1990s and 2000s, inflation declined until it stabilised right around the Fed's target of 2%[2]. In conjunction, interest rates (especially long-term rates) generally fell as well. Since the global financial crisis, interest rates and inflation have generally settled at historically low levels.

[2] Source: St. Louis Fed

All references to performance are in US dollar terms unless otherwise noted. For Professional Client Use Only–Not for Distribution to Retail Clients.

Exhibit 3 shows that the relative performance of value versus growth does not seem to be highly correlated to the environment for rates or inflation. We note, however, that value's performance has seemingly been worse during the recent periods of historically low rates, yet we offered 2016 as an example of a time period with low rates and value outperformance.

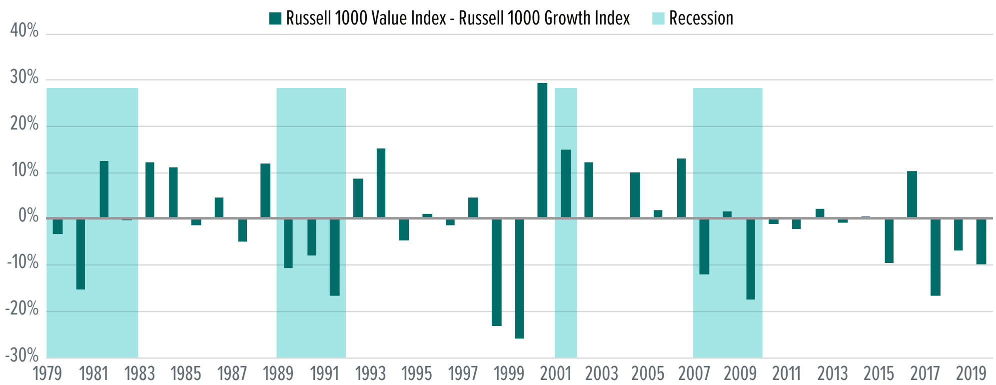
Exhibit 3: A Look at the Data Doesn't Show Much



Source: Bureau of Economic Analysis, Russell, SEI
Data spans 1/1/1979-31/12/2019, Past performance is not a reliable indicator of future results.

While the fundamental dispersions between growth and value are wide and the mispricing of stocks on either end (too optimistic or pessimistic) should be good for value, it is important to keep in mind that US markets are not in the "too pessimistic" scenario associated with bear markets and recession. Notably, as seen in Exhibit 4, the aftermath of recessions has often been a favourable period for value stocks versus growth stocks.

Exhibit 4: Post-Recession Recoveries are Often Good for Value



Source: Federal Reserve Bank of St. Louis, Russell, SEI
Data spans 1/1/1979-31/12/2019, Past performance is not a reliable indicator of future results.

If US markets continue their current trends, growth stocks may not implode, they may simply slow to allow their earnings to catch up to the multiple, enabling value stocks to gain on a relative basis.

Our View: A Little Perspective Please

Yes. Growth has clearly beat value. Yet, value investors made money. Returns for value have been positive, with the Russell 1000 Value Index up 11.79% annualised (a more than 200% cumulative gain) over the 10-year period ending at 31 December 2019. And let's not forget that US growth stocks have been the worldwide market leader. So value looks bad when compared to the absolute best-performing asset class in the world.

The performance of growth stocks has been dominated by the largest-capitalisation stocks, an environment that is typically challenging for active portfolio management.

Broadly speaking, active management as a whole, with its higher-volatility, smaller-cap and fundamental bias, is likely to experience an uptrend when larger-cap growth stocks eventually get recognised for the lack of upside in their valuations. Trees don't grow to the sky.

As passively-managed strategies remain unable to alter their index-tracking mandates, actively-managed US equity strategies have the ability to seek greater exposure to high-quality companies as the market moves into an environment in which companies are valued based on their fundamentals.

This value versus growth comparison begs the question: "What is your goal?" If your goal as an investor is to generate positive returns, value has delivered. If your goal as an investor is to deliver solid risk-adjusted returns over the long term, value has done that. If your goal as in investor is to compare your portfolio to whatever the absolute best-performing investment has been over any given time period, you are probably in for a lifetime of disappointment regardless of what your portfolio holds.