Union Investment

The great rotation

'Growth' vs. 'value' – which is the style of the moment ?

- **In recent years, growth stocks have been the top performers – but now, value stocks are making a comeback**
- **The fiscal policy environment and rising growth rates and yields are supporting value companies**
- **For now, growth stocks have reached the end of their long streak of outperformance**

June 2021

(Not) A question of style

‘Growth’ versus ‘value’ is one of the classic dichotomies of equity investing. On the one hand, we have aspiring companies with a great vision for the future that achieve high growth rates even in weaker phases of the economic cycle. On the other, we have established companies of solid value that are currently going through a weak patch in terms of profitability but have a good chance of turning things around. In the first camp, the search is on for the ‘next big thing’ that will merit a high valuation – an approach made popular by pioneers of growth investing such as Phil Fisher and Thomas Rowe Price Jr. The second camp follows Warren Buffett’s principle of investing in under-valued high-quality companies. A look at historical data reveals that there is good money to be made with both investment styles, although growth stocks have had an edge since 2007. But what about the present and the future? The coronavirus crisis is certainly moving the investment parameters. Does this spell the end of a long streak of outperformance for growth stocks?

Is the tide turning for growth stocks?

An analysis of the bare figures for the past twelve months (see chart 1) seems to suggest that there is little difference. Both growth and value stocks have generated a total return of almost 40 per cent over this period (MSCI AC World index in US dollars). But a closer look at the performance over time and an expansion of the analytical horizon show that some interesting shifts have been taking place below the surface. It is evident that each investment style has its phase – and in the COVID-19 cycle, things change quickly.

There is a time for every style

It helps to look at things chronologically: Between 2009 and the spring of 2020, the global equity markets experienced an unprecedented period of growth – minor setbacks aside – that started with the recovery from the financial crisis and lasted until the coronavirus crisis brought things to a halt eleven years later. But this bull market was special in more ways than just its long duration. Its driving force was also unusual. Broadly speaking, the profit growth

underpinning share price increases was not as significant as it had been in the preceding decade. Instead, investors were ascribing higher valuations to equities.

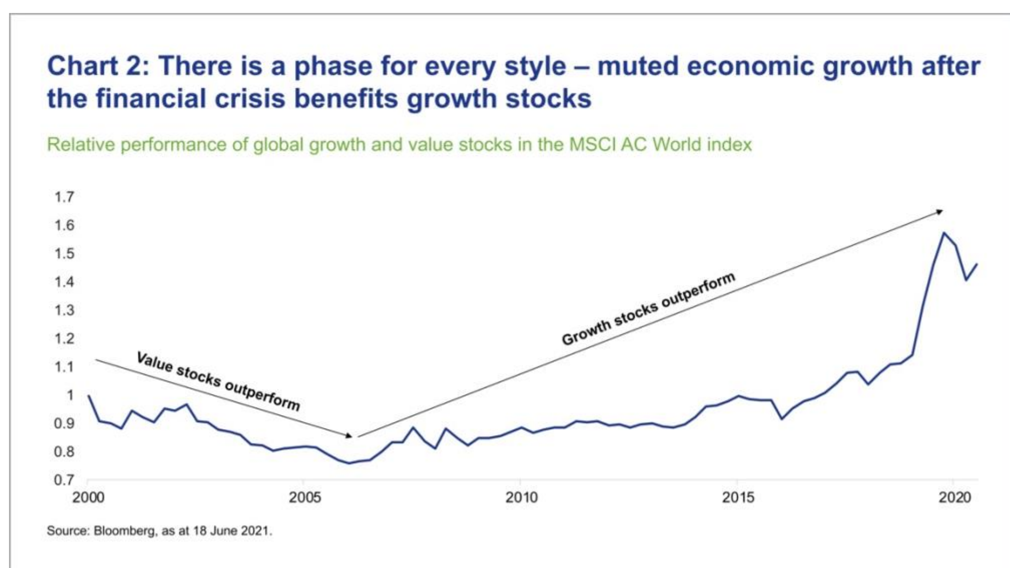
This phenomenon can be traced back to macroeconomic conditions. Compared with the period before the global financial and economic crisis of 2008/2009, (nominal) growth rates were relatively low in the past decade. Between 1980 and 2007, US GDP grew by around 3 per cent per year. After the crisis, growth slowed to just over 1 per cent. Economic growth in Europe was even more stunted as a result of the ensuing euro crisis. Inflation followed a similar trend, remaining at lower levels than before the financial crisis. This was at least in part due to structural effects linked to demographics and digitalisation.

Advantages of different styles dependent on phase of the economic cycle

All of these aspects need to be taken into account when assessing different investment styles in terms of their performance, which depends directly on the prevailing phase of the economic cycle and available alternative investment choices. Growth stocks are particularly popular with investors in times of weak growth in the wider market. When the economy is lacking momentum, as in the years leading up to the coronavirus crisis, investors favour companies that can grow even in these challenging conditions. In the recent past, these were primarily tech companies that – in an otherwise sluggish market environment – enjoyed a kind of upbeat ‘micro-climate’ fuelled by structural shifts towards greater digitalisation, the excellent scalability of their business models and their growing market power.

Chart 2: There is a phase for every style – muted economic growth after the financial crisis benefits growth stocks

Relative performance of global growth and value stocks in the MSCI AC World index



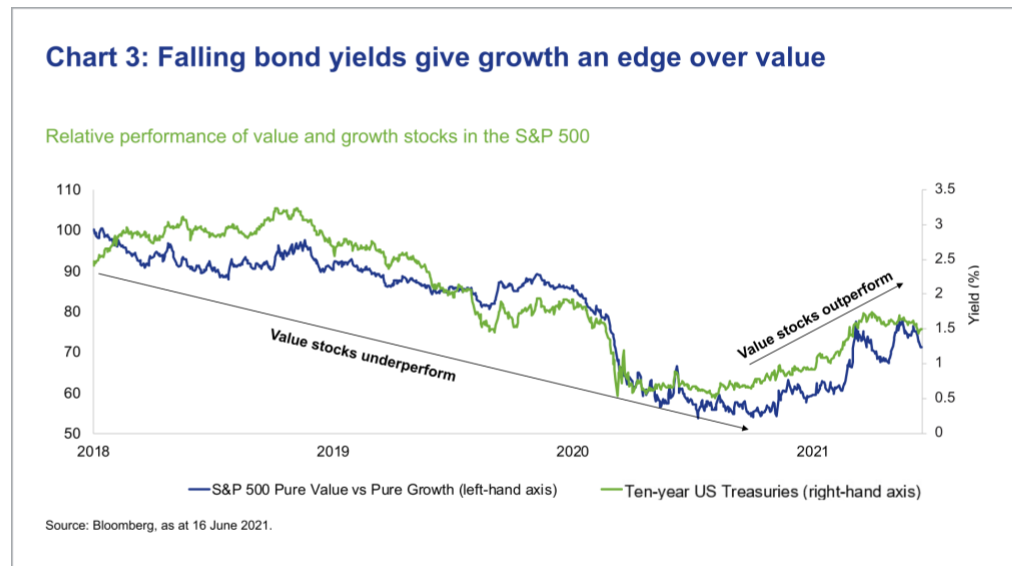
Source: Bloomberg, as at 18 June 2021.

Growth stocks have duration

Growth companies also typically offer a prospect of steady profits, although it can take (a long) time before these are distributed (in the form of dividends). The initial focus is growth. This means that, like bonds, growth stocks effectively have a long duration or period of capital commitment, which makes them more

sensitive to rising interest rates.[1] In the last decade, however, this was an opportunity rather than a risk. The expansionary monetary policy environment created by (in some cases huge) asset purchase programmes depressed bond yields and provided an added tailwind for growth stocks. This is especially true for the period since 2018, when yields on ten-year US government bonds

Chart 3: Falling bond yields give growth an edge over value



Source: Bloomberg, as at 16 June 2021.

dropped from 3.3 per cent to 0.5 per cent (see chart 3).

By contrast, the value approach focuses on equities from companies with substance, a strong market position and relatively stable profits that are undervalued at the time of investment. In addition, there is the potential for a 'turnaround story'. In the words of Warren Buffet: "A great investment opportunity occurs when a marvellous business encounters a one-time huge, but solvable problem."

Banking is a classic value sector

The early and mid-stages of the economic cycle typically provide the best conditions for a successful turnaround. Classic candidates are built on solid foundations, but in times of crisis, demand for their products weakens. During an economic upturn, demand picks up again strongly, although potentially with some delay, depending on the sector. The banking industry is a perfect example of a value sector. Customers' propensity to invest, and thus their demand for credit, is relatively low during an economic slowdown but increases as the economy recovers. The profitability of banks also improves when interest rates are raised, which is exactly what happens when inflation and growth rates are set to rise. Over the past few years, there has been little momentum behind either price levels or economic growth, creating tough conditions for value stocks.

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[1] The interest rate has an impact on the discounted present value of future cash flows.

Comparison of styles during the coronavirus crisis

But how have the two investment styles fared over the past 18 months or so since the beginning of the coronavirus crisis? One undeniable finding is that neither of the two styles was immune to the price crash in March 2020. But from a comparative point of view, there are distinctions to be made. While value stocks in the MSCI AC World index slumped by more than 37 per cent in US dollar terms from their high in mid-February to their low at the end of March 2020, growth stocks fell by less than 33 per cent. Growth stocks also had an edge during the subsequent recovery period in the first half of 2020. At the end of May, they had already returned to their level from the start of the year. Value stocks were still down by 18 per cent at this point and did not recover their pre-crisis shape until January 2021. A continuous outperformance of one equity investment style through two consecutive market phases is very unusual. How did it happen?

Growth stocks were riding high after COVID-19 ...

During this period, growth stocks were truly in a sweet spot. The coronavirus crisis further accelerated the digitalisation trend. This provided an additional boost for the 'growth-heavy' IT sector, which consistently outperformed the overall market in this phase. The concentration, and therefore the relative scarcity, of the few big growth stocks in the market further strengthened their valuation relative to value stocks.

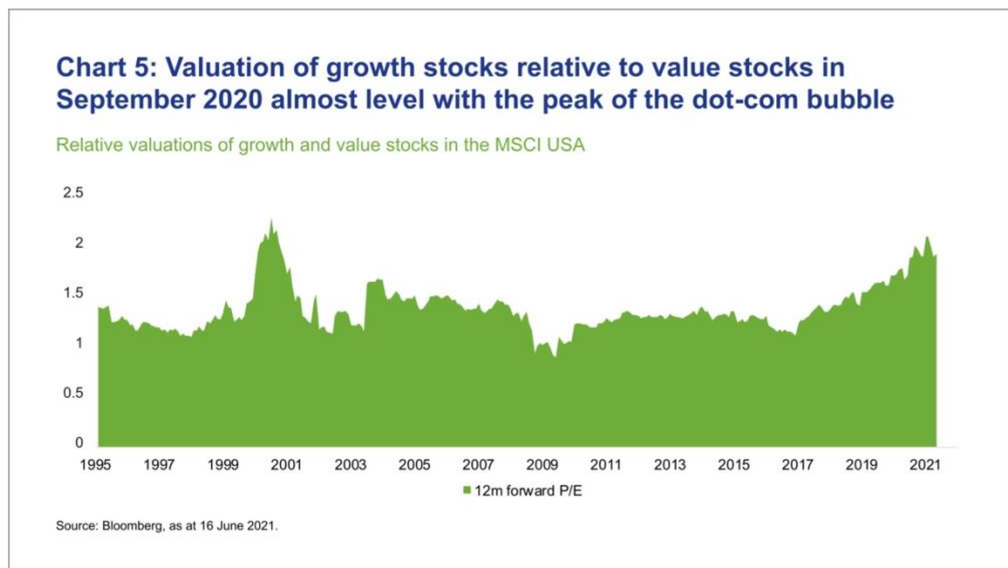
...but then the tide turned

In the third and especially the fourth quarter of 2020, the tide turned and value stocks were back in demand. This was mainly attributable to the prospect of a swift economic recovery accompanied by reflation, i.e. fiscal and economic policy measures that generate upward pressure on prices. The decisive factors in this context were:

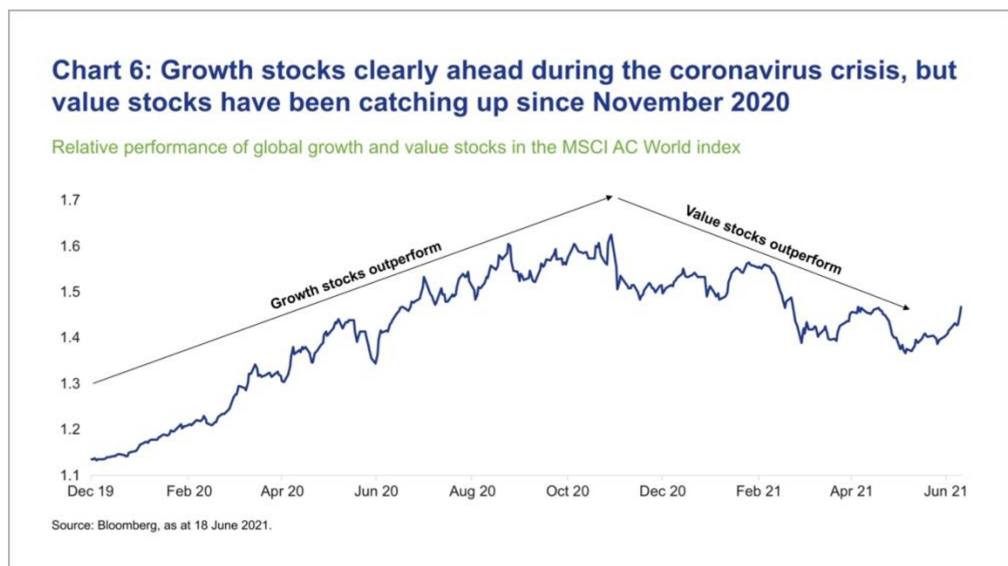
- the unprecedented scale of monetary and fiscal policy support that led to the adoption of the trillion-dollar American Rescue Plan and plans for an ambitious infrastructure programme, the American Jobs Plan, in the US,

- the successful development of vaccines, which – towards the end of 2020 – brought the prospect of a swift economic recovery in 2021 and a bounce-back of consumer spending within closer reach,
- the US Federal Reserve's strategic shift in September 2020 towards greater tolerance of temporarily higher inflation rates,
- and the surge in bond yields, driven by rising inflation expectations, which provided a prospect of higher interest margins for banks and weighed on growth stocks due to their inherent duration.

In addition, growth stocks were extremely overvalued in relative terms (see chart 5) on the back of their recent rally and investors' positions were heavily skewed, which accelerated the shift from growth to value.



Since early November 2020, the value stocks listed in the MSCI AC World index have gained around 37 per cent in US dollar terms – 9.4 percentage points more than the growth stocks in the same index. They have not quite



caught up on the lead that growth stocks had built up since the start of the coronavirus crisis, but there are clear indications of a temporary trend reversal (see chart 6).

The end of a long streak of outperformance by growth stocks

Value stocks benefit from the re-opening, a 'turbo cycle', the end of secular stagnation and rising yields

What lies ahead? The relative advantage of value stocks has diminished a little in recent weeks, but we are not expecting the balance to tip again. In fact, we believe that we are seeing the sun set on years of dominance of growth stocks and would put forward several reasons for this:

- Firstly, economies around the world are currently in the process of reopening. Progress on the vaccination front and falling case numbers have kick-started a revival of the US economy and Europe is following suit. These early and mid-cycle phases are accompanied by persistently strong fiscal policy support (e.g. in the form of freshly initiated infrastructure programmes on both sides of the Atlantic) that drives reflation.
- This leads to the second factor – a 'turbo cycle'. The output gap of national economies, i.e. the difference between potential and actual growth, will close more quickly than during previous upturns. In this scenario, infrastructure programmes laid out over several years create a sort of 'mini-boom'. The cyclical drop in inflation that would often occur under normal circumstances does not materialise. This supports value-oriented investing. At the same time, monetary policy remains expansionary. The Fed and the ECB see through the upward trend in inflation. Sudden interest-rate hikes are therefore not on the agenda and asset purchase programmes continue.
- Thirdly, chances are good that the period of 'secular stagnation' – chronically low nominal economic growth – is coming to an end. Strong fiscal stimulus with significant capital investment means that demand is not simply returning to pre-crisis levels. Instead, the economy is shifting to an altogether steeper growth trajectory. This approach differs fundamentally from that adopted after the financial crisis, when the focus (especially in Europe) was primarily on fiscal consolidation, and investment – for example in infrastructure (think digitalisation) – fell by the wayside. In addition, the structural parameters of inflation will change over the coming years as a result of decarbonisation plans, shifts in industrial policy, demographic trends and the reorganisation of global supply chains. The risk of inflation being too low or even tipping into deflation is decreasing, especially in the US. There is therefore the prospect of higher nominal economic growth rates in the coming years.
- The fourth factor is that higher bond yields are also relatively more favourable for value investments than for growth investments. After all, yields on ten-year German government bonds have risen by more than 40 basis points since the start of the year while yields on ten-year US Treasuries have climbed by more than 60 basis points.

Short-term favourites can change, but value may have an edge in the medium term

However, what the past few weeks have shown us is that these trends can change at short notice. Recently, the performance differential has been narrowing again. Based on data from the past four months, the performances of value and growth stocks in the MSCI AC World index are roughly on a par. Over the last four weeks, growth stocks have, in fact, gained around 4.5 percentage points on value stocks.

Neutral positioning until the end of the year

In terms of portfolio allocation, we are therefore planning to maintain a neutral position towards both investment styles until the end of the year, because the respective benefits and downsides are balancing each other out. The sustained economic recovery and moderately higher expected bond yields favour value investments, while growth stocks benefit from the fact that the positioning of investors is less skewed in their direction than at the height of the 'growth boom' and structural support for digitalisation and IT topics remains strong.

Value offers advantages over the long term

In our opinion, the phenomenon of growth stocks outperforming value stocks that we have seen in recent years will come to an end over the next five years. Against a backdrop of structurally higher nominal growth and the associated moderate rise in bond yields, we regard the premiums that have been paid for the 'growth' attribute until quite recently as no longer justified.

The focus is therefore increasingly shifting back to value investments. Solid companies, e.g. from the financial, pharmaceutical, energy, telecommunications and industrial sectors, have particularly strong upside potential in the current and upcoming phases of the economic cycle. There are also a number of companies with value characteristics in the technology sector, but these tend to be hardware manufacturers rather than the big platform operators that usually fall firmly in the growth camp. In addition, value-oriented indices typically comprise a much lower proportion of tech sector stocks than pure growth indices or (due to the huge weight of the tech giants) indices designed to track the overall market.

Value offers protection against inflation

From a medium- to long-term perspective, there is another argument in favour of value stocks: In times of rising prices, like the current economic phase, value stocks offer a certain degree of protection against inflation. Their lower 'duration' makes them more resilient in this environment than growth investments and banks in particular benefit from the fact that rising inflation expectations push up interest rates.

With regard to portfolio construction, there are two important aspects to consider. Firstly, careful stock-picking remains essential, even when pursuing a specific style. As previously mentioned, indices too can be classed as growth-focused or value-focused. But compared with a proactive selection of the most promising equities, index tracking leaves a lot of potential untapped. And secondly, it is crucial to be able to respond to sudden style rotations in a flexible manner.

Outperformance of growth stocks comes to an end

Compared with pre-coronavirus times, weightings can also be expected to shift more and more in everyday trading. Where the market was previously

dominated by the new ‘nifty fifty’ – a small number of flashy internet and tech companies and other businesses with strong brands – the comeback of value stocks is now heating up the competition. Looking ahead, the style allocation will therefore most likely settle somewhere between an overweight in value investments and a neutral positioning. For now, growth stocks seem to have reached the end of their long streak of outperformance.

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