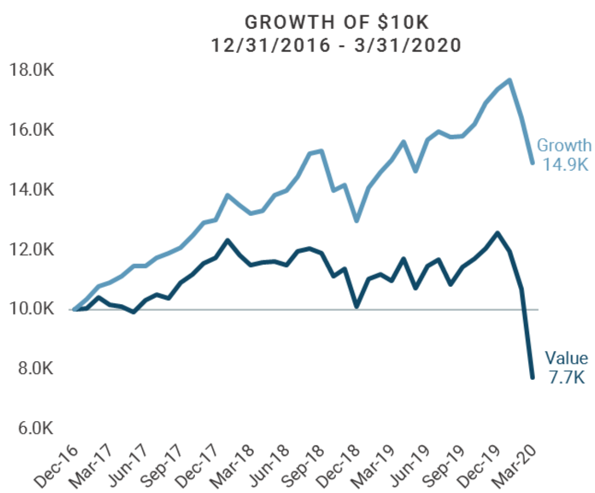
AN UNCOMMON OPPORTUNITY IN VALUE

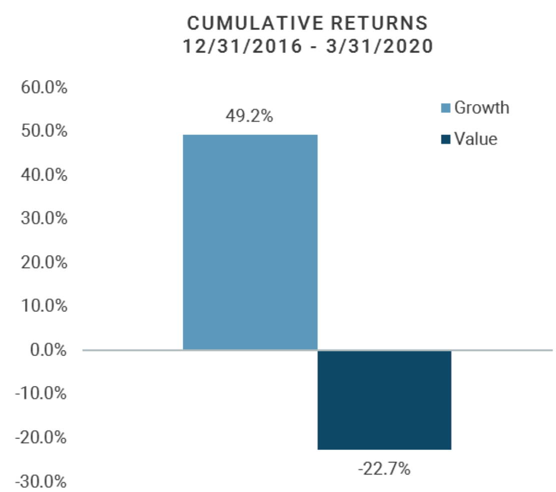
INTRODUCTION

- Value has underperformed growth by a nearly unprecedented magnitude in recent years.
- Valuation spreads are near historical highs.
- This dislocation creates an uncommon opportunity for active value investors.

A $10,000 investment in US growth stocks at the end of 2016 would have grown to $14,916 by March 31, 2020—a +49% cumulative return over the 3+ year period as shown in Chart 1. An equivalent investment in US value stocks would have *declined* to $7,730 over the same period—a -23% cumulative return. The 72 percentage point advantage for growth over the 3+ year period is the largest ever recorded in the 90+ year history of the database used; it surpassed growth's 69 percentage point advantage in the period ended June 2000, near the peak of the internet bubble. This is based on information from the Kenneth French Data Library, which dates back to 1926[1].

Chart 1: Short-Term Performance of Value vs. Growth





A rational investor would likely postulate that growth stocks generated considerably stronger earnings growth than value stocks over this period, which would explain the performance difference. This logical observer would be wrong. In the first quarter of 2020, year-over-year (trailing 12 month) earnings for the Russell 3000 Value Index declined -12% compared to -6% for the Russell 3000 Growth Index[2]. Over the entire 3+ year period, however, earnings (trailing 12 month) for the Russell 3000 Value grew by +25% compared to +27% for the Russell 3000 Growth. The performance difference over that period, therefore, was caused by changes in price

[1] Kenneth French Data Library, Tuck School of Business at Dartmouth College. Value stocks are highest 30% book-to-market, growth stocks are lowest 30% book-to-market. All stocks on NYSE, AMEX, and NASDAQ that have data.

[2] Source: Bloomberg. Based on cumulative growth in trailing 12 month EPS from 12/31/2016 to 3/31/2020. Note: we do not have earnings information for the Kenneth French data series so we use Russell indices as a proxy.

multiples. The price-to-earnings (P/E) ratio for the Russell 3000 Value *declined* by 30% while the P/E ratio for the Russell 3000 Growth *increased* by more than 10%. Earnings for value stocks are expected to decline more than growth stocks in the coming year, but not to the extent that would explain the large change in price multiples. This divergence in valuation multiples presented a formidable challenge for value investors. Questions about whether value investing is dead, broken or still relevant have resurfaced with great prominence—search the phrase "value investing performance" online to see what we mean.

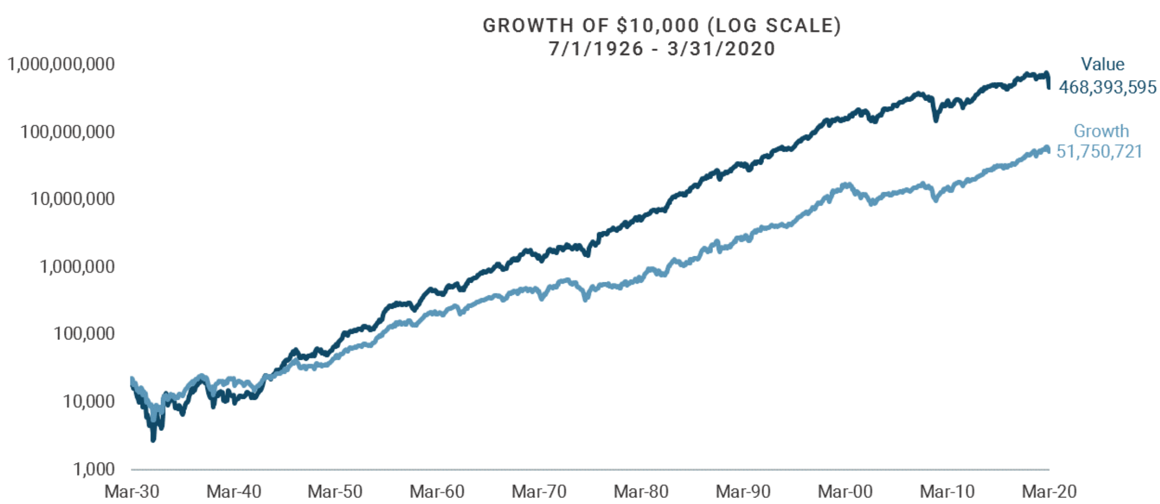
The last several years would be appropriately classified as a momentum market. Momentum markets are often emotion-driven and pay little or no attention to underlying business fundamentals or valuation. During the internet bubble, for example, stocks of companies with little or no earnings were bid up to high valuation multiples because investors either had unrealistic future growth expectations, or more likely, were caught up in the whirlwind of ever-rising stock prices. Fundamental analysis and valuation were relegated to the dustbin during this period, famously described by Alan Greenspan as "irrational exuberance." Level heads prevailed in the early 2000s as valuation relationships reverted toward more typical levels. Value managers that had been declared obsolete came back into vogue and enjoyed a prolonged period of considerable outperformance.

Hotchkis & Wiley (H&W) was one of these managers. We went from being outdated to stylish without changing a thing about the way we invest—adhering to a disciplined, long-term approach to fundamental valuation. We believed then, as we do now, that a business' fundamentals and the price you pay for an ownership stake in that business matter. This newsletter will explain how that philosophy applies to today's market and why we believe that 2020 represents an uncommon opportunity for value managers.

VALUE'S LONG-TERM TRACK RECORD

Using data from the Kenneth French Data Library, value has returned +12.2% annualized since 1926 compared to +9.6% annualized for growth. Due to the power of compound interest, this seemingly modest difference has an enormous effect over such a long period. A $10,000 investment in the growth portfolio in 1926 would have grown to about $52 million by March 2020, while $10,000 invested in the value portfolio would have grown to about $468 million—an amazing nine times the size of the growth portfolio, even after the recent sharp selloff (see Chart 2). Albert Einstein once quipped, "Compound interest is the eighth wonder of the world. He who understands it, earns it…he who doesn't, pays it."

Chart 2: Historical Performance of Value vs. Growth



CAUSE OF THE RECENT VALUE/GROWTH DIVERGENCE

Today is not 1999. While individual exceptions exist, it does not appear that the divergence between growth and value in recent years was triggered by investor greed and unreasonable optimism. In the long run, the earnings and cash flow that a company generates relative to market expectations (i.e., valuation) dictates stock performance. These factors also matter in the short-term, but investor sentiment and short-lived fads/manias can also have considerable influence; this makes short-term performance attribution difficult. There are numerous theories that may explain the cause of today's unprecedented divergence. Scarcity of growth, a preference for non-cyclicals, and low interest rates are among those we believe have the most efficacy.

Scarcity of growth

Forecasts for global economic growth have declined in recent decades. Most point to demographics as the primary among several reasons for more muted economic growth (e.g., slowing and aging population). As overall growth slows, companies with the potential for above-GDP growth are increasingly coveted. In today's market, such companies are disproportionately found in what is often referred to as TECH+, or technology plus technology-related companies in other sectors (e.g., Amazon.com). This group represents well over 40% of the Russell 3000 Growth Index but less than 10% of the Russell 3000 Value Index, and has massively outperformed in recent years.

A preference for non-cyclicals

Unlike the internet bubble, investors have exhibited a palpable aversion to risk, or at least an aversion to what is perceived as risky. Since the financial crisis of 2008/09, global expansion persisted for more than a decade. While the pace of growth was more moderate than prior expansionary periods, its duration was longer. As nascent signs of economic slowdown surfaced, investors began discounting a near-term recession. Consequently, economically-sensitive market segments underperformed their less economically-sensitive counterparts. Cyclical areas of the market comprise larger portions of value portfolios relative to growth, which has been a headwind for value. Energy and Financials, for example, comprise 3% of the Russell 1000 Growth Index but 30% of the Russell 1000 Value Index—these cyclical sectors were the two worst performers during the first quarter of 2020.

Low interest rates

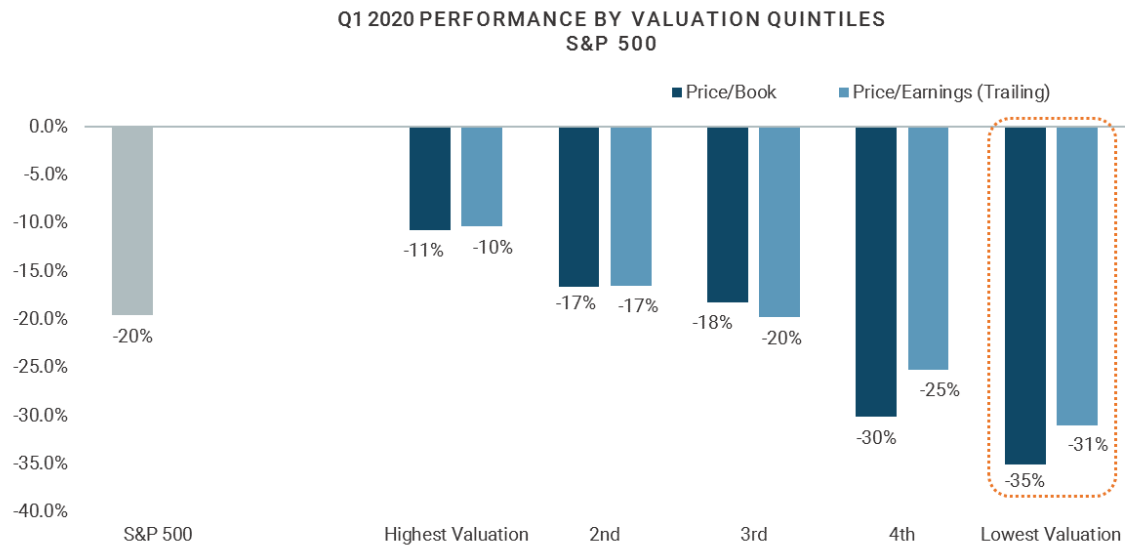
Low interest rates are good for equities. It reduces the cost of debt and lowers the rate at which future cash flows and/or dividends are discounted. This makes sense because fixed income alternatives become less attractive relative to equities. We have contemplated arguments that low rates should benefit growth equities more than value equities. The basis for the argument is that value equities generate cash flows and pay dividends sooner than growth equities. Put another way, a larger percentage of a typical growth equity's intrinsic value is derived from its terminal value estimate, which is far into the future. Like bonds, a longer duration equity is more sensitive to interest rates and therefore should benefit more when rates are low. We agree with the principles of this argument, however, we disagree with the insinuation that value managers do not consider earnings growth when analyzing a company. We own a position that trades at roughly 30x earnings generated last year, which is a rich valuation multiple. Because we expect earnings to grow quite rapidly, however, the stock trades at a much lower level of future earnings. Therefore, the valuation looks attractive despite its typical label as a growth stock (we are also attracted to its net cash balance sheet and a competitively-advantaged business). This is a longer duration security but one we consider attractively valued. There are numerous examples like this, which weakens the argument that low interest rates benefit growth stocks more than value stocks—it is possible but not certain.

We note the financial sector is a possible exception. Like other areas of the market, financials should benefit from a lower discount rate. Unlike other areas of the market, however, earnings of select financials would be reduced in a lower rate environment because the gap between interest earned and interest paid typically narrows (i.e., the net interest margin compresses). Financials comprise a significantly larger portion of value portfolios than growth portfolios, which has presented an additional headwind for value.

COVID-19 & VALUATION SPREADS

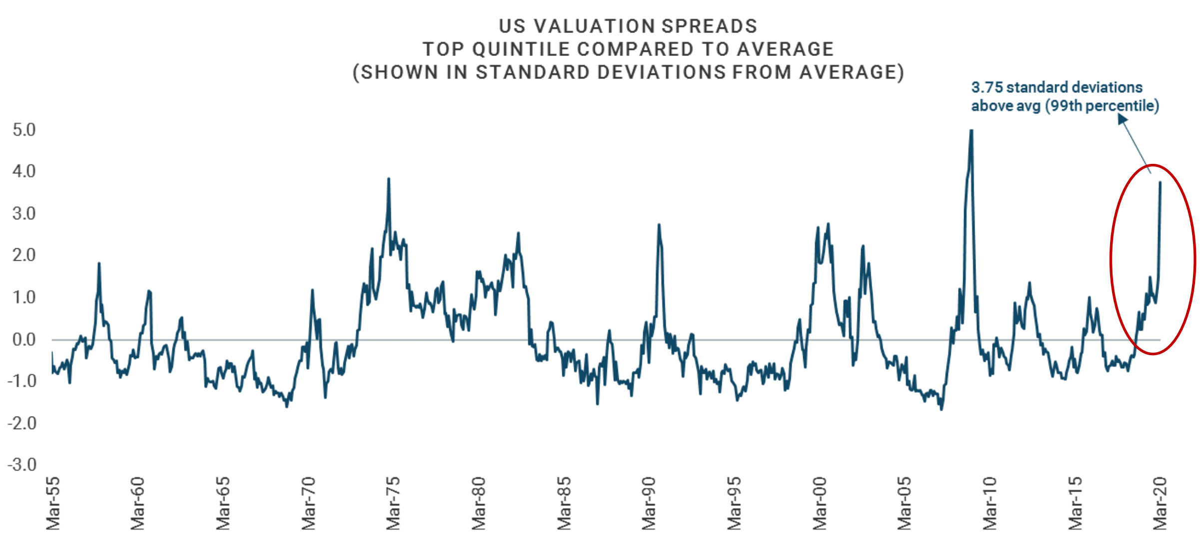
The COVID-19 pandemic exacerbated each of these factors. Growth became scarcer, economically-sensitive stocks were punished, and central banks employed easy monetary policy, reducing interest rates further. Value's disproportionate exposure to these factors caused it to underperform, with the most deeply discounted stocks performing worst (see Chart 3).

Chart 3: Q1 2020 S&P 500 Performance



Value spreads—the valuation gap between growth stocks and value stocks—went from wider-than-average to near record levels. Chart 4 shows valuation spreads as calculated by Empirical Research Partners. To oversimplify, a high positive value represents a period where the gap between expensive stocks and inexpensive stocks is wide; a negative value represents a period where the gap is narrow. When COVID-19 concerns began to run rampant, this gap widened to 3.75 standard deviations which placed it in the 99th percentile historically—it has only been wider during the trough of the financial crisis.

Chart 4: Historical Valuation Spreads as of March 31, 2020



While the previous chart uses a variety of valuation metrics to calculate spreads, we isolate price-to-book in Chart 5 to illustrate the widening of valuations between growth and value indices. The Russell 1000 Growth trades well above its historical average while the Russell 1000 Value trades below its historical average. As a result, the gap between the two is abnormally wide.

Chart 5: Historical Valuation Spreads – Price-to-Book as of March 31, 2020

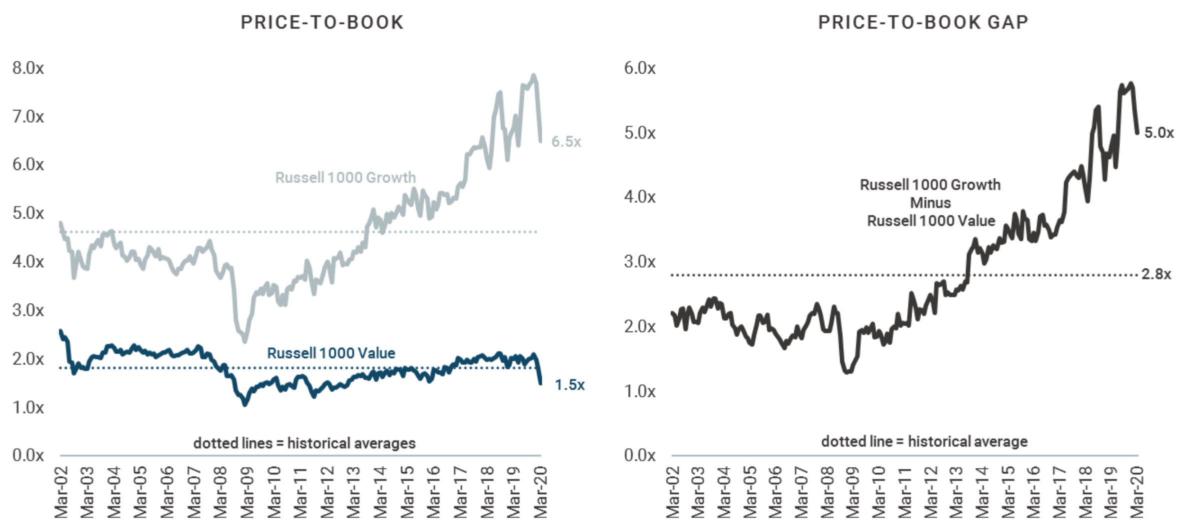
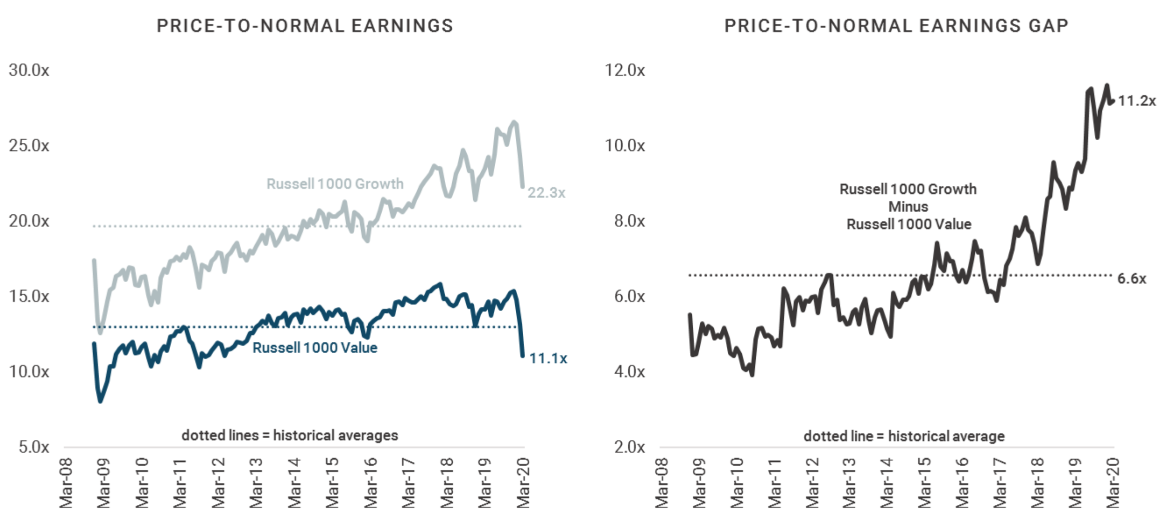


Chart 6 depicts a similar relationship but using price-to-normal earnings rather than price-to-book. Unlike current earnings, normal earnings reflect the reversion of companies' margins and returns on capital toward equilibrium economic and competitive conditions. Using this metric, we observe a similarly wide valuation gap between growth and value. We observe similarly wide valuation gaps using any common valuation metric.

Chart 6: Historical Valuation Spreads – Price-to-Normal Earnings as of March 31, 2020

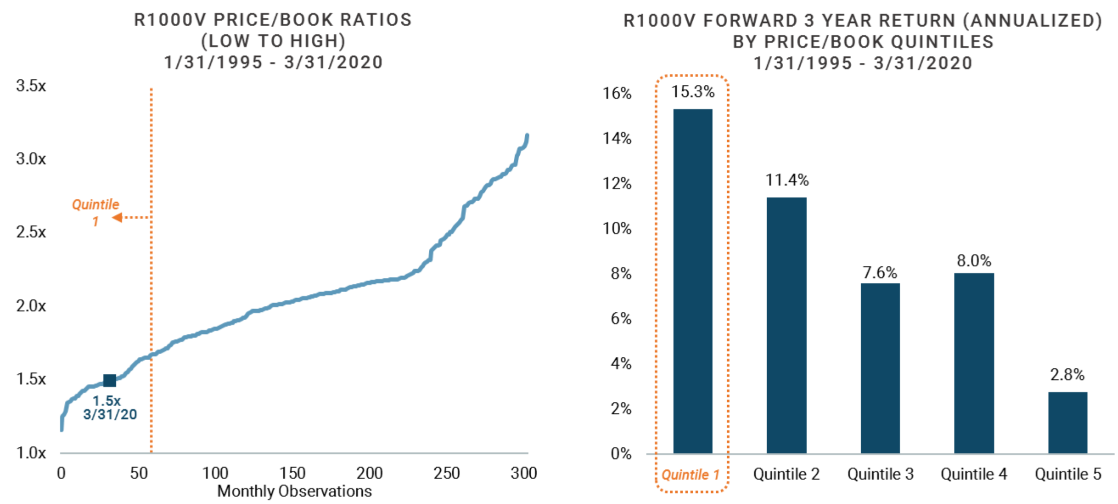


LOOKING AHEAD

Timing a reversion toward more normal value relationships is challenging; however, we view current dislocations as extreme and unsustainable. We believe the valuation gap will narrow as economic conditions normalize and investors refocus on underlying business fundamentals and valuation. As shown in Chart 5, the price-to-book ratio of the Russell 1000 Value is below its historical average. In fact, it trades in the 89th percentile of its own history (i.e., it has only been lower 11% of the time).

Chart 7 highlights how the index has performed subsequent to similar periods. It shows that when the index's price-to-book is in the lowest quintile, as it is today, its average return over the ensuing three-year period has been +15.3% per year. This is considerably higher than returns following periods of more elevated valuation levels.

Chart 7: Historical Value Performance (Index)



While this information makes a convincing case for value, it does not fully capture the scope of today's opportunity. Not only are there wide gaps across growth and value, there are also large valuation gaps *within* the value opportunity set. We believe that disciplined value managers with a long-term focus can create a portfolio with superior prospects to passive alternatives, thus, the opportunity for *active* value is especially compelling. Chart 8 is similar to Chart 7, except it shows a representative H&W Large Cap Fundamental Value portfolio "H&W LCFV" instead of the index (the period shown differs somewhat due to data availability). The portfolio is not just trading at a large discount relative to its history; at 1.0x book value it trades at a ~50% discount to the Russell 1000 Value Index. Historically, the portfolio has performed quite well subsequent to similar periods in the past.

Chart 8: Historical Value Performance (H&W Portfolio)

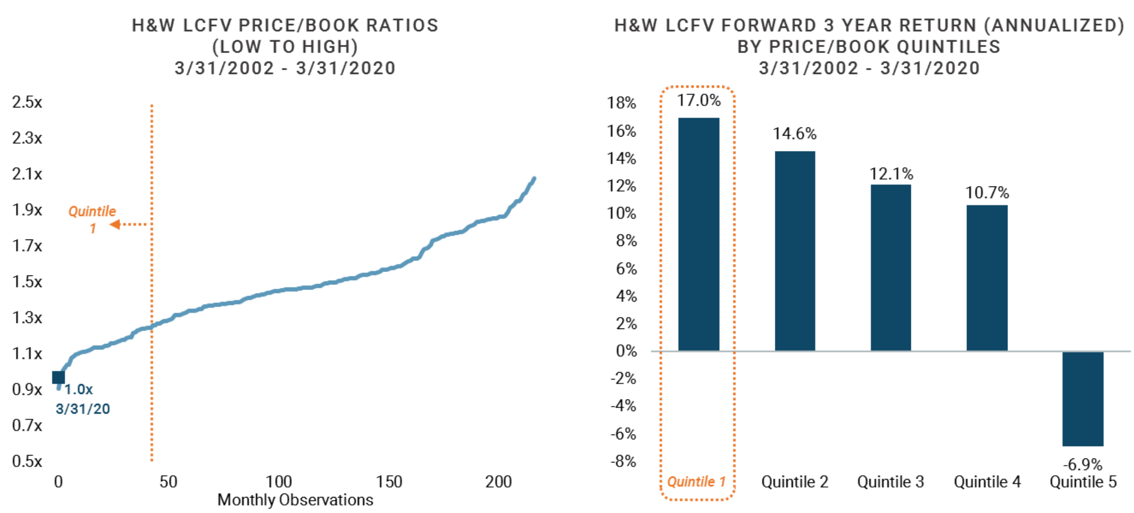
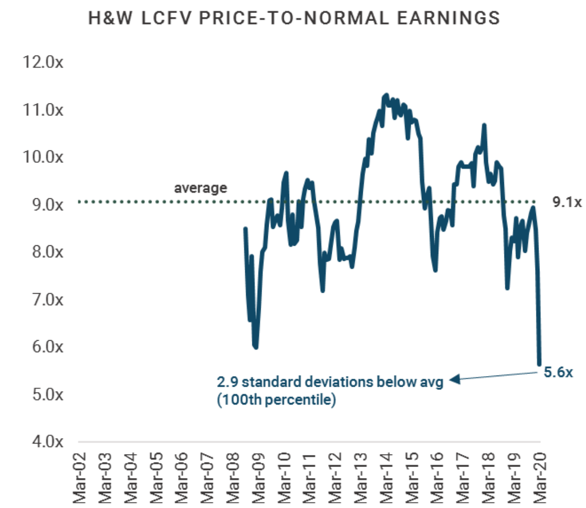


Chart 9 shows the price-to-normal earnings ratio of the H&W LCFV portfolio in absolute terms (left) and relative to the benchmarks (right). We have reliable normal earnings data going back to 2008. The price-to-normal earnings ratio for the Russell 1000 Value trades well below its historical average, but because the portfolio trades at an all-time low its discount to the index is still wide—3.3 standard deviations wider than normal, in fact, which is the widest it has ever been.

Chart 9: H&W Historical Valuation – Price-to-Normal Earnings as of March 31, 2020



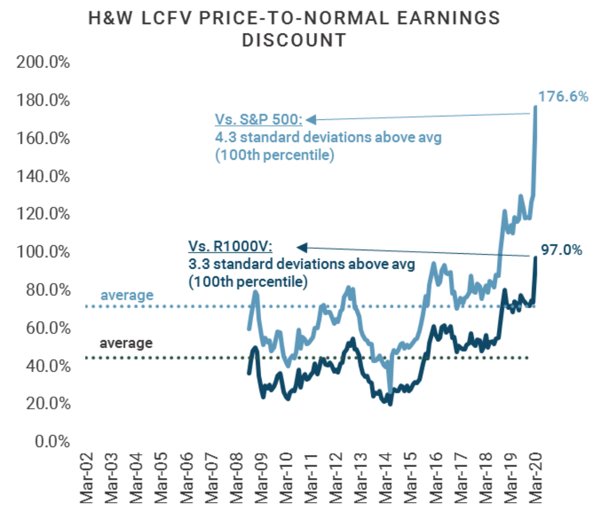
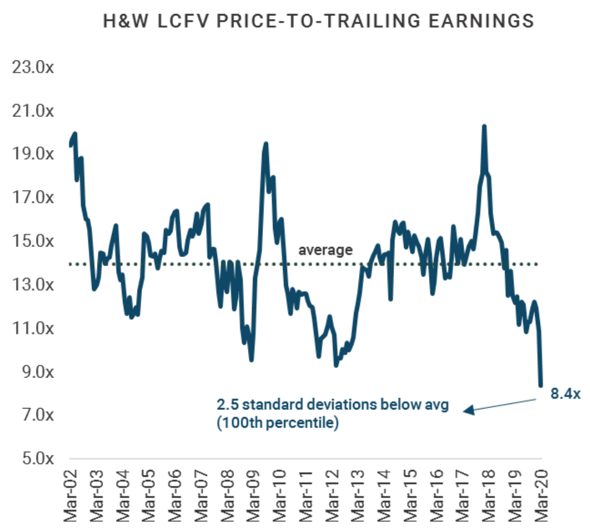
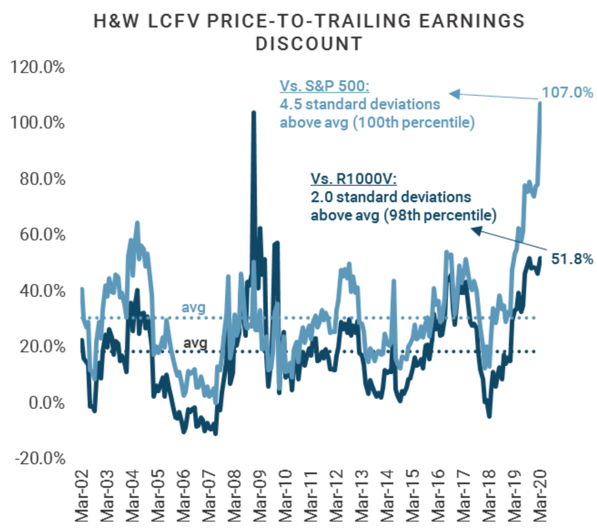


Chart 10 shows the price-to-trailing earnings (rather than normal earnings) ratio of the H&W LCFV portfolio in absolute terms (left) and relative to the benchmarks (right). The portfolio also trades at a record valuation level based on this valuation metric, and near a record level relative to the Russell 1000 Value Index (98th percentile).

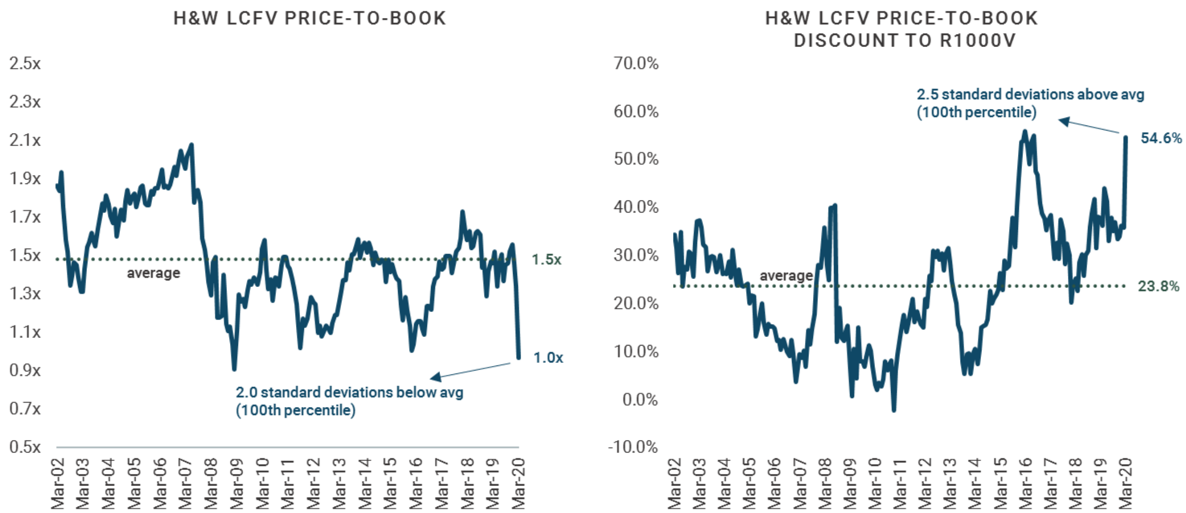
Chart 10: H&W Historical Valuation – Price-to-Trailing Earnings as of March 31, 2020





We observe a similar relationship using the price-to-book ratio, as depicted in Chart 11. The H&W LCFV portfolio trades at a record level in absolute terms (left chart) and relative to the benchmark (right chart).

Chart 11: H&W Historical Valuation – Price-to-Book as of March 31, 2020



The opportunity for active value is summarized in Chart 12. The chart shows the H&W LCFV portfolio relative to the Russell 1000 Value and Growth indices, respectively. While the discount to growth is enormous, the discount to the value index is near record levels as well.

Chart 12: Active Manager's Valuation Discount as of March 31, 2020

CONCLUSION

Current valuation spreads are unsustainably wide and are likely to revert toward normal levels. The impetus and timing of this normalization remains uncertain. A potential catalyst includes increased visibility into the economic recovery from COVID-19, which could refocus investors' attention toward economic fundamentals and valuation. Often times it is value companies' ability to generate earnings and cash flows above low expectations and/or growth companies' inability to outperform lofty expectations that triggers a reversion. Perhaps the market will simply recognize that the current dislocation is too far from economic reality and react accordingly. Whatever the catalyst, we are confident a reversion toward normal value relationships will occur as the current dichotomy does not reflect rational behavior or reasonable economics. The wider the valuation gap becomes, the more powerful and long-lasting the reversion should be. We believe this creates an uncommon opportunity for disciplined, active value managers that emphasize business fundamentals and valuation.

All investments contain risk and may lose value. A value-oriented investment approach involves the risk that value stocks may remain undervalued or may not appreciate in value as anticipated. Value stocks can perform differently from the market as a whole or from other types of stocks and may be out of favor with investors and underperform growth stocks for varying periods of time. Value and growth investing styles will go in and out of favor during different economic environments. Growth investing tends to work well during speculative, momentum-driven markets, while value investing tends to work well following recessionary periods.

Data sources and other disclosure notes:

Charts 1&2: Kenneth French Data Library, Tuck School of Business at Dartmouth College. Value stocks are highest 30% book-to-market, growth stocks are lowest 30% book-to-market. All stocks on NYSE, AMEX, and NASDAQ that have data. “Growth of $10,000” charts reflect a hypothetical investment in “Value” and “Growth” stocks in the scenarios presented. Use of different inception dates and/or time periods may result in significantly different values (dollar amounts).

Chart 3: Bloomberg, Standard & Poor’s, H&W; Chart 4: Empirical Research Partners; Charts 5-12: Bloomberg, H&W.

Charts 8-12: Representative Large Cap Fundamental Value portfolio; client portfolio holdings may vary due to different restrictions, cash flows, and other relevant considerations.

Market Disruption: The recent global coronavirus pandemic has caused and continues to cause disruption in the global economy, unprecedented business and travel disruption and extreme fluctuations in global capital and financial markets. The pandemic may lead to a decline in business and consumer confidence and spending and presents the risk of an economic recession around the globe. The severity and extent of the impact of the pandemic on the U.S. and global capital and financial markets and economies will depend largely on future developments, all of which are highly uncertain and cannot be predicted. This situation is changing rapidly, and additional impacts may arise that we are not aware of currently. H&W is unable to predict the consequences of the upheaval caused by coronavirus pandemic, which, depending on the severity and the length of the outbreak, has the potential to negatively impact the firm’s investment strategies (including the strategies’ performance), and reduce available investment opportunities.

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