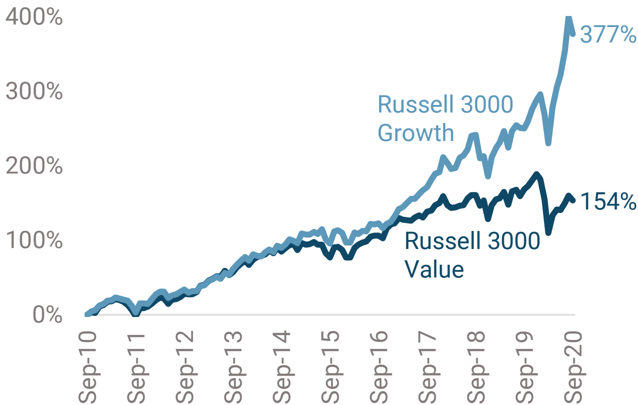
# THE REVIVAL OF VALUE INVESTING

**"If something cannot go on forever, it will stop."**

**-Herbert Stein (1916-1999), American Economist**

The quote above is known as Stein's Law, named after the late economist Herb Stein, former Chair of the Council of Economic Advisers during the Nixon administration (also father to writer/lawyer/actor/comedian Ben Stein). It has been used to explain why certain costs like healthcare or education cannot rise faster than wages forever—at some point the costs would surpass total wages leaving no room for indulgences like food and shelter. It has also been used to explain future population growth, which cannot grow exponentially in the future as it has in the past due to finite physical space and natural resources. In our view, Stein's Law also applies to the prolonged outperformance of growth stocks relative to value stocks (see Chart 1), which we believe will reverse in a formidable way. This paper will highlight the current opportunity for value relative to growth, describe the unique opportunity within value, and finally address the most common counterarguments put forth by growth advocates.

**Chart 1: Cumulative Performance, Last 10 years**
As of September 2020




## VALUE vs. GROWTH

The performance divergence has produced a massive gap between the valuations of growth stocks relative to value stocks (Charts 2 & 3), which we have a hard time justifying via rational economic reasoning.

**Chart 2: Forward P/E (FY2), Last 10 Years**
As of September 2020

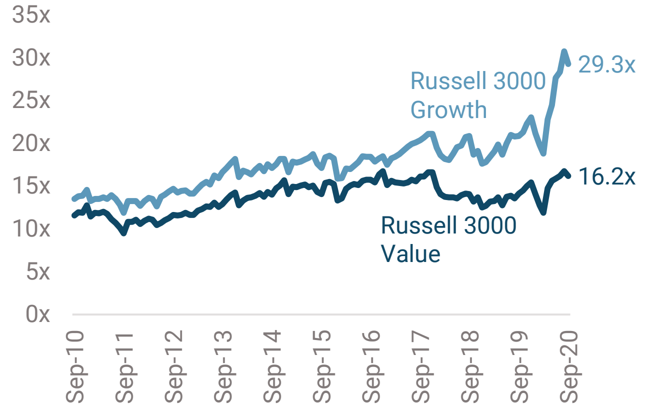
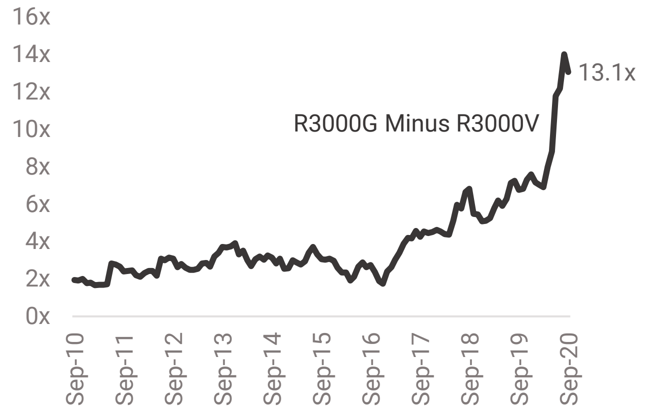


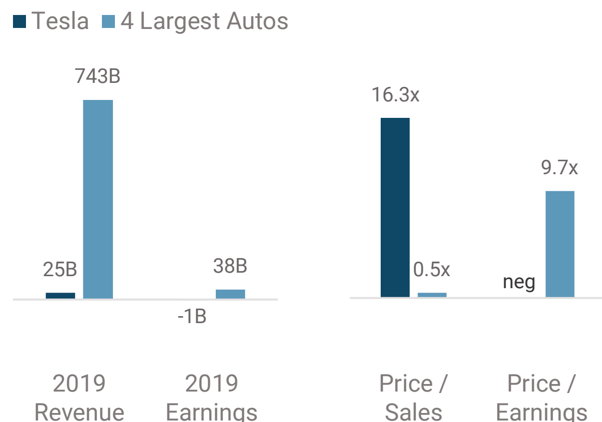

**Chart 3: Forward P/E Gap (FY2), Last 10 Years**
As of September 2020




To illustrate the growth/value dichotomy, consider the current state of the global auto industry. The market cap for Tesla is $400 billion. The market cap for the next four largest global auto manufacturers (Toyota + Daimler/Mercedes Benz + Honda + GM) is $364 billion. For the price of Tesla, you could buy those four companies and keep the leftover $36 billion for a rainy day. Last year, Tesla generated $25 billion in revenue compared to $743 billion for the group of four. Tesla's earnings were negative while the foursome generated $38 billion in earnings. Purchasing $38 billion in earnings compared to $25 billion in revenue seems like a better option at the same price, let

alone a discount. Note that this example uses the 4 largest autos by market cap after Tesla, which are not necessarily the most attractive opportunities. H&W owned autos trade at 0.3x price/sales, 7.1x price/earnings (trailing), and 4.3x price/normal earnings.

**Chart 4: Auto Industry Statistics**
As of September 2020




The dichotomy between growth and value goes well beyond the auto industry. Chart 5 shows consensus earnings per share estimates over the next five years for representative value and growth stocks[1], each from a different sector. Even if earnings grow as expected for Amazon and Netflix, earnings per share in year five will represent just 4% of its current share price. To justify the valuations, one must have confidence that these companies can grow very fast for a very long time. In our opinion, that is a risky proposition.

Meanwhile, earnings per share in year five for Citigroup and Anthem represent 23% and 13% of its current share price, respectively. This represents attractive valuations and provides wiggle room for unexpected hurdles along the way. Benjamin Graham noted in *The Intelligent Investor*, "The margin of safety is always dependent on the price paid." The value examples could encounter challenges and still produce earnings per share that would represent an attractive percentage of its share price. The growth examples earnings per share appears paltry as a percentage of its share price even without any missteps. Let us borrow an analogy conceived by Warren Buffett: If we were driving a 3,000-pound car and came upon a bridge certified for 10,000 pounds, we would comfortably cross; if we were driving a 9,900-pound truck, we would seek an alternate route.

**Chart 5: Consensus Earnings Estimates**
As of September 2020

| | | Value Examples | | Growth Examples | |
|---|---|---|---|---|---|
| | | Citigroup | Anthem | Amazon | Netflix |
| Share Price ($) | | 43 | 269 | 3149 | 500 |
| Consensus EPS ($) | 2021 | 3 | 23 | 48 | 7 |
| | 2022 | 6 | 25 | 60 | 9 |
| | 2023 | 8 | 28 | 78 | 12 |
| | 2024 | 9 | 32 | 97 | 16 |
| | 2025 | 10 | 35 | 114 | 19 |
| Earnings Yield | 2021 | 8% | 8% | 2% | 1% |
| | 2022 | 14% | 9% | 2% | 2% |
| | 2023 | 19% | 11% | 2% | 2% |
| | 2024 | 20% | 12% | 3% | 3% |
| | 2025 | 23% | 13% | 4% | 4% |

*Value vs. Growth Conclusion*

The current dichotomy between value and growth is near record wide levels. This is difficult to justify based on sound fundamental logic, and we view the relative attractiveness of value as among the most compelling in our firm's history.

## OPPORUNITIES WITHIN VALUE

As previously addressed, the valuation gap between growth and value indices is wide. The opportunities within value indexes/universes also varies greatly, and there are even some traditional growth stocks that appear to trade at considerable discounts to intrinsic value. This can be observed by the H&W Large Cap Fundamental Value portfolio's valuation compared to the Russell 1000 Value Index, as shown in Chart 6. The index is slightly above its historical average while the representative portfolio trades significantly below its historical average. As a result, the portfolio's discount to the index is at record levels, as shown in Chart 7.

[1]Stock examples are for illustration purposes and should not be considered investment recommendations. The companies were selected due to their general "value" and "growth" characteristics. There is no guarantee on the future performance of these companies. H&W's opinion of the securities are subject to change without notice.

**Chart 6: Price/Normal Earnings**
As of September 2020

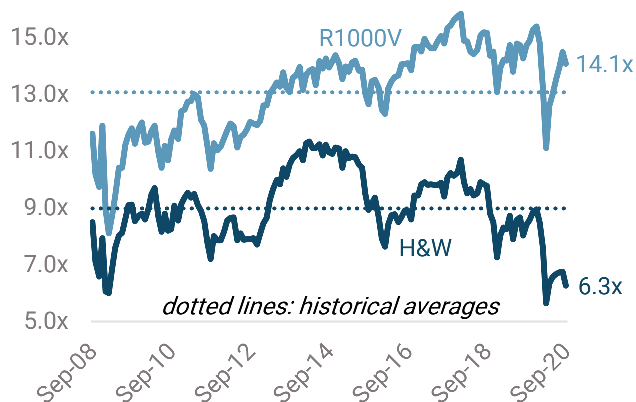



**Chart 7: Price/Normal Earnings Discount H&W vs. Russell 1000 Value**
As of September 2020

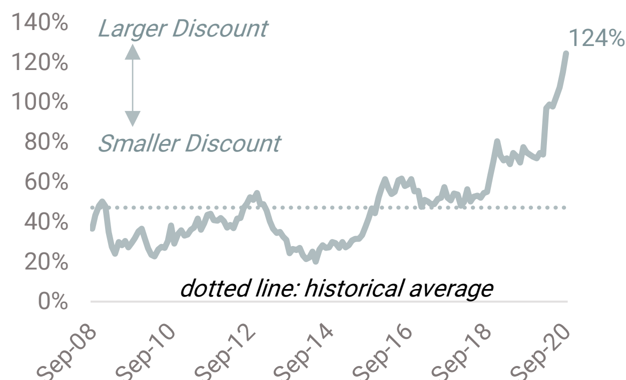



**Chart 8: H&W Active Share**
As of September 2020

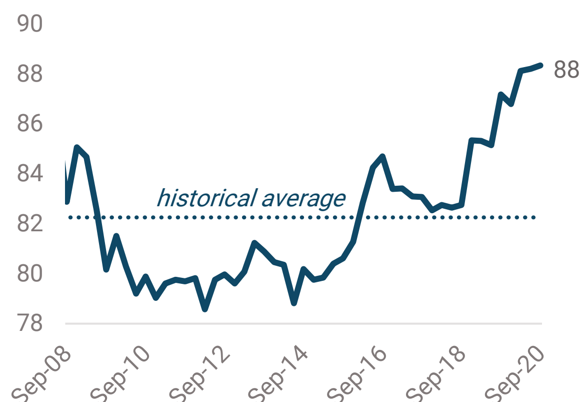
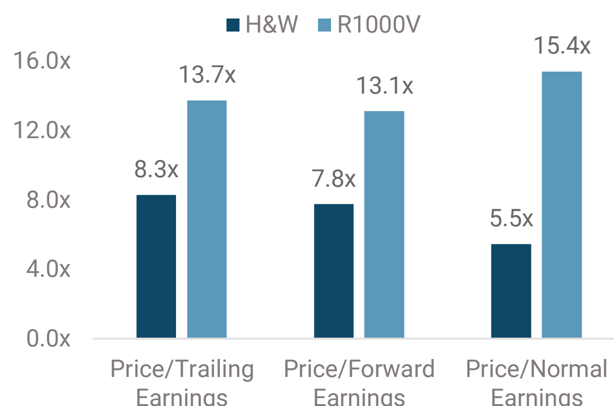



**Chart 9: PE Ratio of Top 10 Positions**
As of September 2020




Acquiring such a large discount to the value benchmark requires two simple things: 1) a portfolio that is very different than the index, and 2) a portfolio invested in stocks trading at exceedingly attractive valuations. Chart 8 shows the H&W Large Cap Fundamental Value portfolio's active share historically. The opportunities within value have diverged and become increasingly selective. Consequently, the portfolio's active share has risen to all time highs in recent years, reflecting our conviction in the positions we own. The reason behind the conviction is the rarely observed attractiveness in valuations, particularly among our most heavily weighted positions, as highlighted in Chart 9.

### *Opportunities Within Value Conclusion*

While the dichotomy between growth and value is extreme, so too are the opportunities within the value universe. We view this as highly conducive for active managers, as the current environment represents an uncommon opportunity to create a portfolio with risk/return characteristics considerably better than passive alternatives.

While we are confident that valuations will converge toward historical/normal relationships in a powerful way, we thought it would be appropriate to acknowledge the *WHY THIS TIME IS DIFFERENT* advocates who believe the divergence will persist, or even continue widening. The most provocative points of view in favor of growth, which we will address in the next two sections are:

1. Growth stocks represent higher quality companies compared to value stocks
2. Low interest rates are better for growth stocks

## Argument #1: Growth stocks represent higher quality companies compared to value stocks

Merriam-Webster defines "quality" as something's *degree of excellence*. Unfortunately, this is an awfully subjective term that cannot be easily quantified to compare businesses. Be that as it may, we gave it an honest attempt. Below are lists of the 20 largest companies in the Russell 1000 Value and the 20 largest companies in the Russell 1000 Growth. Our initial observation is that there are high quality businesses on both lists. We acknowledge, however, that the growth list might have a quality edge because some of its constituents represent truly exceptional businesses—wide competitive moats, low capital intensity, compelling growth (e.g. Apple, Microsoft, Alphabet). As an active manager, we are willing and able to own such businesses so long as the market value trades at a considerable discount to its intrinsic value. In fact, if you combine our two US Large Cap strategies[2], we own an equivalent number of stocks from the value list as from the growth list (3 from each).

| Value | Growth |
|---|---|
| Berkshire Hathaway | Apple |
| Johnson & Johnson | Microsoft |
| JPMorgan | Amazon |
| Verizon | Alphabet |
| Disney | Facebook |
| Intel | Visa |
| Comcast | Nvidia |
| Pfizer | Tesla |
| AT&T | Mastercard |
| Walmart | UnitedHealth Group |
| Procter & Gamble* | Adobe |
| Bank of America | Paypal |
| Cisco | Netflix |
| Home Depot* | Salesforce.com |
| Exxon Mobil | Merck |
| McDonald's | Nike |
| Medtronic | Procter & Gamble* |
| Nextera Energy | Amgen |
| Danaher | Home Depot* |
| Chevron | Abbvie |

*on both lists

We will now compare these value and growth groups by analyzing some of the more common metrics used to determine business quality: return on equity ("ROE"), return on invested capital ("ROIC"), free cash flow ("FCF"), and operating income. For each of these metrics, the higher the better, and the more consistent the better.

**Chart 10: ROE and ROIC, Median of Last 10 Fiscal Years**
As of September 2020

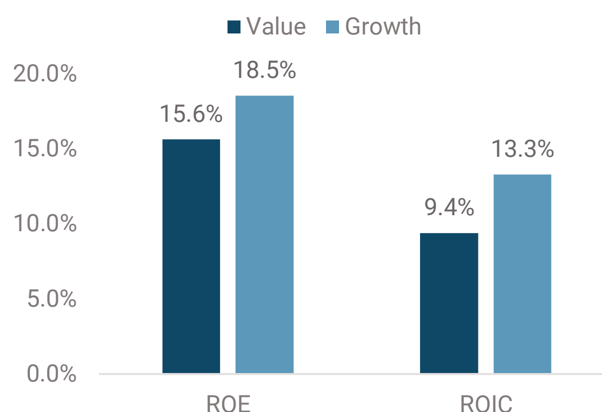
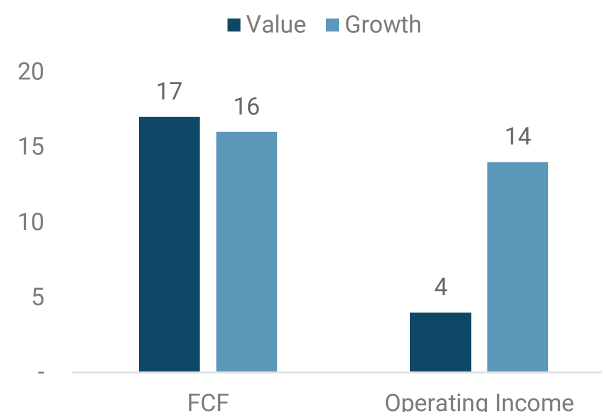



Chart 10 shows growth's median ROE and ROIC has been moderately higher than value's over the past decade. There are a couple of observations to note. First, the absolute ROE and ROIC levels are elevated compared to what would be expected over a longer period due to the generally constructive economic landscape over the past decade. Second, and more important, the *range* of ROE and ROIC from highest to lowest within value is wide, but within growth is even wider. The 10-year median ROE for the 20 value companies ranges from +7% to +47% and for the 20 growth companies ranges from -37% to more than +100%. The 10-year median ROIC for value ranges from +2% to +26% and for growth ranges from -11% to +62%.

**Chart 11: FCF and Operating Income**
**Number of Negative Observation Last 10 Fiscal Years**
As of September 2020



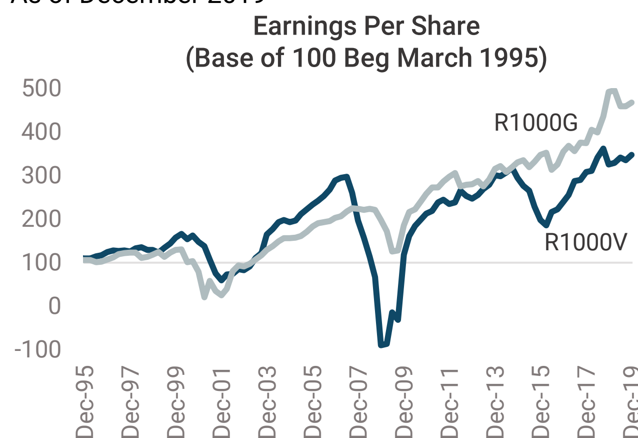

Stable cash flows and operating income are hallmarks of quality businesses. Chart 11 highlights the number of observations (out of 200 total observations: 20 companies over 10 years) where free cash flow and operating income were negative. We focus here on negative observations

[2]US Large Cap strategies include representative Large Cap Fundamental Value and Large Cap Diversified Value portfolios. Securities held are as of 9/30/20 and are subject to change.

rather than overall volatility because it is the negative periods, not volatility per se, that put businesses at risk. Prudent investors are quick to forgive stints of positive cash flow volatility. Admittedly, the aggregate results are not terribly useful. Value's negative periods are dominated by one company, NextEra Energy, which represented 10 of the 17 negative free cash flow observations. Growth's negative periods are dominated by two companies, Tesla and Netflix, which each represented 8 negative free cash flow observations.

Companies with more attractive prospects for growth should also be considered of higher quality than slower growing alternatives. If a company can earn high returns on capital but also grow rapidly, investors should benefit from the compounding of earnings. Paying an egregiously high valuation for this growth, however, can dwarf its benefit. Chart 12 shows the earnings per share growth for the Russell 1000 Growth compared to the Russell 1000 Value over the past 25 years. Unsurprisingly, the growth index has grown earnings per share at a faster rate than the value index, though the margin of its advantage appears reasonably modest.

**Chart 12: Earnings Per Share Growth**
**Base of 100 Beginning March 1995**
As of December 2019



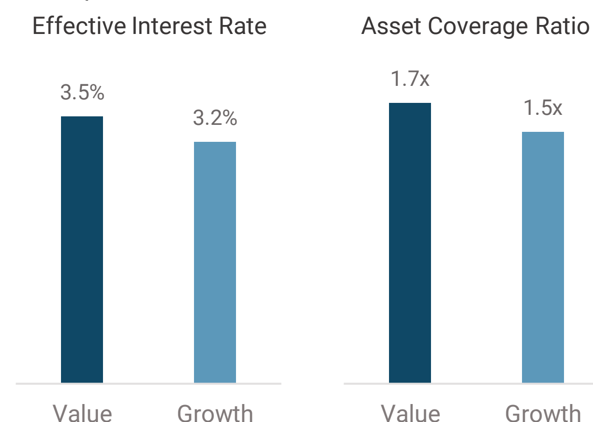

Companies' balance sheet strength is another important element of business quality. Fortunately, a company's borrowing costs, access to capital, ability to fund losses, and asset coverage is relatively easy to compare to peers. Chart 13 shows S&P's credit rating for the 20 value companies' and 20 growth companies' long-term debt obligations. Two of the twenty growth companies, Tesla and Netflix, are rated below investment grade (below BBB). Beyond that, the debt ratings are similar.

**Chart 13: Standard & Poor's Credit Rating**
As of September 2020

| | Value | Growth |
|---|---|---|
| AAA | 1 | 1 |
| AA | 8 | 6 |
| A | 8 | 8 |
| BBB | 3 | 2 |
| BB | 0 | 1 |
| B | 0 | 1 |
| Not Rated | 0 | 1 |
| Total | 20 | 20 |
| Average | A+ | A |

Chart 14 (left) shows the median effective interest rate for our value and growth universes, respectively. This measures a company's total interest incurred as a percentage of total debt and is thus a proxy for a firm's total cost of debt. Chart 14 (right) shows the median asset coverage ratio, which measures a company's ability to cover debt obligations with its tangible assets (higher is better). Countless rhetoric throughout 2020 suggested that value companies' balance sheets were worse than growth companies' balance sheets, which is why value underperformed during the COVID-19 pandemic. This viewpoint appears misguided as the differences in balance sheet strength between the value and growth groups is quite modest.

**Chart 14: Standard & Poor's Credit Rating**
As of September 2020




*Argument #1 Conclusion*

We acknowledge that a sensible person could make the case that growth companies (based on index constituents), on average, are higher quality businesses than value companies. However, the differences are marginal and less obvious than perceived in the market—and certainly not commensurate with the large discrepancy in market valuations.

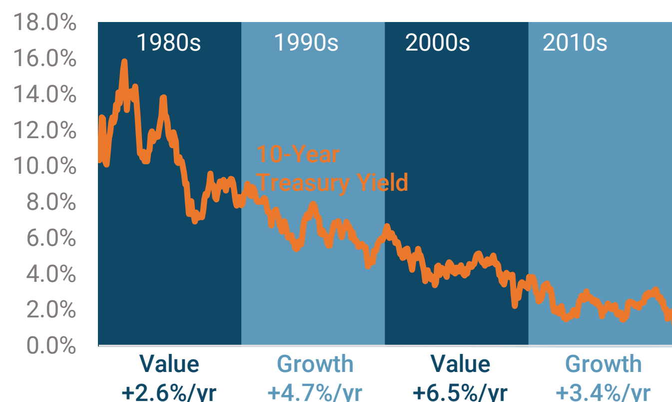
## Argument #2: Low interest rates are better for growth stocks

Low interest rates are good for stocks—both growth and value—for two primary reasons. First, it reduces the cost of debt which increases earnings and lowers the discount rate when calculating the present value of future cash flows. Second, it makes fixed income alternatives less attractive. The case for why low interest rates benefit growth stocks more than value stocks goes as follows:

- A company's intrinsic value equals the present value of its future cash flows
- Relative to value stocks, growth stocks' cash flows are further into the future
- Thus, growth stocks are more sensitive to the rate used to discount future cash flows, and should benefit disproportionately when rates are low (and be hurt disproportionately when rates rise)

This is akin to low duration and high duration bonds. A high duration bond pays distributions later than a low duration bond and is thus more sensitive to interest rate changes. In theory, this makes perfect sense, and we have a difficult time countering the logic. In practice, however, the evidence is less clear. Chart 15 shows the 10-Year Treasury yield from 1980 through 2019, along with the relative performance of the Russell 1000 Value and Russell 1000 Growth in each of the four decades. Each decade experienced declining rates, with the absolute level in each decade lower than its predecessor. Even so, the outperformance of growth and value alternated each decade.

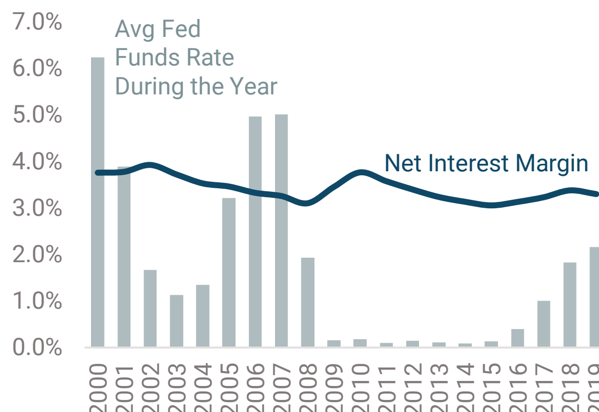
**Chart 15: Russell 1000 Value vs. Russell 1000 Growth**




Another rationale commonly put forth by growth advocates is that financials, particularly banks, do poorly in a low rate environment. Financials typically comprise a significantly larger portion of value portfolios than growth portfolios, furthering growth's advantage in a low rate environment. The assertion is that banks' net interest margins correlate with interest rates, and so earnings decline as rates decline.

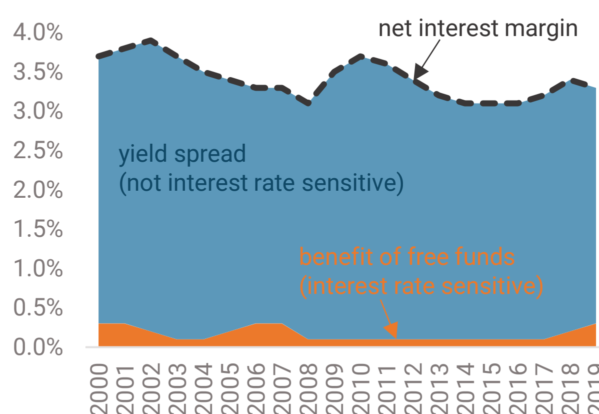
Our contention is that banks are considerably less interest rate sensitive than commonly believed. US banks' net interest margins have been remarkably stable over the past 20 years despite significant fluctuations in interest rates (See Chart 16).

**Chart 16: Net Interest Margin and the Fed Funds Rate**
**All FDIC Banks**
As of December 2019




Banks net interest margin is composed of two factors that we refer to as 1) the yield spread, and 2) the benefit of free funds. Of the two, the yield spread is the more important driver by far, averaging more than 90% of the NIM over the past 20 years (see Chart 17).

**Chart 17: Net Interest Margin & Its Components**
**All FDIC Banks**
As of December 2019




The yield spread has very little, if any, sensitivity to interest rates. It represents the difference between what a bank receives on earning assets and the rate it pays on interest bearing liabilities. Because loans comprise about three-quarters of earning assets, the margin over short term benchmarks that banks earn on their loan books is the primary driver of yield spread. The yield spread is not just insensitive to interest rates, it can sometimes exhibit countercyclical traits. When rates decrease, for example,

businesses and/or consumers may have increased incentive to borrow. This can increase loans as a percentage of earning assets. Further, banks often tighten lending standards as non-bank competitors retreat.

The benefit of free funds is self-defined. It is the benefit banks get from funding part of their earning assets with non-interest-bearing sources, like deposits. As rates move toward zero this benefit dissipates, but again, this typically comprises a small fraction of a banks' NIM. The ultimate effect of persistently low interest rates on bank profitability is likely negative but only marginally so.

### *Argument #2 Conclusion*

While nearly all stock categories should benefit from lower interest rates, the theory that growth stocks should benefit more than value stocks is logical. Empirical evidence is less clear, however, suggesting that other factors have larger influences on performance differences (e.g. valuations, corporate and economic conditions).

At Hotchkis & Wiley, we have always been, and will always be, value investors. However, we are impartial enough to acknowledge pragmatic arguments made by our growth counterparts. When comparing some of the largest, most well-known constituents in the value benchmark to similar companies in the growth benchmark, a reasonable person could conclude that the average growth company is a higher quality business than the average value company—albeit to a modest magnitude. The same rational person could argue that low interest should be better for growth than for value, and that growth companies enjoy near-term technical tailwinds—again, to a modest magnitude.

Our counterargument is two-fold. First, these advantages are modest, and far from commensurate with the enormous divergence in valuations between growth and value. Second, the range in business quality, interest rate sensitivity, and technical trends varies greatly *within* value and *within* growth—a critical consideration for active investors. We are not limited to value index constituents. We will invest in a company conventionally considered a growth stock, so long as it trades at a discount to our intrinsic value estimate. Our adherence to the principles of value investing does not mean that we ignore growth prospects, quality, or macroeconomic trends. It means that we compare those qualities to the price the market commands. When that tradeoff is in our favor we invest; when it is not, we pass. We believe our investors will be rewarded by this discipline; growth's run cannot go on forever, and as Stein's law suggests, it will stop.

Hotchkis & Wiley Research

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**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 1-3, 12, 15 & largest companies in Russell indices table: Bloomberg, Russell; Charts 4-5, 10-11, 14: Bloomberg, Company Reports/Filings; Charts 6-7, 9: Bloomberg, Russell, H&W (Charts 6-9: Representative Large Cap Fundamental Value (LCFV) portfolio; client portfolio holdings may vary due to different restrictions, cash flows, and other relevant considerations - other equity strategies managed by H&W may not have similar portfolio characteristics as highlighted for the LCFV portfolio); Chart 8: Bloomberg, H&W; Chart 13: Bloomberg, S&P; and Charts 16-17: FDIC. Charts 15-17: Certain annual historical data presented in the charts may not be indicative of current year-to-date results through November 30, 2020. Actual results in 2020 could be materially different from the historical information presented.

The securities owned in H&W's US Large Cap strategies that are among the 20 largest companies in the Russell 1000 Value and Russell 1000 Growth indices do not represent all of the securities purchased or sold for advisory clients and are not indicative of current or future holdings or trading activities of H&W's two US Large Cap strategies. H&W has no obligation to disclose purchases or sales of the securities. No assurance is made that these securities, or all investment decisions by H&W were or will be profitable.

Investing in equity securities have greater risks and price volatility than U.S. Treasuries and bonds, where the price of these securities may decline due to various company, industry, and market factors. Investing in value stocks presents the risk that value stocks may fall out of favor with investors and underperform growth stocks during given periods. Investing in smaller, medium-sized and/or newer companies involves greater risks not associated with investing in large company stocks, such as business risk, significant stock price fluctuations and illiquidity.

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. 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 and reduce available investment opportunities.

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