Why the Value Rotation is Not Secular

After years of consistent outperformance post the Global Financial Crisis (GFC), Growth stocks have lagged Value stocks since November 2020. The Value rotation has continued into 2022, with Value outperforming Growth by 750 basis points[1] in the month of January. The question on many investors' minds is whether this rotation to Value represents a secular change in market leadership. We'll provide our reasoning against this belief by reviewing the main factors that drive the Growth versus Value trade, how those factors are likely to evolve from here and how we are navigating the rotation.

Economic Growth – Long term will remain muted, which favors Growth

Growth stocks fare best in mediocre growth environments (0-3% GDP growth)[2]; conversely, Value tends to outperform when economic growth is very strong, which typically occurs early in the economic cycle. In the decade following the GFC, low economic growth, low interest rates and low inflation were the defining macroeconomic characteristics. In periods of low economic growth, investors are willing to pay up for what is scarce, i.e., growth. In 2020, global GDP fell 3.3% but bounced back strongly in 2021, rising 6.2% and is estimated to grow another 4.3% in 2022[3]. As the global economy continues its pandemic recovery, growth is no longer scarce, and the economic growth outlook is supportive of Value through 2022. However, it is apparent the global economy has already moved beyond peak growth and is reverting to its pre-COVID trend. Additionally, long-term economic growth is underpinned by demographics and productivity[4]. As aging populations point to slowing labor force growth, outside of a dramatic improvement in productivity, global growth over the long-term will remain muted, which favors Growth.

Interest Rates – Rising, but to relatively low levels versus history

Value stocks have lower growth rates than their Growth counterparts. As a result, a larger portion of their business value is derived from shorter-term future cash flows relative to Growth. Another way of expressing this difference is to characterize Value and Growth stocks as short- and long-duration equities, respectively. On the eve of the GFC, 10-year Treasury yields were around 4%. More than a decade later, yields had declined to a low of 0.5% in August 2020. As falling interest rates make longer-duration assets more valuable on a relative basis, the post-GFC interest rate environment was a major headwind for Value. While an increase in bond yields was projected with economies reopening, the change in expectations regarding the trajectory of interest rates has been dramatic. In mid-2021, the consensus expected zero interest rate hikes in the US in 2022 and only one by the end of 2023. The market is now pricing in at least four rate hikes this year. With Treasury yields now at 1.8%, interest rates are now a headwind for Growth in the form of valuation compression.

Although interest rates are poised to rise further, they are likely to rise to relatively low levels versus history. In the long-run, interest rates are a function of real GDP growth and inflation[5]. As discussed above, long-run real GDP growth is likely to remain muted, constrained by aging populations in the major global economies of China, Europe, Japan and the US. High government debt-to-GDP ratios around the world are another constraint on long-term economic growth[6]. Inflation is the wildcard, as it has surged to 30-year highs on durable goods shortages, strong wage growth and accelerating rents in the US. While near-term inflation risks are tilted to the upside due to continuing pandemic-related supply-chain, labor and other bottlenecks, long-term inflation expectations have remained anchored in the 2-2.5% range over the past year[7], which is consistent with lower economic growth in the future. With government debt and deficits back to peak levels, keeping real rates abnormally low via inflation represents the least painful option for policymakers to deal with excess leverage. Thus, low real rates are supportive of the valuation of longer duration assets, i.e, Growth.

How We Are Navigating Through the Rotation – Staying true to our process

The current macroeconomic environment is not ideal for our strategy. We are growth investors and the duration of our portfolio is above average. Macro environments are constantly in flux, at times serving as a tailwind and at others, a headwind; but what will not change is our adherence to our philosophy and process. Irrespective of macro conditions, we believe it is possible to identify companies that are exposed to a growth trend, possess competitive advantages that enable them to best exploit that trend and can be purchased at a reasonable valuation in the context of their growth profile and competitive positioning. We do not think of markets, sectors and

[1]Performance of MSCI All-Country World (ACWI) Value Index versus MSCI ACWI Growth Index. Source: MSCI and Bloomberg
[2]Goldman Sachs, "US Thematic Views – What Next for Growth vs. Value?" (June 9, 2021)
[3]Source: Bloomberg
[4]Economic Review, "What Determines Economic Growth?", by David Gould and Roy Ruffin (Second Quarter 1993)
[5]Federal Reserve Bank of San Francisco Economic Letter, "Why Are Long-Term Interest Rates So Low?" by Michael Bauer and Glenn Rudebusch (December 2016)
[6]"Growth in a Time of Debt" by Carmen Reinhart and Kenneth Rogoff (2010)
[7]Federal Reserve Five-Year Forward Breakeven Inflation Rate. Source: FRED

companies in terms of their "labels". The auto industry is often thought of as a "value" sector, but we identified Suzuki Motor and Aptiv as compelling opportunities that could capitalize on the cyclical recovery and secular growth of autos in India and increasing electric vehicle adoption, respectively. Semiconductors are the quintessential "growth" industry, yet we established a position in Micron Technology at multiples that would appeal to value investors.

A key part of our portfolio management process is continually force ranking our holdings by revenue growth (R), valuation (V) and profitability (return on capital) (R) and using this ranking to inform our decisions on adjusting portfolio weights. Internally we call this our "RVR" discipline. In recognition of the headwind rising interest rates poses to our portfolio, over the past year, we have adjusted portfolio weights to lower the duration of the portfolio, by emphasizing the "V" in our "RVR" process. From a sector allocation perspective, we believe the growth franchises that comprise our overweight position in financials are poised to benefit from further interest rate increases.

Conclusion

We believe the recent rotation to Value is not secular. In the near-term, we see above-trend economic growth, higher interest rates and inflation which will continue to favor Value over Growth. Over the medium to long-term, we foresee a return to lower economic growth rates and possibly higher inflation given the unprecedented monetary and fiscal interventions undertaken during the pandemic. A return to mediocre GDP growth favors Growth, but inflation is a murkier variable. While Value has marginally outperformed Growth in past inflationary periods[8], as active growth managers we believe our portfolio companies are well positioned as they have pricing power derived from their strong competitive positioning, higher profitability which translates into greater earnings resilience in the face of rising costs and low levels of debt, which insulates them from higher borrowing costs. While it is difficult at times to ignore the short-term vicissitudes of the market, we remain focused on executing on our investment philosophy and process to deliver superior long-term investment performance.

[8]"The Best Strategies for Inflationary Times" by Neville, Draaisma, Funnell, Harvey and Van Hemert (May 2021)

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As of December 31, 2021, Suzuki Motor had a 2.42%, Aptiv 1.00% and Micron Technology 0.00% in the Chautauqua International Growth Fund and Suzuki Motor had a 1.70%, Aptiv 0.77% and Micron Technology 1.35% in the Chautauqua Global Growth Fund.

The MSCI ACWI Value Index captures large and mid cap securities exhibiting overall value style characteristics across 23 Developed Markets countries and 25 Emerging Markets countries. The MSCI ACWI Growth Index captures large and mid cap securities exhibiting overall growth style characteristics across 23 Developed Markets countries and 25 Emerging Markets countries.

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