3rd March 2022

Elston Insights

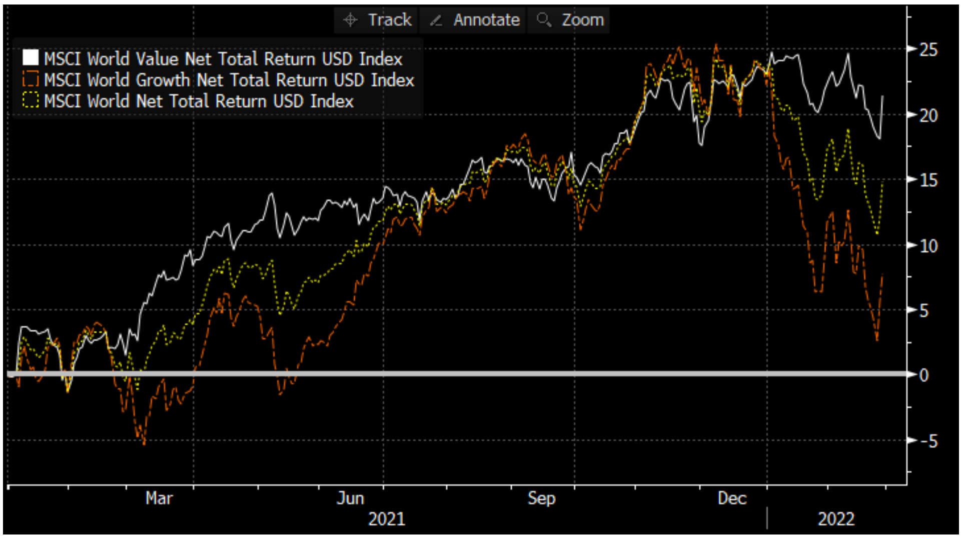
The rotation to Value has room to run

- The late 2020 rotation to Value has been rewarded
- Factor tilts align to economic cycle and inflation regime
- Despite strong relative performance, Value-factor equities have room to run

The "great rotation" to Value began towards the end of 2020 as inflation fears came into focus. It has been rewarded.

Since Dec 2020, the MSCI World Value factor has delivered +21.43% returns to 25th February 2022 compared to +7.70% return for Growth factor and +14.78% for the parent MSCI World index (a traditional market-cap based index), all in GBP terms.

Fig.1. MSCI World and World factor indices, in GBP terms since December 2020



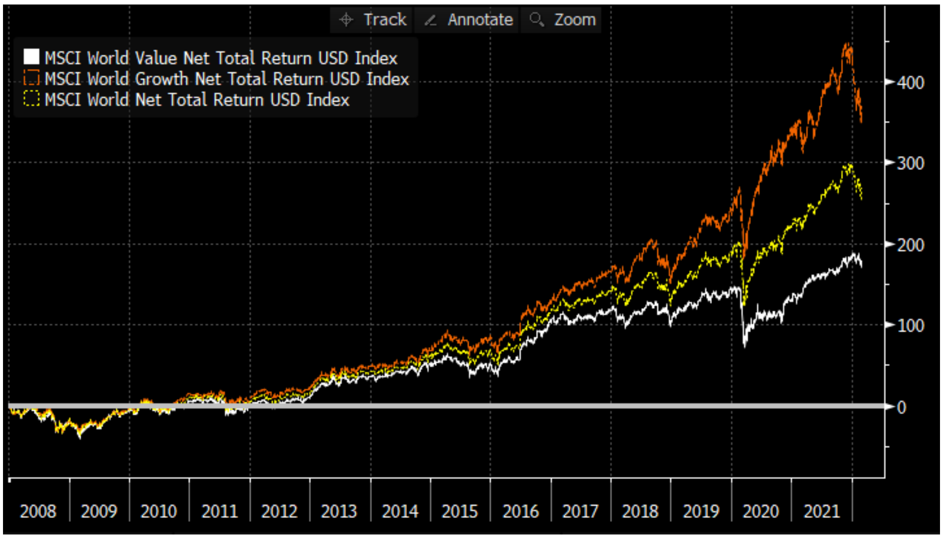
Source: Bloomberg data, 31-Dec-20 to 25-Feb-22 in GBP terms

If we look back further at relative performance since end 2007 to 25-Feb-22, we can see that Value's underperformance relative to Growth is still material.

Over that period, Growth returned +369% (11.54%pa), compared to +179% (7.52%pa) for Value, and +268% (9.63%pa) for traditional market-cap based world equities, in GBP terms.

On this basis, the re-rating of Value, relative to Growth, has room to run in the face of a persistent inflationary regime.

Fig.2. MSCI World and World factor indices, in GBP terms since December 2007



Source: Bloomberg data, 31-Dec-07 to 25-Feb-22 in GBP terms

Value's previous heyday

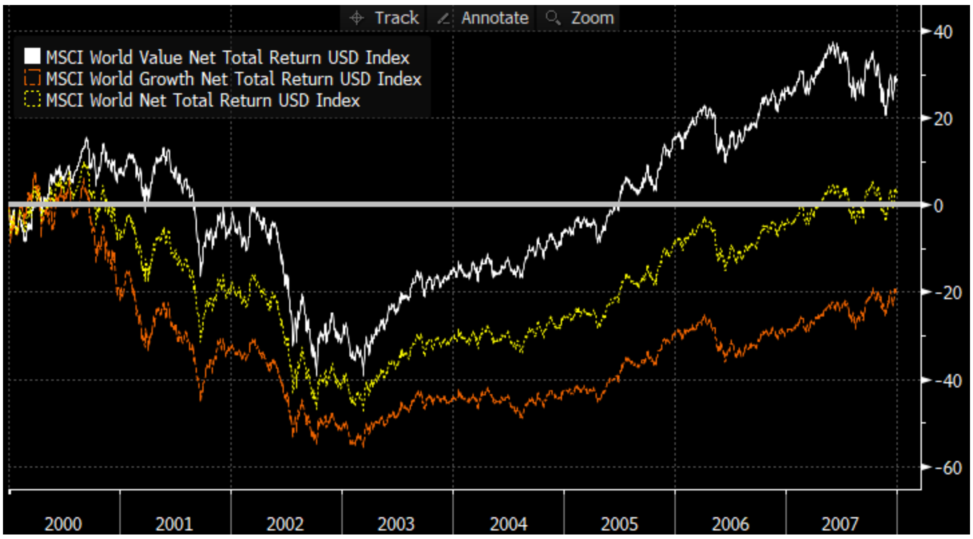
Proponents of Value investing point to its consistent performance over time. However, we think it makes more sense to align factor allocations or "tilts" to the prevailing market regime.

As shown above, the relative underperformance of Value to Growth lasted from 2008 to 2020, which is not "short-term".

Value factor's previous heyday was in the post 1990s tech-bubble era up until the financial crisis.

From December 1999 to December 2007, Value delivered a total return of +28.88%, compared to Growth -19.655 and traditional world equities +3.21% in GBP terms.

Fig.3. MSCI World and World factor indices, in GBP terms from 1999 to 2007



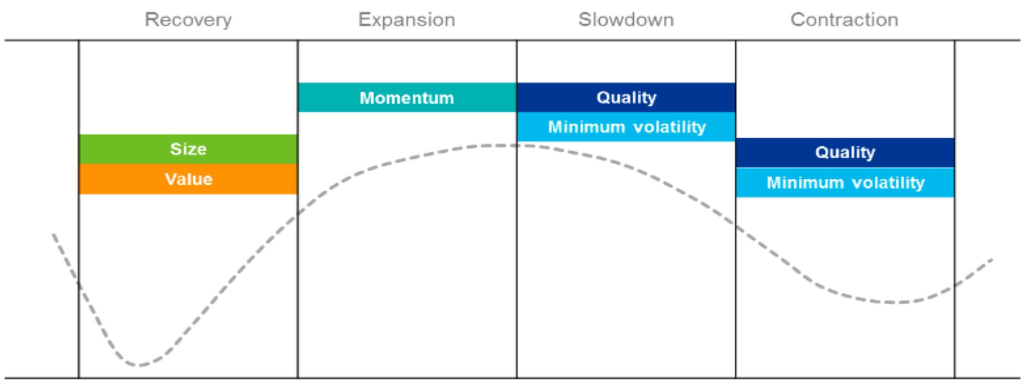
Source: Bloomberg data, 31-Dec-99 to 31-Dec-07 in GBP terms

After the financial crisis, the policy response of near-zero interest rates and Quantitative Easing benefitted longer-duration "Growth" factor equities.

Factor tilts over the economic cycle

The relative performance of different factors is influenced by the economic cycle. With different factor exposures typically benefitting during different stages of the economic cycle: recovery, expansion, slowdown, and contraction.

Fig.4. Aligning factor tilts to economic cycle



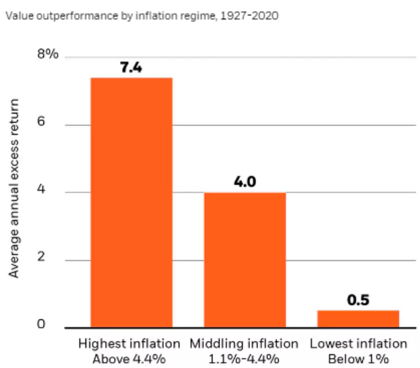
SOURCE: BLACKROCK. FOR ILLUSTRATIVE PURPOSES ONLY.

Value factor and inflation

Research also demonstrates how the Value factor tends to outperform in higher inflationary regimes. This is because it represents "shorter-duration" equities that deliver near-term earnings and dividends. These are more valuable in today's money relative to long-term future earnings when inflation – and therefore discount rates – rise.

A study of the US stock market 1927-2020 suggests that Value-style investing significantly outperforms Growth-style investing during higher inflationary regimes.

Fig.5. Value outperformance by inflation regime (US, 1927-2020)



Source: BlackRock, with data from the Kenneth R. French Data Library and from Robert J. Shiller. Fama/French data utilizes the CRSP universe, which includes all companies incorporated in the U.S. and listed on the NYSE, AMEX or NASDAQ exchanges. The level of annual inflation is defined as the year-over-year change in the Consumer Price Index (CPI). "Lowest inflation" represents the bottom 20 years of inflation readings; "highest inflation" represents the top 20 years; and "middling inflation" represents the remainder. The numbers below represent the high-low range in inflation readings for each regime. Value outperformance is annualized and calculated across various inflation regimes using annual data from 1927 to 2020. Value outperformance represents the performance of value stocks minus growth stocks, as defined by the Fama/French HML research factor (i.e., "high valuation minus low valuation" using book to price).

Source: BlackRock, Opportunity still alive in value stocks, de Spirito March 2021

Summary

Factor allocation can make a material difference to performance outcomes over multi-year periods. The relative performance of different factors is influenced by the prevailing economic regime, both from a growth and inflation perspective.

As we see the current high inflation regimes for at least 5 years (based on break-even inflation rates), we believe a tilt towards the Value factor within equity valuations is prudent for the medium-term.

Find out more

Access our CISI-accredited CPD on an Introduction to Factor Investing

Research Team, Elston Consulting

Find out more

For more insights and information on research, portfolios and indices, visit:

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