

## Whiplash: On Value, Growth, and Ignoring the Fundamentals

Neil Constable and Rick Friedman

After a decade of lagging relative returns, value equities delivered impressive performance in 2016, outperforming growth stocks by 10% in the US.<sup>1</sup> As Exhibit 1 indicates, value started to break away in the second quarter due in part to an improving economic outlook and a view that central banks, in particular the US Federal Reserve, would pivot toward a more neutral monetary policy. The spread between value and growth widened markedly in the fourth quarter as 10-year Treasury yields rose and the budding reflation theme strengthened on the back of the election of President Trump.<sup>2</sup> In 2016, the Russell 3000 Value index, bolstered by gains in sectors such as Financials, Energy, and Materials, rose 18.4% while the Technology and Consumer Staples laden Russell 3000 Growth index chalked up gains of only 7.8%. The story looked quite similar from a global perspective with value outperforming growth by approximately 8% and 7% in EAFE and the emerging markets, respectively.<sup>3</sup>

Exhibit 1 – 2016 Marked Value’s Strongest Year in a Decade



Source: GMO

US Value and US Growth represented by the Russell 3000 Value and Russell 3000 Growth indexes, respectively.

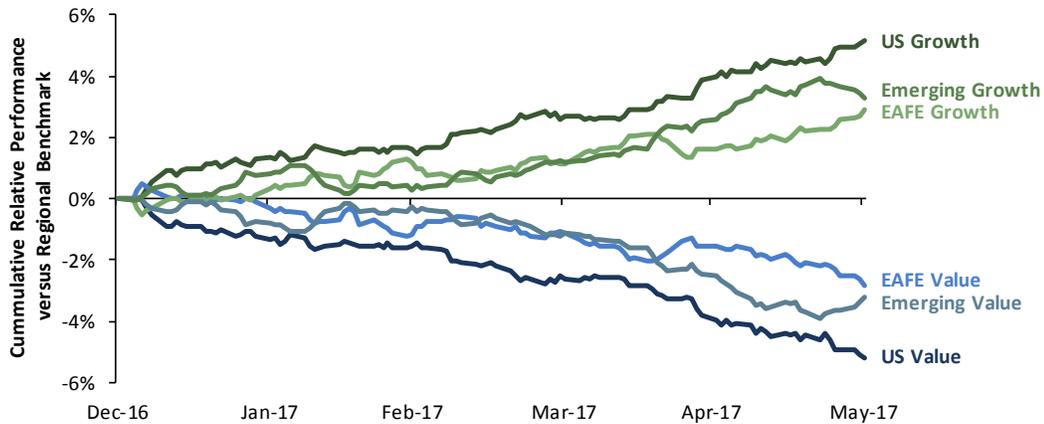
<sup>1</sup> As measured by the total returns of the Russell 3000 Value and Growth indexes.

<sup>2</sup> The strong performance of value stocks as long-term yields rose is not a coincidence: Value’s performance has been very positively correlated with 10-year yields over the last 12 to 18 months. For more on this, see Neil Constable and Rick Friedman, “For Whom the Bond Tolls: Low Rate Beneficiaries in a Rising Rate Environment,” April 17, 2017. This white paper is available at [www.gmo.com](http://www.gmo.com).

<sup>3</sup> As measured by the total returns of the MSCI EAFE Value, MSCI EAFE Growth, MSCI Emerging Value, and MSCI Emerging Growth indexes.

With an almost artistic sense of symmetry, the markets have all but completely erased last year's gains for value over growth thus far in 2017. While the US Federal Reserve has continued to telegraph rising short-term rates, a sign of faith in a firming economy, many of the supposedly pro-growth policy initiatives of the new US administration seem to be bogged down already. In response, the US yield curve has flattened and investors have shifted allegiance from cyclical opportunities to growth names. Outside of the US, value and growth were more in sync until mid-March, at which point the relative returns moved significantly in favor of growth.

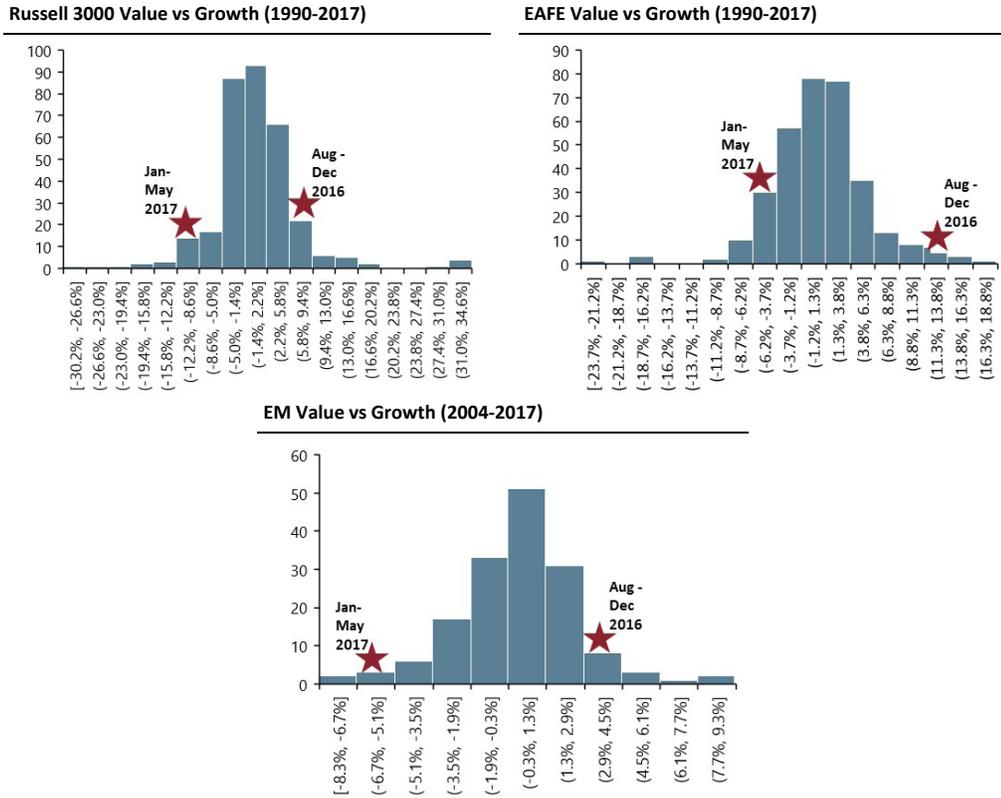
**Exhibit 2 – Styles Reversed Early in 2017 with Growth Outperforming Globally**



Source: GMO  
 Indexes include Russell 3000 Value, Russell 3000 Growth, MSCI EAFE Value, MSCI EAFE Growth, MSCI Emerging Value, and MSCI Emerging Growth.

Style shifts are common, but the magnitude of the change from late 2016 to early 2017 has been particularly dramatic. As the histograms in Exhibit 3 show, value's outperformance in the last 5 months of 2016 was quite strong. The Russell 3000 Value index outperformed its growth counterpart by 6.7% during that period, a 90<sup>th</sup> percentile outcome. Value's 10.4% underperformance relative to growth in 2017 through May was an even more extreme 5<sup>th</sup> percentile event, meaning only 5% of all the 5-month periods dating back to 1990 have seen value underperform by as much as the style has this year. The story has been similar outside the US. EAFE value delivered 97<sup>th</sup> percentile outperformance of 11.6% in the last 5 months of 2016, followed by 5.9% of underperformance (a 5<sup>th</sup> percentile reading) this year through May. While it took emerging growth a bit longer to pull away from value this year, the 5-month relative returns marked a similarly extreme style shift from late last year. After delivering strong relative returns in late 2016, emerging value (measured by the S&P IFCI Value and Growth indexes) trailed growth by nearly 6%, a 3<sup>rd</sup> percentile outcome going back to 2004.

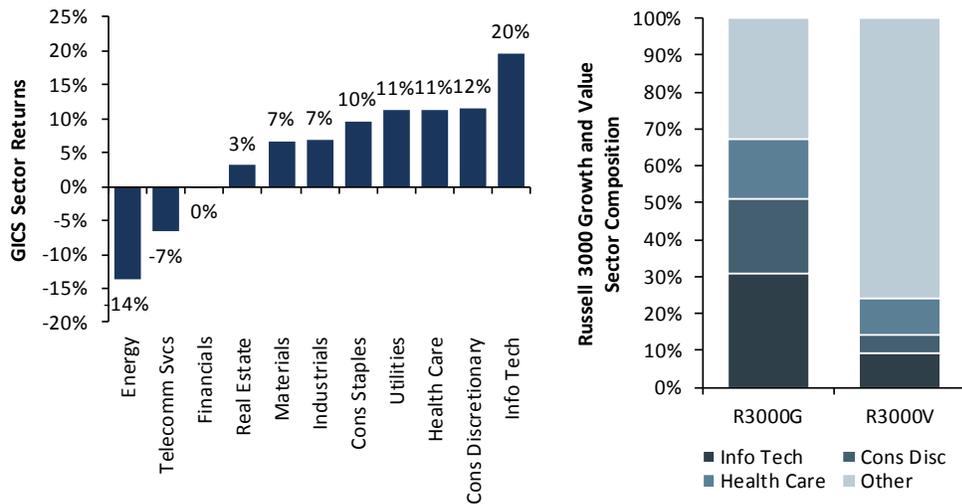
### Exhibit 3 – Value vs. Growth Distribution of 5-Month Returns



Source: GMO  
Emerging represented by S&P IFCI index.

There have been several important drivers of this large deviation in performance between value and growth. First, considering the top performing sectors of 2017 through May helps shed some light. As Exhibit 4 indicates, Information Technology, Health Care, and Consumer Discretionary have been the hot sectors. Given these three sectors make up nearly 70% of the Russell 3000 Growth index and only 24% of the Russell 3000 Value index, it is no wonder that value has had a difficult time pacing growth this year.

### Exhibit 4 – US Sector Returns and Index Concentration Have Heavily Favored Growth in 2017



Source: GMO  
Returns YTD through 5/31/17; Sector weights as of 12/31/16

Moreover, a small number of very large stocks within Information Technology have accounted for a significant portion of that sector's strong returns. Apple, Alphabet, Amazon, Microsoft, and Facebook, in addition to some other high flyers such as Nvidia and Netflix, were on average up 28% through May, helping to lift the Russell 3000 Growth index almost 14% in the first 5 months of 2017. A similar story unfolded outside the US, specifically within the emerging markets, as Chinese internet names such as Tencent and Alibaba soared over 40% and Samsung rallied 24%. The positive skew in returns toward a concentrated group of largely growth names has hit value-oriented investment strategies particularly hard this year.

It should be noted that value's underperformance *cannot* be explained solely by its relative underweight of the Information Technology sector. For example, in the US, a sector-neutral value portfolio consisting of the cheapest quartile of stocks from within each sector would still have underperformed a sector-neutral growth portfolio by approximately 4% in the first 5 months of 2017.

It is also worth pointing out that it is not necessarily every growth stock that has outperformed. Much of the US growth rally can be accounted for by considering the highest quality stocks in the US. On GMO's quantitative definition of quality,<sup>4</sup> the highest quality quartile of the US market has outpaced the broad market by nearly 6% so far in 2017. Like the growth index, the GMO quality group is tilted toward IT, Health Care, and Staples, however it focuses on a special subset of companies that we expect to have a sustainable competitive advantage and have proven to be adept allocators of shareholders' capital.

### **The market is running ahead of fundamentals**

What else can account for the relative performance? In short, growth stocks have been strongly re-rated versus value stocks thus far in 2017. In Exhibit 5, for each of the US, EAFE, and the emerging markets, we have decomposed the year-to-date returns of the cheapest and most expensive quartiles within each region on GMO's composite value metric.<sup>5</sup> The decomposition breaks the total returns for each group into realized changes in 12-month forward P/E ratios, changes in 12-month forward earnings estimates, dividends received, and a rebalancing term.<sup>6</sup> As shown in green in Exhibit 5, for all regions, growth stocks have experienced an expansion of forward multiples that are far in excess of that experienced by value stocks.

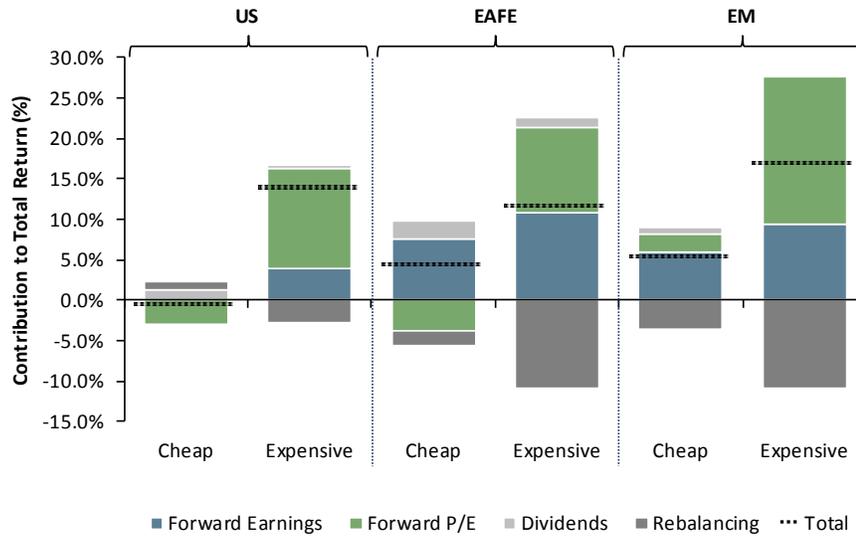
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<sup>4</sup>GMO's quantitative quality metric is derived from a firm's level of profitability, the stability of profitability, and overall level of indebtedness. High quality firms typically have competitive advantages conferred by intellectual property, brands, or dominant market positions. Low quality firms typically operate in businesses with low barriers to entry or are particularly exposed to cyclical economic forces.

<sup>5</sup>GMO's composite value metric is a blended measure utilizing many commonly used valuation ratios such as price-to-sales, price-to-earnings, and price-to-book. The cheapest and most expensive quartiles of stocks are reasonable proxies for value and growth stocks, respectively.

<sup>6</sup>The rebalancing term accounts for the returns attributable to changes in both the composition and weightings of the securities within the cheap and expensive groups over the course of the study period. Over long periods of time, the rebalancing effect is negative for growth as stocks leave the group by getting cheaper and enter after appreciating in value. The opposite is generally true for value.

Exhibit 5 – Global Growth Stocks Driven by Multiple Expansion in 2017

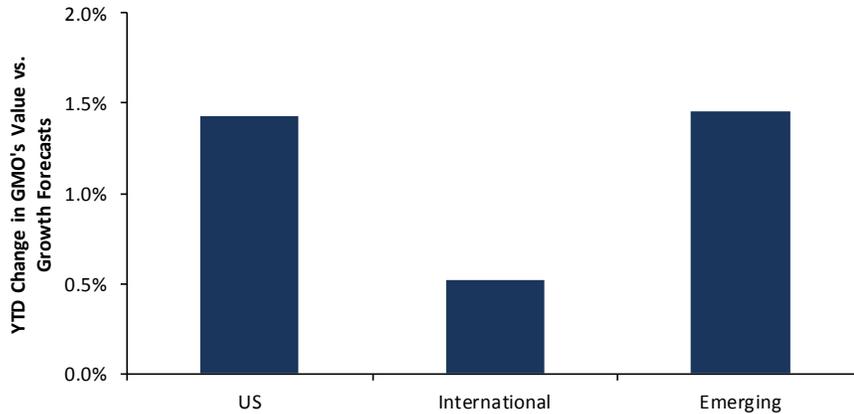


Source: GMO  
5-month period ended 5/31/17

In the US and the emerging markets, some of growth’s strong absolute and relative performance is due to increased earnings forecasts on the part of analysts, though multiple expansion clearly has been the driver in those regions. Within EAFE, growth stocks benefited about equally from increased earnings estimates and expanding multiples. For value stocks it has been a different story altogether. US value stocks have seen little action in the way of either changing earnings estimates or changes in multiples. For EAFE and emerging, value stocks have also had their earnings estimates increase and yet their multiples have not responded in kind. In fact, EAFE value stocks have seen multiples contract even as analysts have become more bullish on their future earnings prospects. **Overall, the lion’s share of the performance gap between value and growth across the globe can be accounted for by an expansion in multiples that has outstripped even the habitually bullish analysts’ expectations for future earnings. This should be no small consolation to valuation-oriented investors: Multiples running ahead of fundamentals is a classic sign of over-extrapolation by investors.**

On a forward-looking basis, GMO’s 7-year top-down asset class forecasts for value were only modestly more attractive than growth at the beginning of 2017 within the US and EAFE. By contrast, in emerging markets, we already had a very strong preference for value over growth coming into this year. Given the recent disparate returns, the gap between our value and growth forecasts has widened out, particularly so in the US as Exhibit 6 indicates. This display captures the change in GMO’s relative forecasts for value and growth through mid-May, the date of our most recent forecast. Given that a main component of our forecasts is mean reversion in multiples, the continued multiple expansion during the month of May will only strengthen our preference for value over growth when we next update our forecasts.

## Exhibit 6 – GMO’s Value Forecasts Have Become More Attractive Relative to Growth



Source: GMO

Chart represents change in GMO's forecasts from 12/31/16 to 4/30/17.

Note: Emerging forecast spread is based upon implied Growth forecast given GMO does not directly construct an Emerging Growth forecast.

### The stars are starting to align for value

While underperformance is never pleasant, we believe there are “good” and “bad” ways for a value investor to lose over a short time horizon. The first 5 months of 2017 likely fit into the “good” category: The valuations for growth stocks are now pricing in earnings levels that are in excess of analysts’ expectations and the market is applying ever-expanding multiples to growth stocks while global profit margins continue to hover around record highs. This is all classic preamble to value outperforming as an expensive market retreats to lower valuations. Finally, as was discussed in our recent white paper,<sup>7</sup> value stocks are currently negatively correlated with 10-year US government bonds and so value is also very well-positioned to benefit from a rising rate environment. With mean reversion, investor behavior, and interest rates all lining up on the same side, things are indeed starting to look up for value.

<sup>7</sup>Ibid.

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