October 2019

# Is it time for a revival of the value style?

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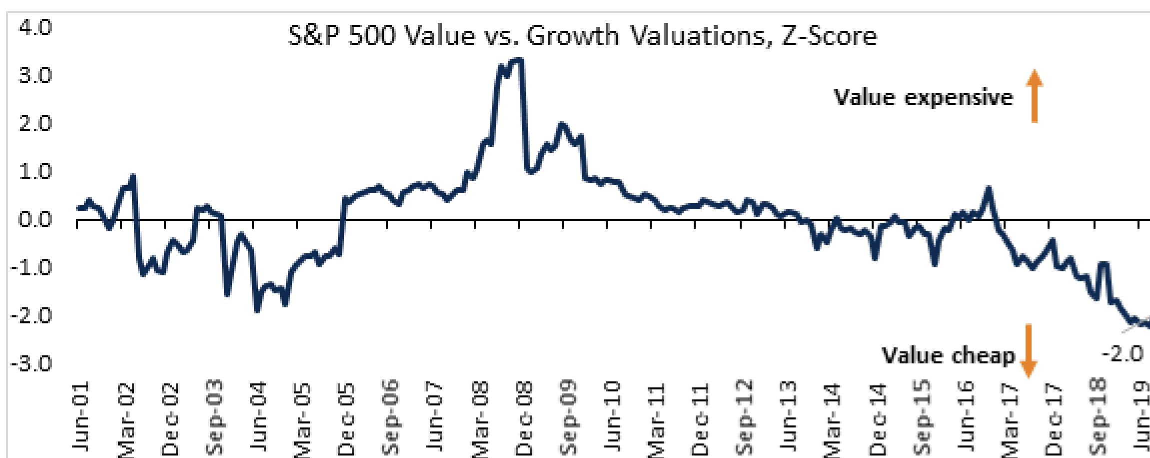
I've written in the past about an extreme divergence between the performance of value and growth styles of investing. In brief, value style investing is the selection of securities that are underpriced or undervalued based on an analysis of the operations and finances of the company issuing the securities. Growth investing focuses on companies whose earnings are expected to grow at a rate above the market average. By definition, growth stocks trade at a premium price, but by some metrics, the current valuation premium on growth has not been at this level since the height of the tech bubble in 2000. To understand whether or not the September revival of the value style is sustainable, we must first review what caused the divergence in the first place.

As often quoted in academia, value stocks sustained long-term outperformance in the decades leading up to the financial crisis. So what changed? One major theory is that a slowing economy heightened interest in faster-growing companies at a time when there are few to be found. The U.S. economy, for example, has slowed from GDP growth of over 3% per annum in the 1980s and 1990s to less than 2% on average since 2008. Fast-growing companies have been hard to come by in the slower-growing environment following the financial crisis. The resulting supply and demand imbalance has left growth valuations elevated.



Graph Source: Morningstar, Bloomberg Finance L.P. As at August 31, 2019. Z-score is based on 12-month forward price earnings. Value is based on the S&P 500 Value Index, growth is based on the S&P 500 Growth Index.

In early September, there occurred one of the sharpest rotations into value stocks since 2008. When style divergences become extreme, rotations can be rapid and styles can give back gains made over prolonged periods in a matter of days or weeks. In the recent rotation, value made up for approximately five months of underperformance in less than a week. Previous large shifts occurred in 2011 and 2016. The 2011 episode

saw growth stocks recover nearly all their losses quickly, but in 2016, value stocks were able to hold on to their lead for the year. The catalysts for value's outperformance in early September were better-than-expected economic data, easing trade tensions and an unwinding of the August collapse in bond yields. Overall, cyclical sectors like energy, financials and materials currently make up a larger portion of the value index than the growth index. These sectors tend to benefit from higher interest rates and stronger economic growth.

What does the future hold? The reality is the long-term structural headwinds to value remain largely in place. Without a sustained rise in trend growth rates or higher interest rates, similar to what prevailed in the environment that boosted value stocks prior to the financial crisis, a sustained rotation into value is unlikely to occur. In the short term, however, value could be supported by an upturn in the business cycle reminiscent of 2016. That being said, we still believe value is a key component to our overall strategic allocation and we continue to maintain style diversification across our portfolios while actively adjusting our exposures to take advantage of short-term dislocations.

*Combined top 15 equity holdings as of September 30, 2019 of the Evolution 40i60e Standard portfolio with Alpha-style exposure:*

| | | |
|---|---|---|
| 1. Microsoft Corp. | 1. Toronto-Dominion Bank | 6. Magna International Inc. |
| 2. Enbridge Inc. | 2. IA Financial Corporation | 7. ATCO |
| 3. Canadian Natural Resources Ltd. | 3. Royal Bank of Canada | 8. Franco-Nevada Corp. |
| 4. SPDR Gold Shares | 4. Gilead Sciences, Inc. | 9. Bank of Nova Scotia |
| 5. AltaGas Ltd. | 5. Alphabet Inc. | 10. Suncor Energy Inc. |

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