Is there still a case for value?

Value equities

welcome to brighter

The performance of "value" equities through the COVID-19 pandemic has increased questions over the relevance of the value factor in building robust equity portfolios (i.e. buying stocks on low accounting measures of value). Not only has the poor performance in 2020 come on the back of a protracted period of underperformance stretching back over a decade, but value also failed to provide protection in a falling market — a characteristic many might have expected from value investing. So what does this mean for value going forward?

Is there still a strategic, long-term case for value?

There are legitimate questions to ask about value investing. Earnings today are likely to be less reliant on capital than in the past, which could justify the high (relative to history) price-to-book ratios we have seen recently. Low interest rates increase the value (in today's terms) of future earnings via lower discount rates, which supports higher valuation multiples for companies with high growth expectations. Lastly, the impact of falling oil prices, and converse positive outcome for low-carbon investments, may also point to structural challenges for value investing relative to growth.

However, despite an arguably unsupportive macro environment, we continue to believe that a well-diversified active equity portfolio should include exposure to value equities in order to offer diversification of excess returns and enhance expected outcomes. Without exposure to value, investors may risk missing out on the benefits of that diversification.

Data from recent crises suggests that a speedy recovery is likely to be supportive of value investing generally. If we experience a period of extended economic uncertainty before a recovery takes hold, we suspect that a fundamental and more selective approach to value is more likely to win out over more systematic, or naïve, contemporaries, with a focus on using judgment to differentiate the winners and losers.

The average annual value premium was a whopping 5.5% between 1927 and 2008, but has declined noticeably since.

Value investing — A recap

Mercer has four principles for building robust equity portfolios: (1) invest broadly; (2) invest in a balanced range of return drivers; (3) go active where appropriate; and (4) invest sustainably. Value, along with other return-enhancing factors such as quality, momentum, size and low volatility, is one of five key "factors" we recommend diversifying across to ensure portfolios have exposure to a diversified range of systematic return drivers.

Figure 1: Mercer's equity guiding principles for investment

Invest across the broadest universe possible

Invest actively only where appropriate

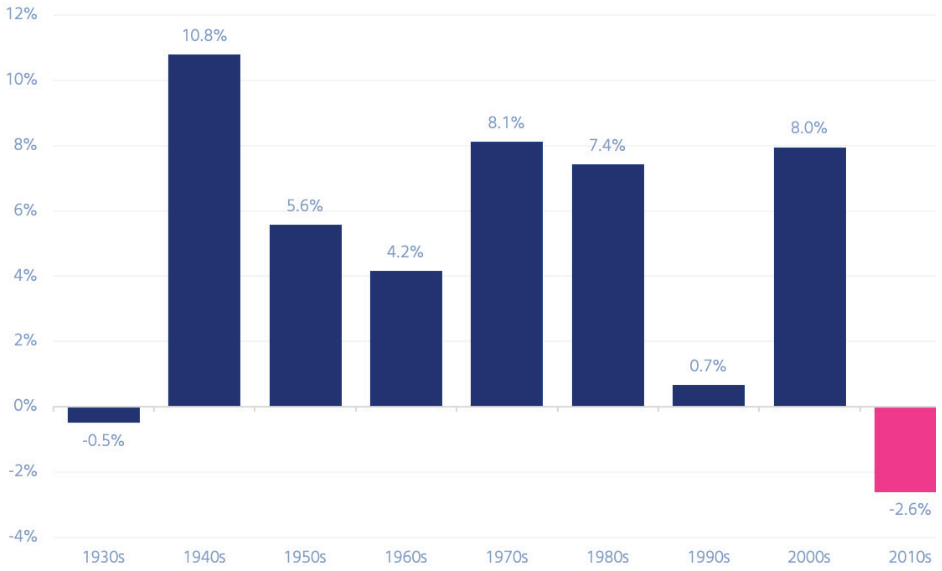
Invest in a balanced range of return drivers

Invest sustainably

Value investing is among the oldest and best-known styles of equity investing. A number of empirical studies have demonstrated the historical existence of a "value premium" (shorthand for the outperformance of value stocks over the wider market) over long periods of time. Eugene Fama and Kenneth French (Fama and French) initially published the most famous of those studies in 1993.[1] The average annual value premium was a whopping 5.5% between 1927 and 2008, but has declined noticeably since.[2]

[1] Fama and French, 1993, "Common Risk Factors in the Returns on Stocks and Bonds", *Journal of Financial Economics*.
[2] Performance is calculated using the methodology defined by Fama & French and sourced from https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html.

Figure 2: Average annual performance of Fama & French ("HML") value factor by decade



Source: Kenneth French. Performance is calculated using the methodology defined by Fama & French and is shown for the period January 1, 1930 to December 31, 2019. See Fama and French, 1993, "Common Risk Factors in the Returns on Stocks and Bonds", Journal of Financial Economics, for a complete description of the factor returns.

The academic literature has expanded significantly since and the theoretical arguments for the existence of a value premium now typically fall into one of two categories:

- **Value stocks outperform because they are higher risk**. This was the argument originally put forward by Fama & French: value stocks are cheaper because they are more risky by some measure unrelated to the market beta.
- **Value stocks outperform because investors do not behave in line with traditional finance theory.** Other explanations put forth are rooted in investor preferences or behavior. Humans (even investors) often exhibit biases when assessing very likely or very unlikely outcomes. When evaluating individual equities, investors may over-extrapolate past earnings growth, and over- or under-react to new information.

It is reasonable to presume that a combination of non-beta risk compensation and human behavioral biases drove the historical success of value (where value outperformed growth in seven of the last nine decades). However, the most recent decade, ending in 2019, proved to be the worst showing for value. In the first quarter of 2020, we have seen this trend of growth dominating value continue.

Is value structurally challenged?

What has gone wrong since the Global Financial Crisis?

Despite the long-term empirical and theoretical arguments for value investing, it has not worked in recent years. Fama & French's study shows the average value premium over the last 10 calendar years (since the Global Financial Crisis) was -2.6%, with only 2013 and 2016 offering any respite for value.[3] Equally, using the performance of value indices, over the decade to March 30, 2020, the MSCI World Value index has underperformed its growth equivalent by 4.5% p.a.[4]

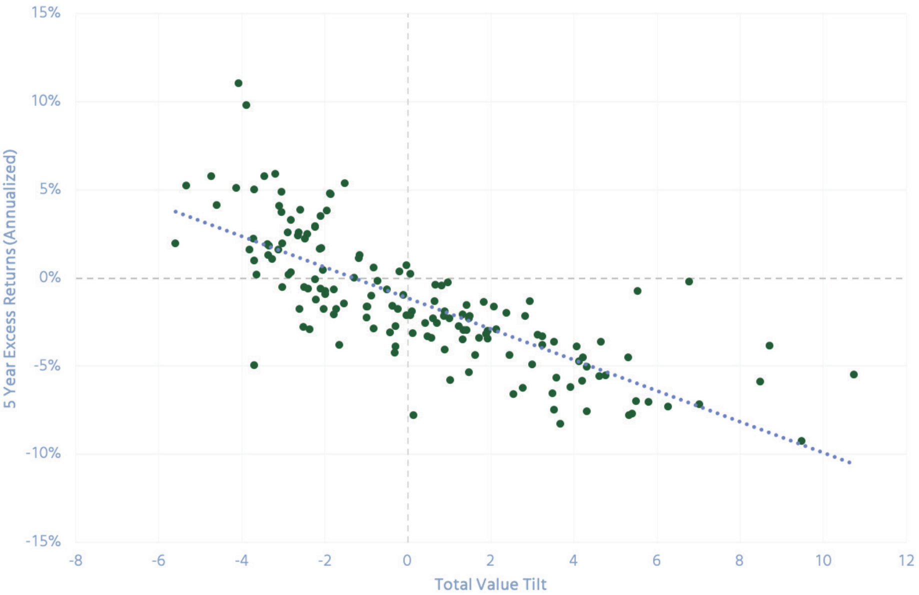
We can see a similar headwind in active manager returns as well, as larger tilts towards value investing appear to have led to greater underperformance.

Looking in the rearview mirror doesn't always help. But it is worth considering why value investing might have failed over the past decade, in spite of its longer-term success.

[3] Source: Kenneth French. Performance is calculated using the methodology defined by Fama & French and is shown for the period January 1, 1930 to December 31, 2019. See Fama and French, 1993, "Common Risk Factors in the Returns on Stocks and Bonds," *Journal of Financial Economics*, for a complete description of the factor returns.

[4] Source: MercerInsight™. Performance quoted is the gross total return for the selected index in US dollars Please see Important Notices for additional information on indexes.

Figure 3: 5-year outperformance of active global equity strategies by value-style tilt



Source: StyleAnalytics, MercerInsight™. Performance shown is for Mercer's active global equities (Core and All Countries) universes, and each manager's performance is shown against their stated benchmark. All performance is to March 31, 2020. Portfolio tilts are calculated based on holdings as at December 31, 2019.

Performance of value in a crisis[5]

Value performed particularly poorly through Q1 2020 and into April. March, when the MSCI World fell 13%, was the third-worst month for value relative to growth in 45 years, with the value index underperforming growth by 6.7% (only December 1999 and February 2000 were worse).[6] Some suggest this underperformance, particularly the lack of protection provided by value, undermines the case for value further.

However, it is not that unusual for value to underperform in a falling market. Since 1975, value outperformed in 62% of negative MSCI World months; in sharp falls of over 5%, value outperformed on 52% of occasions. In addition, value has become increasingly cyclical over the last decade.

As of the end of March 2020, the MSCI World Value Index had meaningful overweights to Financials, Energy and Utilities and was underweight Technology and Consumer Discretionary. Given the nature of this most recent crisis, the poor performance of value to date should not be a surprise given the way that the value index is constructed. This view is supported by analysis conducted by Research Affiliates, which suggests that value performs well in a market crisis only if that crisis is preceded by an asset bubble, as opposed to a shock to the economy, as we have seen with the recent pandemic.[7]

[5] Performance figures quoted in this section are sourced from MercerInsight™ using total returns. The performance of value is measured using the MSCI World Value Index and the performance of growth is measured using the MSCI World Growth Index. Please see Important Notices for additional information on indexes.

[6] Performance sourced from MercerInsight™ for the period January 1, 1975 to March 31, 2020. Relative performance for value and growth calculated using performance differential for the MSCI World Value (Total Return) Index and the MSCI World Growth (Total Return) Index.

[7] *Value in Recessions and Recoveries* (Research Affiliates, 2020) https://www.researchaffiliates.com/en_us/publications/articles/808-value-in-recessions-and-recoveries.html

Figure 4: Performance of value during crises and recoveries

Event description		MSCI World Value Index	MSCI World Index	Relative performance of value	Time
1987 stock market crash	Crash	-17.1%	-20.4%	3.3%	3 months
	Recovery	33.1%	28.2%	5.0%	12 months
2000 – 2002 tech bubble	Crash	-35.5%	-46.3%	10.8%	30 months
	Recovery	106.3%	90.9%	15.3%	39 months
2007 – 2009 global financial crisis	Crash	-56.3%	-53.7%	-2.6%	15 months
	Recovery	123.6%	120.9%	2.7%	50 months
COVID-19	Crash	-26.8%	-20.9%	-5.9%	3 months
	Recovery	-	-	-	

Source: MercerInsight™. Crash and recovery periods for each crisis determined based on the peak and trough of the MSCI World Index for the period January 1, 1975 to March 31, 2020.

Value equities tend to outperform the broader market in a recovery. Analysis from StyleAnalytics looking at the 1987 crash, the Tech Bubble and the Financial Crisis, shows that, coming out of each crisis, value factors performed better than growth, quality, momentum and low-volatility factors.[8] This potential to perform when other factors do not is a large part of why we continue to support an allocation to value equities as a diversifying source of excess returns.

If we have learned anything from the recent pandemic, it is that there are many unknowns that can impact markets and alter our best guess at what is to come. We should be prepared, and well diversified, for any outcome.

Value equities tend to outperform the broader market in a recovery.

Are markets more efficient?

It could simply be that markets are now more efficient. A rise in systematic investing (including smart beta and quantitative strategies) could have led to the erosion of the value premium. Perhaps, but it seems unlikely to us that there is a higher proportion of assets invested in value strategies now than at any other time. Active managers using growth or defensive-biased approaches have been more successful, than their value counterparts, in attracting assets over the last decade, and it is hard to think of any value-focused organizations that have materially grown assets in value-equity strategies over recent years.

There is also little evidence of behavioral biases becoming diluted. In fact, we could be seeing the opposite: many "value" strategies are embracing quality characteristics, asset managers are seeding "quality-growth" or defensive strategies. Many asset owners frustrated with the performance of value are pursuing better-performing styles of investing. In Mercer's view, there seems to be little appetite for taking on the risk (company specific and agency risk) required to pursue a genuine value approach.

This could make the case for a value recovery stronger now than it has been for some time.

[8] *Factors in Stock Market Crashes and Portfolio Recoveries (Style Analytics, 2020)* www.styleanalytics.com/research-articles/factors-in-portfolio-recovery-from-a-stock-market-crash/

New-economy companies are less dependent on capital

Another rationale for the underperformance of value is that fundamental changes to our economy have led to a re-pricing of stocks. Price-to-book ratios, in particular, may be higher because modern companies need less capital to generate profits sustainably, thanks to modern technology. Specifically, companies with a higher reliance on intangible assets, such as research and development costs or brand value, which are not captured in a traditional accounting metrics, arguably undermine the use of book value as a measure of value.

However, while we would agree a fundamental shift from old-economy to new-economy businesses has created headwinds for value investing in the last decade, it doesn't necessarily undermine the case for value going forward. That would require further transformation, which, while possible, is not certain.

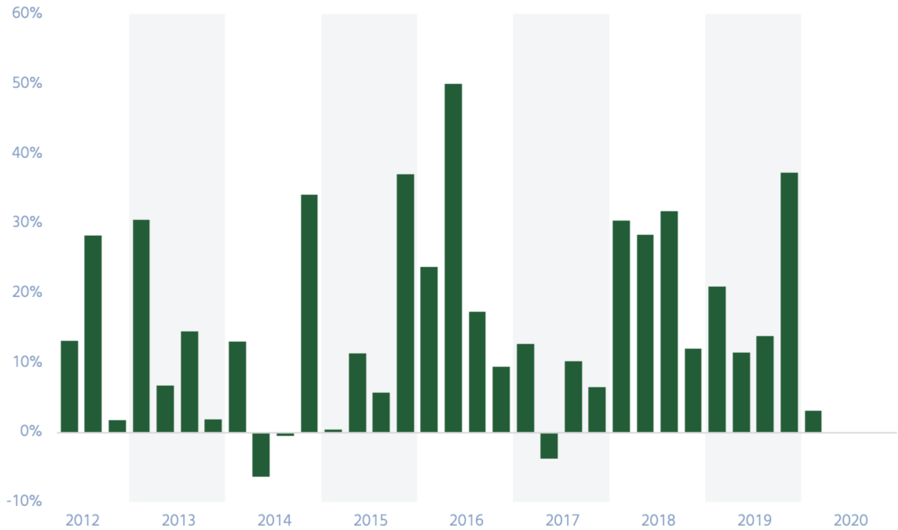
A fundamental shift from old-economy to new-economy businesses has created headwinds for value investing.

Disappointing fundamentals amplify growth sentiment

We have undoubtedly seen traditional value industries deliver disappointing earnings relative to their growth counterparts, and often relative to pre-announcement expectations, which may mean that they were cheap for a reason. If those disappointing fundamentals continue, clearly that would not be good for value investors. Conversely, many growth stocks have, for an extended period, repeatedly delivered above expected earnings growth. This earnings growth has often occurred at the expense of traditional value companies' business models. Although positive earnings surprises — see Figure 5 for some notable growth stocks — cannot continue indefinitely, they have shown remarkable persistence.

The persistence of good news for high-growth stocks has amplified trends in investor sentiment, compounding poor performance for out-of-favor stocks.

Figure 5: Average quarterly earnings surprises for Facebook, Amazon, Apple, Netflix, Alphabet, Microsoft and Salesforce

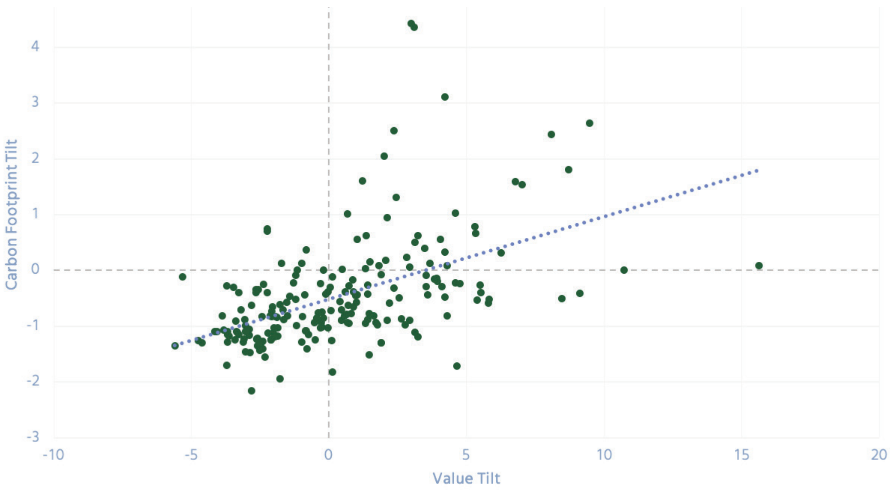


Source: Bloomberg. Mercer calculations, arithmetic mean of earnings surprises for the period from March 31, 2012 to March 31, 2020.

Accounting for environmental risks

Value strategies are typically biased toward carbon-intensive industries. We can see this in the carbon footprint of the indexes, as well as when we analyse active investment strategies monitored by Mercer. The impact of a tilt to carbon-intensive industries on performance over the past five years is likely to have been negative, as environmental concerns have risen sharply on many investors' agendas. The impact on prospective performance is harder to determine, but if climate risk is not yet fully priced into share prices, this may well be an additional challenge for value investors.

Figure 6: Carbon exposure of active global equities by value-style tilt



Source: StyleAnalytics, MercerInsight™. Portfolio tilts are calculated based on holdings as at 31 December 2019.

Lower interest rates made future earnings more valuable, but those forecasts may fall

Lastly, we expect that the prevailing macro environment of loose monetary policy and low interest rates has also been a boon for growth investors and a drag for value investing. Lower interest rates, and a flatter yield curve, can hurt the profitability of banks (a large allocation in many value indexes, and therefore portfolios), but should also benefit long duration assets as future cash flows are discounted at a lower rate (future cash flows are typically higher, if less certain, for high-growth companies).

On the other hand, it is possible that struggling companies in traditional value industries have benefited from low refinancing rates. Retailers, for example, may have been able to stay afloat longer than they otherwise would. With typically higher starting levels of leverage, renewed economic hardship could hit traditional value industries hard.

On balance, persistently low interest rates, structurally low inflation and the economic confidence they have supported have likely helped growth stocks more than value stocks.

What now for value?

It is impossible to say for certain. Before the emergence of the coronavirus pandemic there was a plausible argument that the macro environment may shift to one more beneficial to value stocks. In particular, rising interest rates and inflation may increase on the back of robust economic performance and expansionary government policy in many developed economies. Since the pandemic and subsequent economic retraction, however, this now appears unlikely in the short-to-medium term and a low-interest-rate environment that, all else equal, supports long-duration assets (quality and growth) would seem likely to persist for a while to come.

However, all else is not equal. Although future earnings may continue to be discounted using low interest rates, those future earnings and earnings growth forecasts are under threat. The prospect of lasting challenges to economic growth is a greater challenge for stock prices predicated on high levels of earnings growth.

What we can say for sure, is that the spread between valuations for growth and value, which was elevated at the end of 2019 has widened further over the first quarter of 2020 to historically high levels. Historically, extreme valuation spreads have preceded periods of strong performance for the value factor. However, even then we do not know how company's earnings or book values will be impaired by the pending economic recession or whether this will impact value or growth companies more.

Given all this uncertainty, it is perhaps worth returning to the reasons why a traditional value approach has worked for so long. As mentioned at the start of this paper, the case put forward for the existence of a value premium is either the reward for a risk taken (for those who subscribe to efficient market theory) or the result of investors' behavioral biases (for followers of behavioral finance). The challenges that the value factor has faced are real and may continue. However, to take the view that value investing is no longer relevant in an equity portfolio, you need to believe that either:

- Risk is no longer rewarded or investor behavior has fundamentally changed, and as such the value premium will not exist going forward; or
- You have sufficient confidence that the divergence in performance will worsen, because the issues value has faced (outlined in this paper) will continue — the significance of intangibles will increase, rates will drop further and positive sentiment towards growth stocks will improve.

We do not subscribe to either view, and as such we continue to believe value remains a relevant investment approach, as part of a diversified portfolio. However, we also suggest that thought be given to how best to navigate the challenges value may face in the period ahead.

Figure 7: Relative valuations of growth equities vs value equities

Source: Thomson Reuters Datastream. Values shown are calculated using the price-to-book ratios and the price-to-earnings ratios of the MSCI World Growth Index and the MSCI World Value Index. A value of 2 on the chart for price-to-book indicates that the price-to-book ratio for the MSCI World Growth Index is double that of the MSCI World Value Index. Valuations shown for the period January 1, 1981 to April 30, 2020.

How to capture value in the current market environment

We have discussed value here in general terms, frequently using the MSCI value indices as a proxy for value as if there were a universally agreed approach to value investing. That is not the case, though, and value indices are often a poor proxy for active value strategies.

There are many different types of active approaches to value, which makes it hard to generalize. Further, with reliable active manager returns going back just 25 years, covering only a few market cycles with arguably different characteristics driving returns, empirical data provides limited insight into how different approaches perform in different environments.

That said, our expectation is that in a period of extended economic uncertainty, a fundamental and more selective approach to value is more likely to win out with a focus on using judgment to differentiate the winners and losers. However, a long-term outlook is needed for such an approach and the path is likely to be bumpy.

Broader, systematic approaches to value, on the other hand, continue to bring diversification to a broad equity portfolio and have the potential to benefit most in a quick, sharp recovery if they capture high risk opportunities that may have been in jeopardy during a sustained downturn.

We continue to believe value remains a relevant investment approach, as part of a diversified portfolio.

What does this all mean for investors?

There are a range of plausible explanations for why today's economy is fundamentally different to any historical comparison — earnings may be less reliant on capital, for example, and falling interest rates are likely to have enhanced growth equity returns. And while valuations spreads may be extreme in some areas, creating some optimism (and opportunity) for value investors, the headwinds for value that we have outlined may persist for some time.

However, while these difficult conditions are very real, the recent coronavirus pandemic reminds us that it is nigh on impossible to forecast the future with any accuracy; and even if we do attempt it, we can have only a relatively low degree of confidence in which style may win out in any particular environment. Returning to our guiding principles, we continue to believe that diversification is key in building well balanced portfolios, especially in times of heightened uncertainty. We believe having exposure to a value style (in some form) is essential for ensuring a well-balanced equity portfolio.

Our advice to investors is:

- **Don't give up on value**: we don't know what is around the corner and we believe the long-term drivers of the value factor remain evident - retaining value exposure in a portfolio can provide diversification to those styles of investing that have worked well over the last decade.
- **Review total portfolio exposures**: while we continue to believe exposure to value (in some form) remains important in building robust active equity portfolios, we do not think value (or any factor) should dominate portfolio exposures.
- **Review value managers**: ensure managers employed to deliver value exposure remain consistent in their approach and continue to provide genuine value exposure.
- **The current environment may favor a more judgmental approach**: we believe a long-term judgmental approach to value is likely to be best placed to navigate those uncertainties and headwinds we have outlined. In contrast, solely backward-looking systematic strategies, particularly in index form, may face the most challenges — especially if economic uncertainty persists.

Value as a style has faced many challenges in the past ten years, and these may continue for some time. We continue to reassess the merits of our highly rated value strategies within that context, and we will adjust our recommendations accordingly. Those value strategies that are best able to navigate those challenges, and we believe are able to meet their investment objectives, should continue to form part of a broadly diversified active equity portfolio.

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