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INSIGHT

A short-term value bounce ignites a long-term debate

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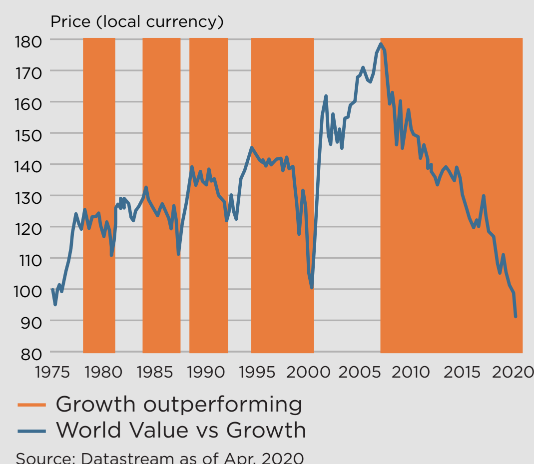
The market narrative often centers around the old question of "growth vs value", a debate that goes as far back as the 1930's with the founding of T. Rowe Price. Thomas Rowe Price Jr, established a "growth" focused investment style, which was later reinforced in the 1950's by Philip Fishers' influential book "Common Stocks and Uncommon Profits". As of late June 2020, we observe that global value stocks have been in a relative bear market vs "growth" stocks since the end of 2006 (Figure 1), but the recent value rally has yet again re-ignited this debate.

We all recognize that 2020 has so far been anything but an ordinary year. After the collapse in global equity prices at the start of the year, the initial rebound has also been uncharacteristic. The rebound from the lows in late March was led by the growth leaders of the past decade and not as is usual by the value cohort, primarily made up of Financial, Energy and Capital Goods companies. Recently though we have seen these companies outperforming and after such a long period of strong returns by "growth" companies – one has to ask oneself – what is next?

Before we share our view on this debate a couple of clarifications are in order. The true value of any company and its shares is obviously related to the earnings growth rate that the company can generate, or as Warren Buffet is quoted as saying "growth and value is joined by the hip". Value stocks are often simplistically described as stocks with a low valuation multiple such as a low Price-to-Book or P/E multiple and growth stocks as stocks with above average growth, which typically trade at high valuation multiples. At C Worldwide Asset Management we invest in companies where we deem the company can sustainably

Figure 1: Growth vs value



Source: Datastream as of Apr. 2020

compound its earnings above GDP-growth over many years and that the majority of the company's value is due to future growth and not past growth. We do not necessarily seek the highest growth companies and we do not shy away from investing in what are traditionally seen as value sectors, such as Financials and Capital Goods. When we invest in these sectors, we invest in the growing part of those sectors. Despite this, we are often put in the growth-style category, even though our view of growth vs value is more granular than the two simply defined categories that are often discussed.

The mechanics of a value rally is somewhat different from when growth stocks outperform; the sharp moves upwards are often shorter in duration and in most cases they are driven by depressed valuation multiples moving higher, even as profits tend to decline. In fact, a study by Exane shows that in value rallies over the last 20 years in Europe, profits declined in 75% of all value rallies. It is thus multiple expansion – in the belief that a company's low Return on Equity (ROE) will increase as low net margins move higher – which propels value rallies. In the case of "deep-value" investments the rallies are driven by the view that valuation simply have reached unsustainably low levels and therefore must revert higher. Our investments in companies with above average ROE are predicated on the knowledge that, if the company can sustainably re-investment its profits at an above average ROE, then this should continue to drive above average earnings growth.

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As the world quickly closed down due to the coronavirus pandemic, many economic indicators such as jobless claims and PMI surveys (Purchasing Managers' Index) collapsed at an unprecedented rate. When governments and central banks then re-boot economies with equally unprecedented levels of stimulus (USD18 trillion of stimulus vs an expected USD10 trillion fall in GDP), a violent short-term bounce in depressed value assets is to be expected given the short-term 'sugar rush' that this liquidity fuels. However, when we look out medium – and longer-term, the picture still points to growth assets as being attractive.

It is almost impossible to talk about growth stocks without talking about the category's largest constituents, namely technology stocks. While some other categories of companies might very well be growing as a group sustainably faster than the general economy (and thus may very well pique our interest), over the medium term, the future of growth stocks is intrinsically linked to the future of technology. The digital transformation in combination with business models for digital goods and services with close to zero marginal cost means that these companies have been able to grow fast and very profitably, often at the expense of "traditional" companies selling physical goods. The sector's size with a combined market cap of close to 20% of the S&P 500, gives reason for reflection, but also points to the massive societal changes we are experiencing. Traditional value investors focusing on multiples such as low price-to-book, will fail to accurately assess the value that companies are now creating from intangible assets that are not reflected on corporate balance sheets.

The pandemic reinforces the long-term drivers of growth vs value

Many of the longer-term trends driving the technology sector seem only to have been accelerated by the recent pandemic. Credit card data from Bank of America shows that during the shutdowns online spending was close to 30% of credit card volumes. This number was previously around 15% and historically increased about 1-1.5% points per year – indicating that we have seen adoption advance the equivalent of 15 years in 15 weeks. While these numbers were assured to be rising rapidly as consumers had no other alternative than to shop online in many countries, subsequent surveys indicate that these changes in behavioral patterns might be sticky. 17% of consumers surveyed by Bank of America said they will never shop in a mall again and 63% said that they will reduce the amount of clothing they buy in physical stores. In the spring, we conducted a number of calls to industry experts to understand the migration of data into the cloud; all agreed that the pandemic has accelerated the adoption and companies previously talking about a 5-10 year adoption

are now in many cases aiming for 2-3 years.

The pandemic could even have effects on one of the major longer-term drivers of growth stocks and why they have performed so well since the end of 2006, namely low interest rates. A study of 12 major pandemic's effects on interest rates by Òscar Jordà, Sanjay R. Singh and Alan M. Taylor found that interest rates stay substantially depressed for about 40 years following pandemics (Figure 2). This contrasts with what happens after wars when capital is destroyed, when instead inflation picks up. The "war" on the pandemic that world governments are fighting has clearly not resulted in any physical destruction, but the size of the stimulus response is unseen outside of actual wars.

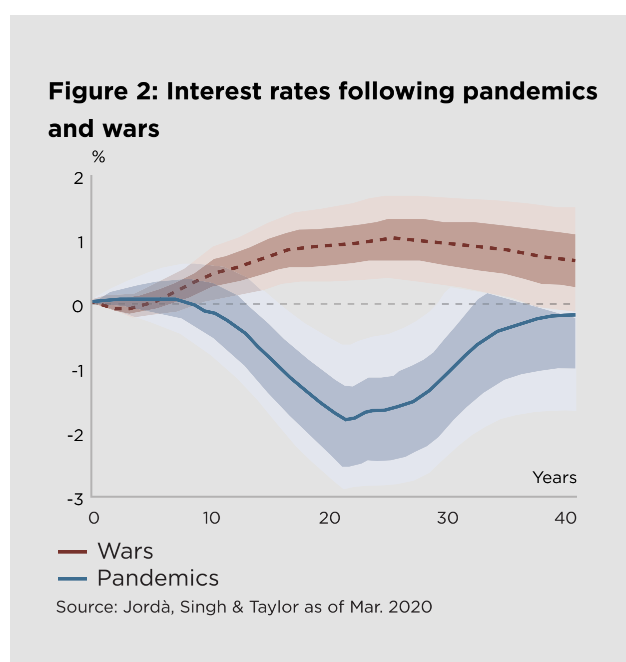

Figure 2: Interest rates following pandemics and wars

Source: Jordà, Singh & Taylor as of Mar. 2020

Strategists at Goldman Sachs highlight among their top three drivers for the next market cycle high debt levels and low nominal growth (the other two of the top three drivers were low inflation and the continued digital revolution). In the fight against the economic damage resulting from COVID-19 and the lockdowns, countries have added in some cases 10-20% of GDP to their existing debt pile, hence also reinforcing this long-term driver. They conclude "...unless the underlying fundamentals of low nominal growth, bond yields and earnings changes, or there is a significant challenge to the digital revolution, we would see such rotations as tactical not secular." In other words, growth should continue to outperform value in the long term.

As governments now embark on a fiscal spending spree, the onset of inflation could be a real risk to continued outperformance of growth stocks

What are the key risks to our thesis?

Herein lie the key factors to watch if the growth category will be truly challenged this time around. As we have touched upon above, several of them seem unlikely to change. The recurring pattern of pandemic-induced suppression of interest rates, in combination with the acceleration of deflationary tendencies driven by technological change, should work as an offset against value's greatest friend – inflation. As governments now embark on a fiscal spending spree, the onset of inflation could be a real risk to continued outperformance of growth stocks. Still, it is hard to argue against the many drivers of lower inflation emanating from the pandemic.

One longer-term driver of economic growth, demographic development, continues largely unaffected by the coronavirus. One could argue that the slowing or in some cases negative population growth, that we now see in some countries, would make workers scarcer and thus drive up wages and inflation. However, where we have seen this trend most pronounced, in Japan, this has not been the case. Wages for male workers remarkably fell in nominal terms, but increased slightly in real terms between 2000 and 2018. One should not forget that this development was seen during a period when economic growth was strong in other countries, whereas global economic growth is now slowing more broadly. These are all forces that were not present during the last periods of high inflation. In the late 1940's the world was rebuilding after the most devastating war ever fought and in the 1970's demographics was not nearly as bad as the current situation.

While additional taxes and regulation could hurt profitable growth companies, the battle lines of the next trade war seem increasingly to be drawn between

countries' technological champions. Burdening them with more taxes and regulation would hence be counterproductive to their own strategic interests. In fact, during several of the cold war periods between the UK and Germany in 1890-1914 and also between the US and Russia in the 1960's and 80's, technology and the companies involved in its development, helped by government programs, have taken the greatest leaps forward . As China is increasingly challenging the US on the technology front, we would not be surprised to see this dynamic play out again and ultimately benefit growth investments in the technology sector.

While the continuation of growth outperforming value seems to be the consensus view, we find that the pandemic has accelerated several of its core drivers. Some are already evident such as higher online penetration while others are more speculative such as the US-China trade war turning into a cold war – fought yet again with technology.

An un-consensus view on the most consensus sector overweight

We would finally like to leave the reader with what we consider less of a consensus opinion. This is an idea recently put forward by strategy analyst Ben Thompson in his blog "Stratchery" and also in recent interviews, the view that technology is actually very much like other sectors; it is not as disruptive as most people think.

While it might disrupt companies outside its own sphere much like car companies disrupted horses a hundred years ago, it is now less disruptive than commonly believed *within* the technology sector. This view also ties in nicely with the work on longer-term technological cycles by Professor Carlota Perez, expressed in her book "Technological Revolutions and Financial Capital". After an initial overinvestment driven boom-and-bust (the tech crash of 2000 and the shakeout of car manufacturers in the 1920-30's), the remaining champions (Ford, General Motors and Chrysler) stayed relevant for many more decades. Few investors (and valuation models...) express the belief that Google, Amazon and Microsoft might stay on top for as long as the car companies did, despite many similarities. This generation of industry leaders could also be less disruptive within this small cohort thus putting us as investors only in the early stage of these companies' growth trajectories.

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