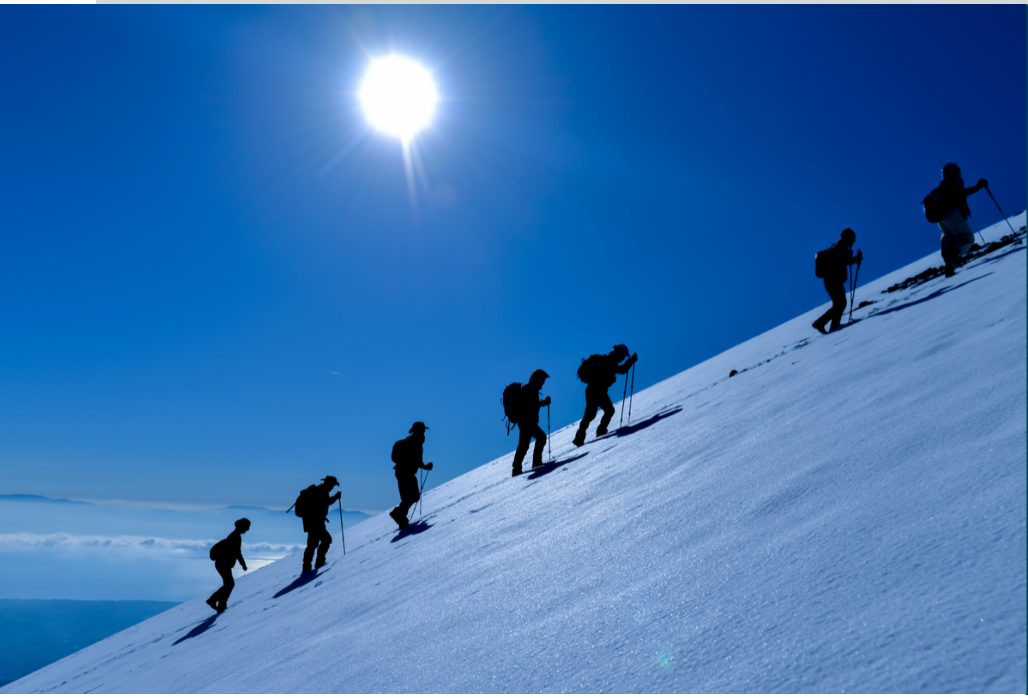
Quiet Counsel

Spring 2018
Investment Outlook



Leith Wheeler
INVESTMENT COUNSEL LTD.
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Value Through the Cycle

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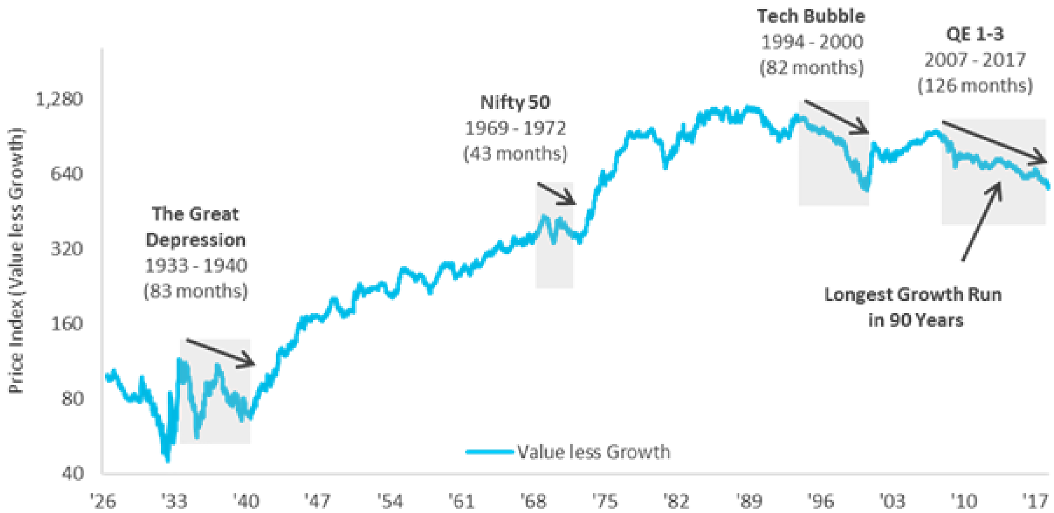
Being a "value" investor through a growth market cycle requires patience and discipline, and this past decade has required a bigger dose than usual of both. But a look at the many factors that have driven this growth run – and how they have been rapidly changing of late – makes a compelling case that commitment to the value approach will be rewarded.

In the long-term, value investing has proven a superior approach in the U.S. market, having delivered 3.1% more return per year from 1926 through 2017 than growth investing[1]. In the short-term, though, investment styles behave just like fashion trends: they come into and go out of favour. Figure 1 illustrates the long-term outperformance of value, punctuated with several periods of growth dominance – including the current record-setting one, at 126 months. Over this period, growth has outperformed value by 76%.

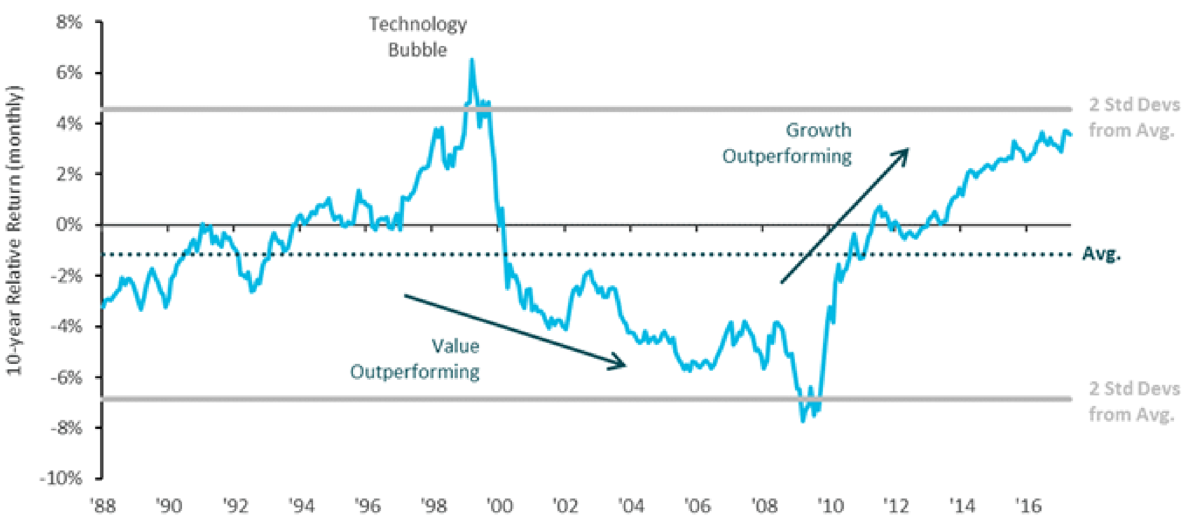
Figure 1: Outperformance of Value and Growth styles - July 1, 1926 to March 31, 2018



Source: Bloomberg; FactSet; FAMA Data 1926-1975; Fundstrat Global Advisors.

A stock's price-to-earnings (P/E) ratio reflects investor sentiment toward that stock – it is essentially the multiple of expected future earnings that an investor is willing to pay today to own the company. The higher the multiple, the more optimistic the buyer. It may be hard to believe, but growth and value stocks carried a virtually identical multiple as recently as 2006 while today – at average 1-year forward P/E ratios of 20x and 15x, respectively – it's as wide as it's been in those 12 years. Figure 2 below provides a closer look at growth's outperformance in recent years – which has relied largely on an increase in multiples. The levels are approaching the historically important "two-standard-deviations from mean" point, which means we are a long way from normal. Reversion to the mean – or a return to normal – is therefore more likely at this point than continued growth to the sky.

Figure 2: Annualized rolling 10-year relative total return of Growth versus Value (March 31, 2018)



So it is time to take stock of what's driven the current growth cycle and position ourselves in the context of that run. Why has growth outperformed, and what may change this?

To get some perspective, we sat down with Matt Egenes, client portfolio manager with Barrow, Hanley, Mewhinney & Strauss (BH). BH is the second-largest manager of active U.S. value equities in America[2], and the team there manages large- and mid-capitalization value and dividend-focused U.S. equity portfolios for Leith Wheeler clients.

[1] To put the 3.1% additional return into perspective: $100 invested in a value strategy in 1926 that earned 5% per year would be worth $8,500 today $100 invested at 8.1% per year would be worth $136,400 or 16 times more

In Egenes' view, there have been three key drivers of the dominance of growth since the credit crisis in 2008: modest overall economic growth, low interest rates, and specific challenges for traditional "value" industries. Let's take each factor in turn, and note what may be changing.

Beating the bogey: What happens when the economy catches up with "growth" stock earnings?

One of the key reasons growth stocks have outperformed the broader market since the 2008 credit crisis is that they've beaten low expectations. Essentially, because the economy has grown (until recently) at only modest rates – even out of the hole of 2008 – investors have focused their attention on companies, any company, that could beat those modest levels. The result has been fund flows into even mediocre growth stocks, simply because investors have been starved for an alternative. With the acceleration of broad economic growth, however, the premium that growth stocks have commanded may diminish and the tailwind they have enjoyed may reverse.

"We are getting some pretty strong earnings coming through and in an environment where earnings are more plentiful, one could rightfully argue: 'Why would you pay 40 to 50 times earnings for a company that's growing 10% per year when you could buy a cyclical industrial company like Johnson Controls for 12 to 14 times earnings for about the same growth?'" Egenes asks. "At some point valuation matters."

Traditional "value" sectors of Financials and Energy headwinds may subside

Energy and Financials stocks represent nearly 40% of the S&P 500 Value Index, and both of these sectors have laboured under challenges outside the control of management in recent years.

Increased regulatory oversight of Financials since 2008 has resulted in a new, lower "ceiling" on profitability for the banks – and put a dent in value portfolio returns as a result. Higher capital requirements have decreased the pot that could be lent out or traded, and regulations have discouraged both organic and acquisitive growth by smaller Financials players.

"Systemically Important Financial Institution (SIFI) regulation applies to banks that have assets of greater than $50 billion," Egenes explains. "And it constrains their growth."

He points to the example of New York Community Bank Corp, which has purposely maintained its assets at or below $50 billion in order to avoid oversight by SIFI. When the bank considered the acquisition of Astoria Bank recently, one that would accelerate their growth but cause them to hurdle that $50 billion line, the deal fell apart because of the embedded costs of submitting to the new, higher scrutiny.

"If this SIFI threshold gets lifted, which we think it will, from $50 billion to something like $250 billion, that gives them a lot of head room to start growing their loan book again."

If he is right, it would mean better earnings growth potential for many Financials, and a likely consolidation of the industry. Both of these changes would mean higher multiples and prices paid for stocks in the sector.

Another sector that has dragged down value portfolios has been Energy, mainly due to depressed earnings on the back of low commodity prices. Egenes sees opportunity here as well.

"I think we're on the other side of that now," he says. "We're lapping very weak comparables. [Crude oil prices] are now at $60-something, but I look back to that period of time two, three, four years ago… With the price of oil at $30 a barrel, the earnings were very scarce in Energy. But again, that's starting to change. In addition, select Energy companies have right-sized their cost structures in anticipation of a lower commodity environment. As a result, high revenue derived from higher oil prices flows directly to the bottom line."

[2] Source: Pensions & Investments May 29, 2017, based on U.S. institutional, tax-exempt assets as of December 31, 2016.

Interest rates giveth, interest rates taketh away

One of the less visible and perhaps less intuitive impacts of the U.S. Federal Reserve (Fed) and Bank of Canada's persistent, very-low interest rate policy is the way it favours growth stock valuations over value. The reason is this: when allocating capital, investors in growth stocks expect their thesis to play out over a longer time period and the low rates support higher valuations. Let us explain.

Value investors are anticipating a turn in investor sentiment, or that current operational or financial issues will prove transitory and return the company to healthy earnings. These are changes anticipated within the near future of three to four years.

Investors in growth stocks, on the other hand, forecast long-term trends and extrapolate (often aggressive) growth rates to target (sale) prices much further into the future.

Investors use a "discount rate" to translate all future cash flows into today's dollars. This is how they estimate what a stock is worth today. When interest rates are low, the discount rate is low. And when the discount rate is low, today's valuation is higher. So when rates are low, valuations that rely on longer cash flow forecasts – growth stocks – benefit more.

Egenes points out that growth stocks have been part of a basket of riskier assets that have benefited from the accommodative central bank policy. "Growth has certainly outperformed, small cap has outperformed, lower quality has outperformed," he says – but notes that those days may be numbered. "With the Fed on record saying they're going to increase short term interest rates at least three times in 2018, if not four, we're on a pattern of normalization for rates. This bodes well for value stocks."

As for the "higher octane" growth stocks that have borrowed to fund that growth, rising interest rates will certainly bring investor attention back to risk as levered companies will see their cash interest costs rise just as their valuations fall.

Near-record valuation gaps. Rising interest rates. Improving value sector outlooks. A rising bar for growth to attract capital.

It may not be today, or tomorrow, or even this quarter, but the cycle will rotate and value investors will be rewarded. Now more than ever, though, patience and discipline are a value investor's most important virtues.

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