ALTERNATIVES

Value Unbound: The Implications of a Nascent Value Revival

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After a long and deep period of underperformance compared with growth stocks, global value stocks have finally outperformed their growth counterparts in the first part of 2016. Citing both historical data and current economic trends, Templeton Global Equity Group's Norm Boersma, Cindy Sweeting and Heather Arnold maintain their belief that value's comeback will not likely be short-lived. Here, they expand upon the value theme and explain why they think value's nascent outperformance may really have some legs.

Last autumn, we observed that value as an investment style was experiencing its worst underperformance on record compared with growth (in terms of both magnitude and duration) and was trading near the largest valuation discount ever by some measures.[1] Like the mighty Prometheus, bound by Zeus and forced to question his faith in humanity, value has been similarly constrained by adversity, causing some investors to doubt their long-held faith in this venerable and time-tested investment discipline. Thus far in 2016, however, value has begun to come unbound; by some accounts, we recently experienced the best quarter of value outperformance in two years.

Clarity and Conviction in a Sea of Uncertainty

The Danish philosopher Søren Kierkegaard observed that "life can only be understood backward, but it must be lived forward." With the benefit of hindsight, events of the past often seem rational, even inevitable. Yet the present is always fraught with uncertainty. The same observation applies to financial markets, and especially so today. Indeed, investor uncertainty reached an extremely high level in the first few months of 2016.

Global equity markets have more than doubled from 2008-2009 financial crisis lows, but with concerns about China, credit, central bank policies, currencies and commodities all piling up, where do we go from here? Investors who missed out on the financial-crisis rebound may be reluctant to wade in now, while those who participated in the recovery may be tempted to take profits. The investment climate today seems to be a cautious one, noticeably bereft of conviction.

Yet at Templeton, our conviction in a value discipline has only strengthened. This is largely rooted in our long experience as value investors, which helps us “understand the market backwards,” to paraphrase Kierkegaard. Having lived through a number of these cycles, we believe the current moment stands out as especially compelling. The spread between the valuation of the market’s cheapest stocks and its most expensive stocks has blown out to historic highs. As of March 31, 2016, on a price/earnings (P/E) basis, popular momentum stocks had become nearly three times more expensive than seemingly unloved value stocks.[2]

Paying More for Momentum

Value Stocks' vs. Momentum Stocks' Price-to-Earnings (P/E) Ratios, January 2, 2001–March 31, 2016

Source: Cornerstone Macro, as of March 31, 2016. Value stocks are represented by the S&P 500 Value Index, and momentum stocks are represented by the S&P 500 Momentum Index. Indexes are unmanaged, and one cannot invest directly in a index. They do not reflect any fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future performance. The P/E ratio is an equity valuation multiple defined as market price per share divided by annual earnings per share.

Looking back through history, whenever value stocks have gotten this cheap, subsequent long-term returns have generally been strong.[3] From current depressed valuation levels, value stocks have in the past, on average, doubled over the next five years.[4] Not that we necessarily expect returns of this magnitude this time around, but based on the data and our six decades of experience investing through various market cycles, we believe the current risk/reward proposition is heavily skewed in favor of long-term value investors.

Dotcom Redux: Why Staples Is the New Tech

Investors would have to go back to the height of the technology, media and telecom (TMT) bubble frenzy in 2000 to find the last time value traded at such an extreme discount.[5] That episode provides an interesting inverse corollary to today's environment. We believe it was investor greed that propelled growth stocks to such extreme heights back then; today, fear seems to be sustaining the momentum as investors pay up for the perception of safety and stability in an uncertain environment. Now, as then, we have a distinctly two-tiered market. The momentum drivers today—caution and risk aversion—may be less exciting than the promise of a new technology paradigm, but the consequent valuation disparity is roughly the same. Indeed, the consumer staples sector appears to be the new tech as the market bids up growth and safety at the expense of value. During the TMT bubble, all it took to topple tech stocks priced for perfection was a little bit of bad news. Just a little bit of good news may be sufficient today to spark a recovery among value stocks that seem to be pricing in permanent disappointment.

Waiting for a Catalyst

Yet, understandably, many investors are holding out for a stronger value catalyst than "just a little bit of good news." In past commentaries, we identified rising interest rates and the mean-reverting tendencies of both valuation and performance as potential value catalysts. In past value cycles, rising interest rates corresponded with a clearly strengthening economy. In essence, the argument goes, rising rates didn't cause the value rebound, they were merely an effect of a stronger economy and building inflationary pressures, themselves the primary catalysts for value. Today, however, global economic growth is moderate, deflationary pressures persist and most major central banks are explicitly easing policy. While the US Federal Reserve (Fed) appears to be cautious in

regard to potential rate hikes, it is not embarking on policy tightening against a backdrop of overwhelming macro strength. Significant uncertainty persists, the Fed’s positioning is still fairly dovish, and US rate hikes may be paused or even reversed should financial or economic headwinds intensify. So, the skeptics ask, how will value recover absent a definitive macroeconomic rebound?

Value Has Historically Outperformed During US Interest-Rate Liftoff

Cumulative 3-Year Total Return Following a US Federal Reserve Liftoff
Since December 31, 1974 (six periods through 2007)

Source: Calculations performed by Franklin Templeton Investments using data sourced from FactSet. See www.franklintempletondatasources.com for additional data provider information. Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future performance.

While value has indeed benefited from economic recovery in the past, it is by no means a precondition for a value rebound. Investors waiting for an improving economic cycle would have missed the value upturn in 2000, for example. On the other hand, investors fleeing value in anticipation of economic weakness would have missed value’s outperformance during the recession of 1981-1982. In each of these instances, we believe value stocks simply became too cheap and mean reversion prompted a value rally. The point is that while value *can* be pro-cyclically correlated to the economy, this isn’t always the case. We consider the starting point valuation of value stocks (or any style factor, for that matter) to be a far more accurate predictor of future returns than the outlook for economic growth.

Not only that, but starting point valuations are knowable, unlike future economic growth. When it comes to value, today's valuation starting point is distinctly compelling, in our view.

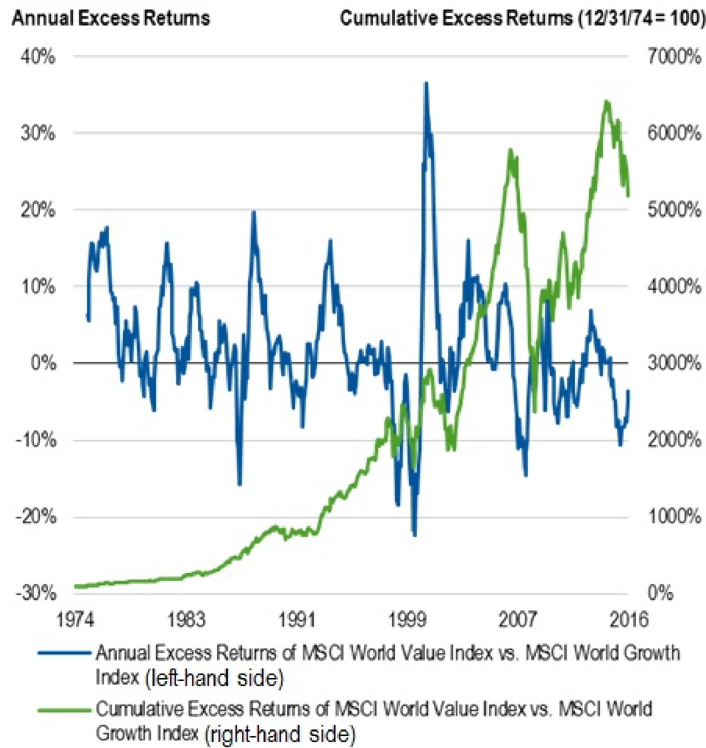
For investors still seeking a value catalyst beyond interest rates and mean reversion, we believe there is an additional development which bodes well for value going forward. Since the global financial crisis, value stocks have been primarily concentrated in either resource sectors (energy and materials) or rate-sensitive sectors (financials). For many, being a "value investor" therefore has meant taking on commodity risk and/or interest-rate risk. Recently, however, value has proliferated beyond just a few deep cyclical sectors; across the market, the gulf between the cheapest and most expensive stocks *within* sectors has widened. For example, value is just as cheap today within pharmaceuticals and biotech as it is within financials and energy.[6] The spread of value to many different sectors and regions may enhance the style's appeal in the eyes of the generalist investor, helping perpetuate the potential for value recovery.

You Have to Be There to Benefit

Another important lesson that we have learned over the years is that returns to value accrue intermittently. The chart below overlays the long-term cumulative outperformance of value over time with the shorter-term annualized returns. While value has historically compounded gains over time (green line), it has swung around considerably in the short term (blue line). Our conclusion is that value works over the long term, but you have to be there to benefit.

Value Has Been Erratic Short Term, but Effective Long Term

Annual Cumulative and Excess Returns of the MSCI World Value Index vs. the MSCI World Growth Index
December 31, 1974–February 29, 2016



Source: FactSet. See www.franklintempletondatasources.com for additional data provider information. Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future performance.

In other words, when value recovers it tends to do so abruptly and investors must be positioned accordingly to reap the full potential rewards. This can be difficult because it requires the discipline to buy usually unpopular stocks and the patience to hold onto those stocks in the face of adversity and volatility. At Templeton, we buy on market pessimism, and the market can remain at odds with our portfolios for a considerable stretch. Following one of the worst periods for value on record, and with the style still trading at significant valuation discounts even after a nascent rally, we believe there is cause for cautious optimism, and that “value unbound” describes the most compelling opportunity in equity markets today.

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1. Source: FactSet. See www.franklintempletondatasources.com for additional data provider information. Value is represented by the MSCI World Value Index, and growth is represented by the MSCI World Growth Index. Performance of the MSCI World Value Index compared to the MSCI World Growth Index is measured from the inception of the indexes on December 31, 1975 through March 31, 2016. Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future performance.

2. Source: Cornerstone Macro. Momentum stocks are represented by the S&P 500 Momentum Index, and value stocks are represented by the S&P 500 Value Index. Indexes are unmanaged, and one cannot invest directly in an index. Past performance is not an indicator or a guarantee of future performance.

3. Past performance is not an indicator or a guarantee of future performance.

4. Source: Sanford C. Bernstein & Co., as February 29, 2016. Past performance is not an indicator or a guarantee of future performance.

5. Source: Ibid.

6. Sources: MSCI, FactSet, Sanford C. Bernstein & Co. See www.franklintempletondatasources.com for additional data provider information. Past performance is not an indicator or a guarantee of future performance.

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