Will Value ever outperform again?

A Featured Report by Ned Davis Research

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Executive Summary

The current Growth secular bull is the longest on record, causing some to ask when, or whether, Value will reclaim its championship belt as the style with superior long-term returns.

Our view is that yes, **Value will outperform again,** but it requires certain macro conditions. Those requirements have not changed, but the nature of the U.S. economy has. The consumer/debt-based economy has led to slower growth and longer expansions, which favors Growth stocks.

Conditions are **getting closer to supporting a Value secular bull, but they are not quite in place.** The biggest is sustained GDP growth above potential without help from the Fed, or **escape velocity.**

A steeper yield curve, normal Fed policy, more extreme valuations in Growth stocks, and the end of the buyback boom would also hasten the return to a Value secular bull.

Growth's record run has led investors to seek alternative measures of Value. Concepts such as **quality, volatility,** and **momentum** are finding their niches. Presently, they lack industry standard definitions and in some cases stability in their constituents to supplant Growth and Value.

For stock selection, we found portfolios with characteristics of the opposite style box have outperformed. The NDR stock screener has saved **VARG (Value at a reasonable growth)** and **GARP (Growth at a reasonable price)** portfolios.

How Growth/Value secular rotations happen

Major shifts depend on macroeconomic conditions

Rarely do they line up at a single point in time

KEY TAKEAWAYS

The current Growth secular bull is the longest on record, but also the weakest.

The changing composition of the economy has widened Growth's window in recent decades.

Conditions are getting closer for a Value secular bull, but they are not quite in place.

Growth stocks have been outperforming Value stocks since 2006. That is **by far the longest run on record (chart, right).** If the current secular trend survives until June, it will double the second-longest Growth secular bull, the 1993-2000 period that ended with the internet bubble.

Secular trends do not die of old age. Something, or more likely several things, need to change for Value to outperform Growth over a multi-year period. Before discussing what those changes might be, it is worthwhile to examine how the current Growth secular bull got to be so long in the first place.

How Growth lasted this long

First, Growth's outperformance has been weaker than of any previous secular bulls. The Growth/Value ratio has risen at pace of 4.0% per year since July 2006, **less than half the gain per annum** (GPA) of the second-weakest Growth secular bull (8.9% in 1969-72). The smaller outperformance means that **Growth stocks are not as overbought versus Value stocks as they were at previous secular turning points.**

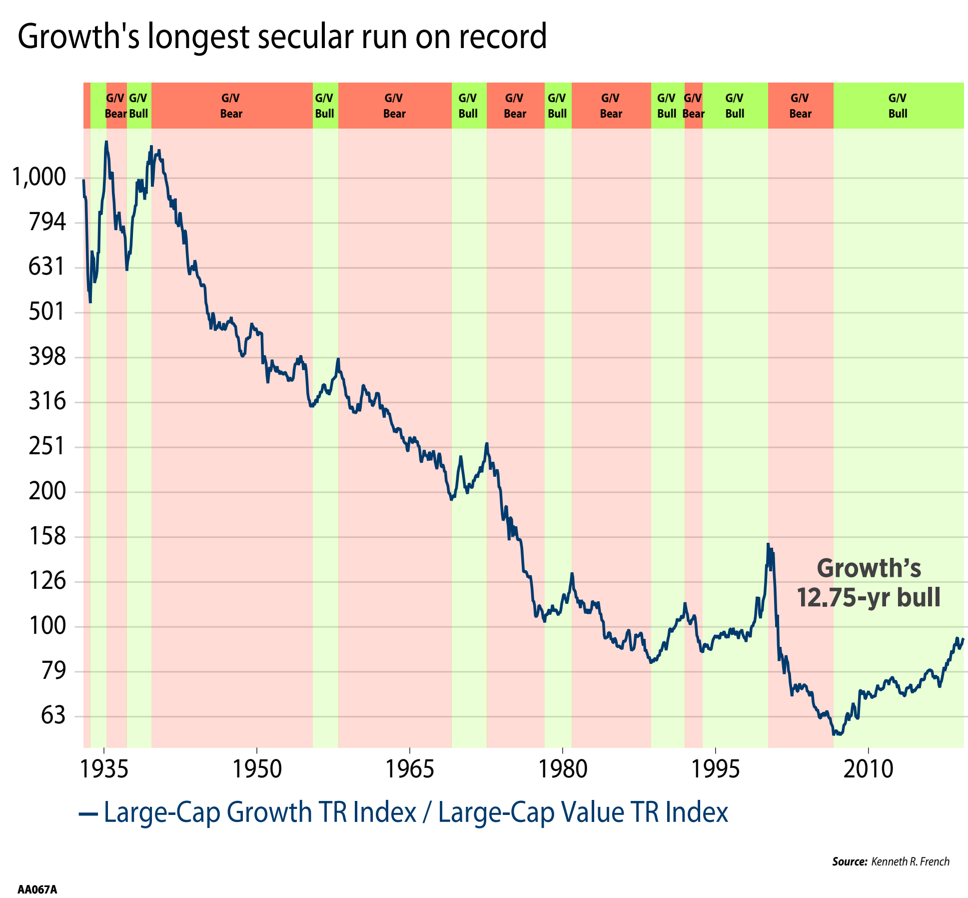
Blame Fama-French

Second, **the market has arbitraged away the advantage of buying cheap Value stocks**. Value outperformed almost uninterrupted from 1935 to 1988. It was around that time Eugene Fama and Kenneth French popularized their three factor model. One factor was price/book, which evolved into Value. Once investors became aware of the benefits of owning cheap Value stocks, they arbitraged it away.

That does not mean that Value cannot enjoy another secular bull, but the back-and-forth over the past 30 years is more likely to be the norm moving forward than the previous 50 years.

Low altitude escape velocity

Third, **the nature of the economy has changed**. From the 1930s through the 1970s, the U.S. economy was manufacturing based. Inventory builds and Fed tightening cycles caused more frequent recessions, but the economy recovered from them more quickly.



How Growth/Value secular rotations happen

Escape velocity is a term that economists borrowed from physicists. It refers to the amount of energy needed to launch a spaceship into orbit.

Economically, escape velocity is the amount of economic growth needed for the economy to expand without the benefit of monetary or fiscal stimulus. In most expansions through the 1980s, it took less than four quarters for the economy to reach escape velocity **(table, right).**

As the economy shifted from manufacturing to consumption **(chart, below)**, economic cycles changed. Expansions have gradually lasted longer because consumer spending is more stable than manufacturing. Longer expansions and dovish Fed policies led to an explosion of debt from 175% of GPD in 1982 to 345%.

Economy taking longer to reach escape velocity

Expansion Start (Quarter-end)	Escape Velocity Achieved	# Quarters from Expansion Start to Escape Velocity
December 1949	June 1950	2
June 1954	December 1954	2
June 1958	March 1959	3
March 1961	December 1961	3
December 1970	June 1972	6
March 1975	June 1978	13
December 1982	June 1983	2
March 1991	March 1994	12
December 2001	June 2005	14
June 2009	?	39 (?)
Median		3

Escape velocity threshold criteria:
Real GDP y/y % change > Potential real GDP y/y % change.
Real Fed Funds Rate > 0.5%.
This condition guarantees that there is no monetary stimulus from the Fed.
Sources: National Bureau of Economic Research, Federal Reserve Board, Department of Commerce.

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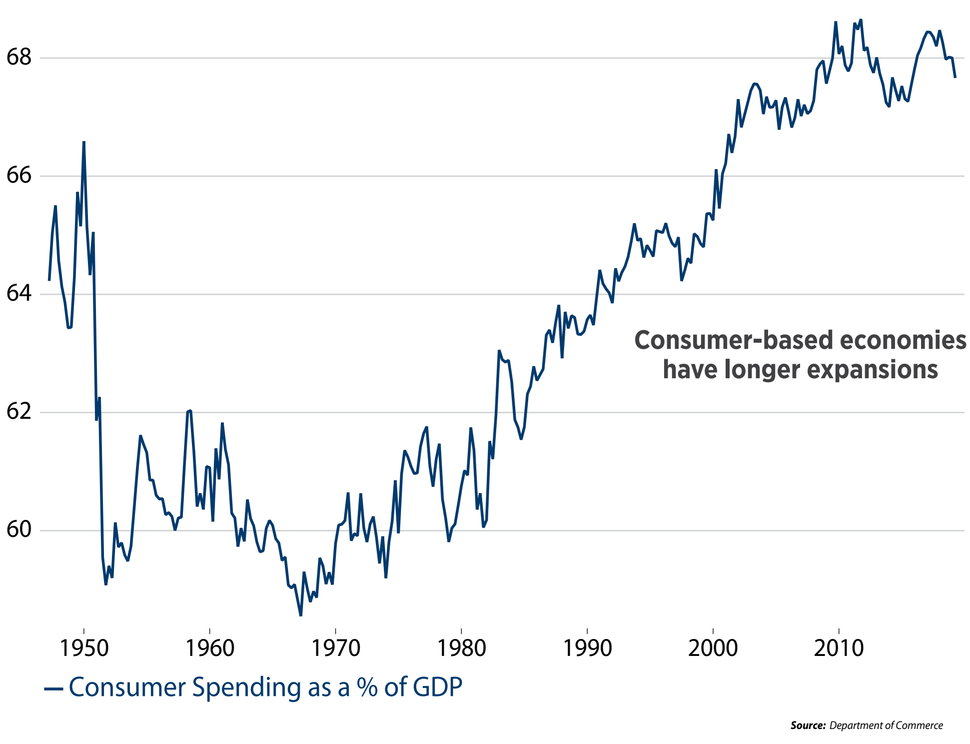
Consumer spending biggest part of U.S. economy



The upshot is that even after recessions technically ended, **the recovery to escape velocity took longer** because the economy was still digging out of the debt overhang from the previous expansion. The expansions beginning in 1991 and 2001 took 3-4 years to hit escape velocity.

The current expansion is almost 10 years old and on the verge of becoming the longest in post-war history. According to NDR's U.S. Economist Veneta Dimitrova's criteria, the economy is approaching escape velocity. However, she doubts that real GDP will be sustainable at these levels due to diminishing tax cut benefits and a transitory drop in inflation.

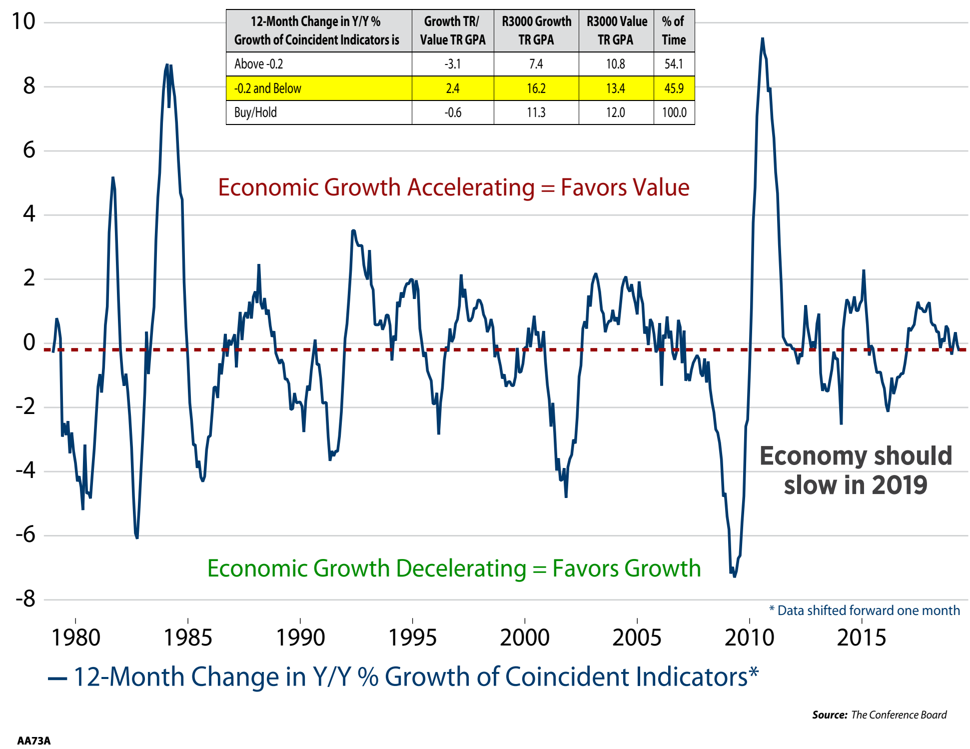
A transition to escape velocity would be the biggest driver of a Value secular bull. It may be **getting close**, but the burden of proof is on the economy to prove it can sustain faster growth.

How Growth/Value secular rotations happen

Slow growth favors Growth
In addition to the pace of economic growth, the change in the growth rate can be a major headwind or tailwind for Growth versus Value. **When economic growth is sluggish, investors flock to the few companies that can grow anyway.** Almost by definition, those are Growth stocks.

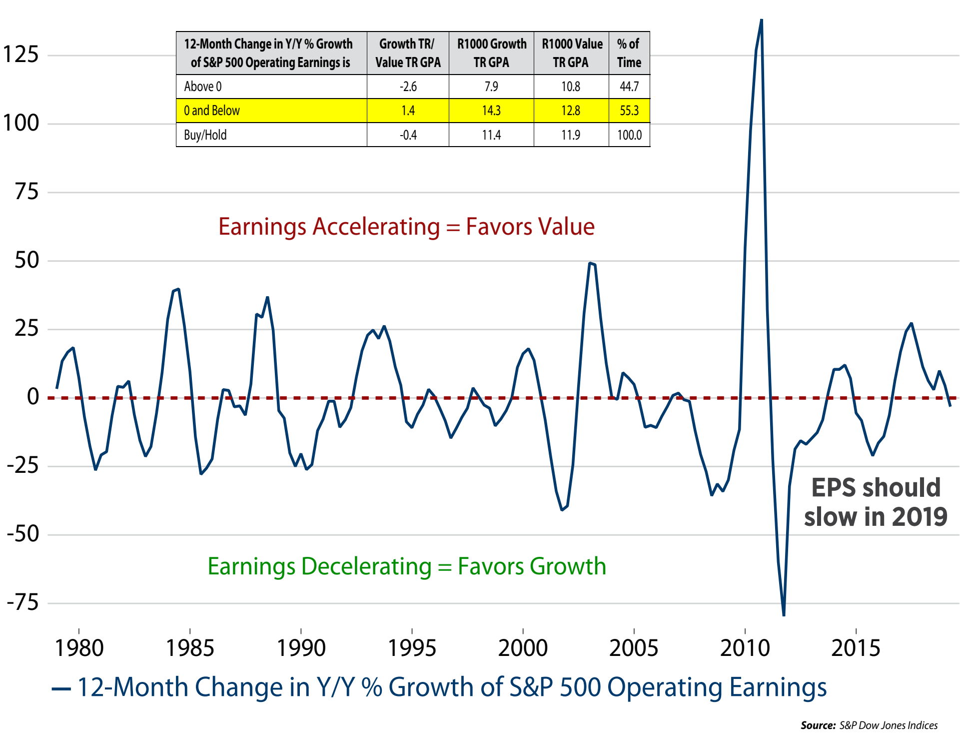
Index providers like Russell and S&P use multiple factors to classify stocks as Growth or Value. Companies with high long-term earnings and sales growth are put in the Growth bucket. As a result, the relative performance of Growth versus Value is counterintuitive to some: slow economic growth favors steady Growth stocks, while fast economic growth favors cyclical Value names **(chart, right).**

Sluggish economy favors Growth



12-Month Change in Y/Y % Growth of Coincident Indicators is	Growth TR/ Value TR GPA	R3000 Growth TR GPA	R3000 Value TR GPA	% of Time
Above -0.2	-3.1	7.4	10.8	54.1
-0.2 and Below	2.4	16.2	13.4	45.9
Buy/Hold	-0.6	11.3	12.0	100.0

Earnings deceleration favors Growth



12-Month Change in Y/Y % Growth of S&P 500 Operating Earnings is	Growth TR/ Value TR GPA	R1000 Growth TR GPA	R1000 Value TR GPA	% of Time
Above 0	-2.6	7.9	10.8	44.7
0 and Below	1.4	14.3	12.8	55.3
Buy/Hold	-0.4	11.4	11.9	100.0

The same concept applies to earnings growth. When earnings growth has been slower than it was a year ago, investors have favored **Growth stocks because their earnings are not as dependent on the overall market** and economy **(chart, left).** Conversely, when earnings growth has been accelerating, Value has outperformed Growth, on average.

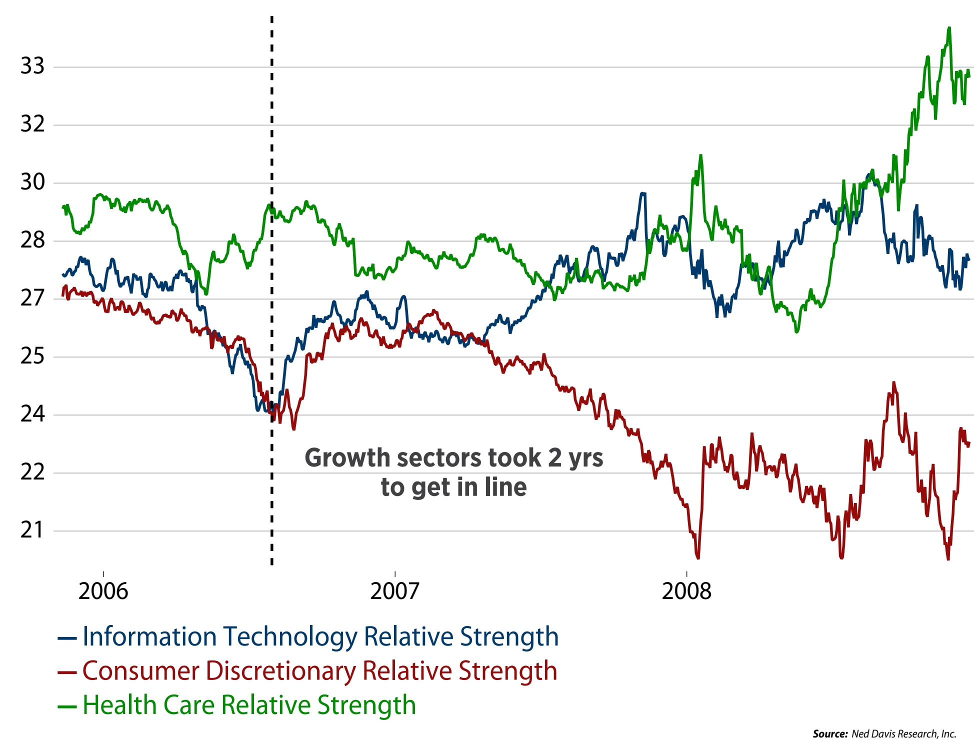
How Growth/Value secular rotations happen

Not all at once

The chart on page 3 shows the inflection points of Growth versus Value. That can give a false sense that everything happens at once. In reality, **for categories as broad as Growth and Value, rotations unfold over months, or even years.**

Take the last rotation from Value to Growth in 2006 as an example. The three biggest Growth sectors in 2006 were Technology, Consumer Discretionary, and Health Care. Technology bottomed relative to the S&P 500 in August 2006, one month after the Growth/Value ratio **(chart, right).** Consumer Discretionary's relative strength bounced in late 2006, but the bottom dropped out in 2007 and 2008 during the Great Recession. Health Care traded in-line with the market until November 2008.

Gradual rotation to Growth 2006-08



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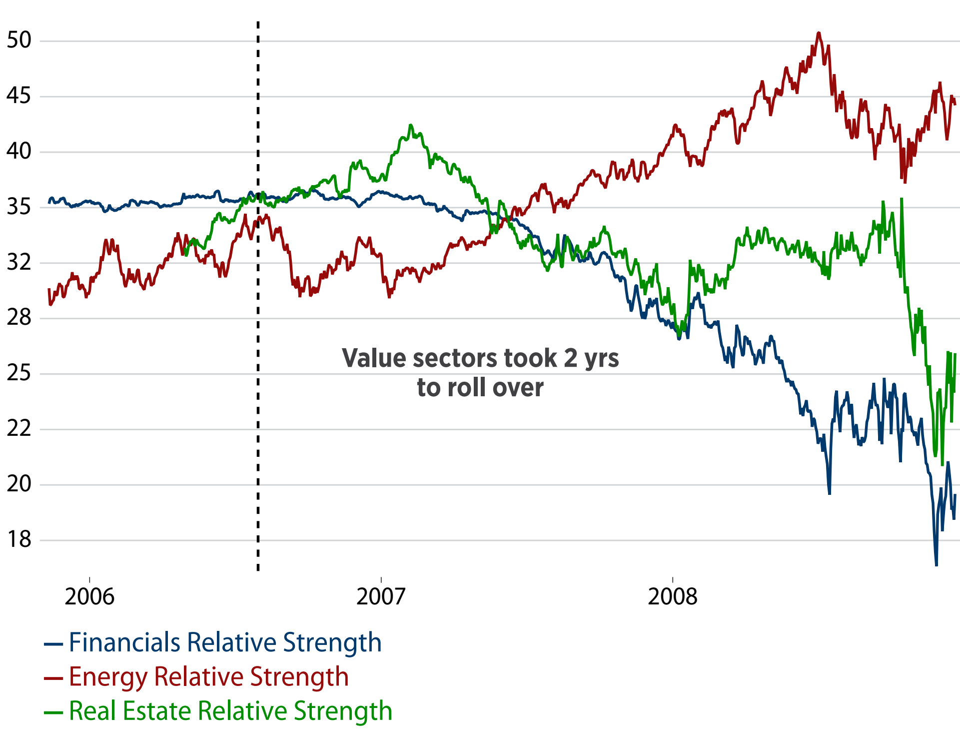
Gradual rotation from Value 2006-08



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Three of the most important Value sectors in 2006 were Financials, Real Estate, and Energy **(chart, left)**. Financials' relative strength peaked in September 2006, two months after Value gave way to Growth. Real Estate did not peak until February 2007, when the housing market began its decent in earnest. Energy did not peak until July 2008, when crude oil hit $145 per barrel.

How Growth/Value secular rotations happen

Will Value ever outperform again?
After 12.75 years of swimming upstream, Value managers have to be wondering if the current will ever flow in their direction. One of the reasons for becoming a Value manager was the ability to achieve superior returns by buying undervalued stocks. Our answer is **yes, Value will enjoy a multi-year run of outperformance again...when the macro conditions are right.** Unfortunately for Value managers, **those macro conditions are not in place.**

Every time Value has mounted a multi-month rebound in the last several years, a strategist or two has made the call for a long-term rotation to Value. To date, they have proven to be incorrect. The Russell 3000 Growth/Value ratio made a new high as recently as April 26, 2019.

We point out the failed calls not as an admonishment, but as a contrast to the NDR approach. We identify factors, track them, and when the weight of the evidence changes, so does our view.

What to watch
The Growth/Value secular watch report is now on the NDR website as SMF_42, and is shown **below. The majority of the indicators side with growth.** However, it is worth noting that a few major ones, like **escape velocity and buybacks, could be close to flipping. If they do, we would look to become secular bulls on Value for the first time in over a decade.**

Our last Featured Report on Growth/ Value in November 2013 concluded that the Growth bull had more time. If we write a report in 5.5 years, we highly doubt we will be talking about the continued Growth secular bull.

The charts on page 6 illustrate that while we may be able to pinpoint a date in hindsight, the rotation will likely unfold piecemeal. The next two sections examine four challenges that Value needs to overcome and five items to watch for Growth to lose favor.

Secular forces favor Growth over Value, but some are getting close to flipping

Indicator	Direction or Level	Favors	Chart	Notes
Growth/Value Trend	Rising	Growth	AA067A	Growth continues to make new relative strength highs
Escape Velocity ← **Close to flipping**	Rising	Neutral	ECON_20	Economic growth touching potential, but may not be sustainable
Economic acceleration/deceleration	Falling	Growth	AA73A	Sluggish economic growth favors Growth
Earnings acceleration/deceleration	Falling	Growth	AA77	Earnings deceleration favors Growth
Growth/Value sector's economic sensitivity	Rising	Growth	BA3020	Sluggish economic growth favors Growth
Growth/Value sector's yield curve sensitivity	High	Growth	BA3023	Flat/inverted yield curve favors Growth
Growth/Value sector's dividend yield sensitivity	High	Value	BA3024	Powell pivot favors Value-oriented dividend stocks
Payers' vs. Non-Payers P/E ratios	Low	Value	SBOX_273B_SP5	Dividend Payers cheap versus Non-Payers
Growth/Value sector's beta sensitivity	Low	Growth	BA3021	Secular bull a headwind for defensive Value
Growth/Value relative earnings yields	Level	Neutral	AA62	Growth modestly more expensive than Value
FANGs P/E ratio	Middle	Neutral	DAVIS231	FANGs not as expensive as they used to be
S&P 500 Net Repurchases 4Q Total ← **Could be key driver**	High	Neutral	BENCH_558	Biggest repurchasers tend to be Growth stocks

Indicators shaded green = favors Growth. Indicator shaded red = favors Value. Indicator shaded yellow = neutral.

Sources: Russell, Department of Commerce, S&P Dow Jones Indices, The Conference Board, S&P Capital IQ Compustat.

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Four challenges for Value

Macroeconomic conditions are headwinds

Secular shift to Value may require faster sustained economic growth

KEY TAKEAWAYS

Some sectors tilt Growth or Value, but those tilts drift over time.

Cyclical Value needs stronger economic growth and a steeper yield curve.

Defensive Value benefits from the Powell pivot, but not the broad market secular bull.

Sectors have style tilts

There are many ways to group stocks. Growth and Value is one. By sector is another. The Global Industry Classification Standard, or GICS, classifies publicly traded stocks by their lines of business.

Sector and style classifications are independent of each other, meaning that a stock is simultaneously classified as Growth or Value and grouped in a sector. When individual stock weights in Growth and Value are aggregated by sector, some sectors tend to be tilted toward Growth, while others are tilted toward Value **(table, right).**

Technology has been the biggest Growth sector for decades. Consumer Discretionary has also been Growth-oriented. Communications Services, which was created in 2018 by combining the old Telecom sector, media stocks from Consumer Discretionary, and media companies from Technology, also tilts toward Growth. Health Care has been Growth in the past, but has been more balanced recently due to mega-cap Pharmaceutical companies taking on Value characteristics.

Due to its low price/book ratio, **Financials is the biggest Value sector.** Energy, Utilities, and Real Estate also tend to be Value-oriented.

Growth/Value's tectonic plates

Sector tilts toward Growth or Value are stable in the short run, but they **drift over time.** A sector whose weight has gotten too high in Growth is at risk of being overbought and overvalued. For example, Energy is a Value sector most of the time, but in 2010, after a multi-year run of outperformance, it had almost as big of a weight in the Russell 3000 Growth as in the Russell 3000 Value **(chart, page 9).** That was a sign of an Energy bubble.

A deeper understanding of how Value can outperform can be ascertained by analyzing sector tilts, what drives them, and where they are in their respective cycles. Focusing on Value, four key trends stand out as necessary for a Value secular bull to unfold. The trends may not happen at once, creating **opportunities for Value managers to outperform their benchmark during a likely multi-year transition.**

Several sectors are biased to Growth or Value

GICS Sector	Russell 3000 Growth % Weight	Russell 3000 Value % Weight	Spread % (G - V)
Information Technology	31.6	9.7	21.9
Consumer Discretionary	15.0	4.9	10.1
Industrials	11.8	7.2	4.6
Communication Services	9.3	6.3	3.1
Health Care	12.7	12.2	0.5
Materials	1.8	3.6	-1.8
Consumer Staples	5.5	7.3	-1.9
Real Estate	2.3	5.4	-3.1
Utilities	0.0	6.4	-6.3
Energy	0.8	8.5	-7.7
Financials	4.1	22.0	-17.8

S&P Dow Jones Indices launched the Real Estate sector on 2016-09-19 and replaced the Telecom Services sector with an expanded Communication Services sector on 2018-09-24; Financials excluding Real Estate. Prior data is an NDR estimate.
Sources: Russell and S&P/MSCI GICS.

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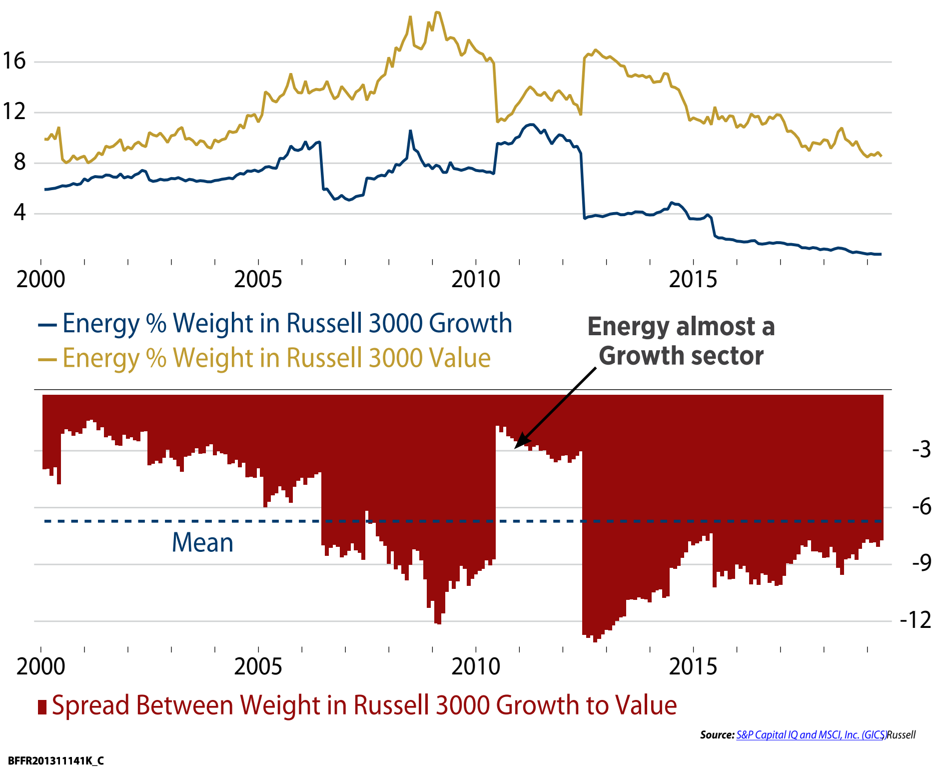
Four challenges for Value

#1 Cyclical Value needs stronger economy

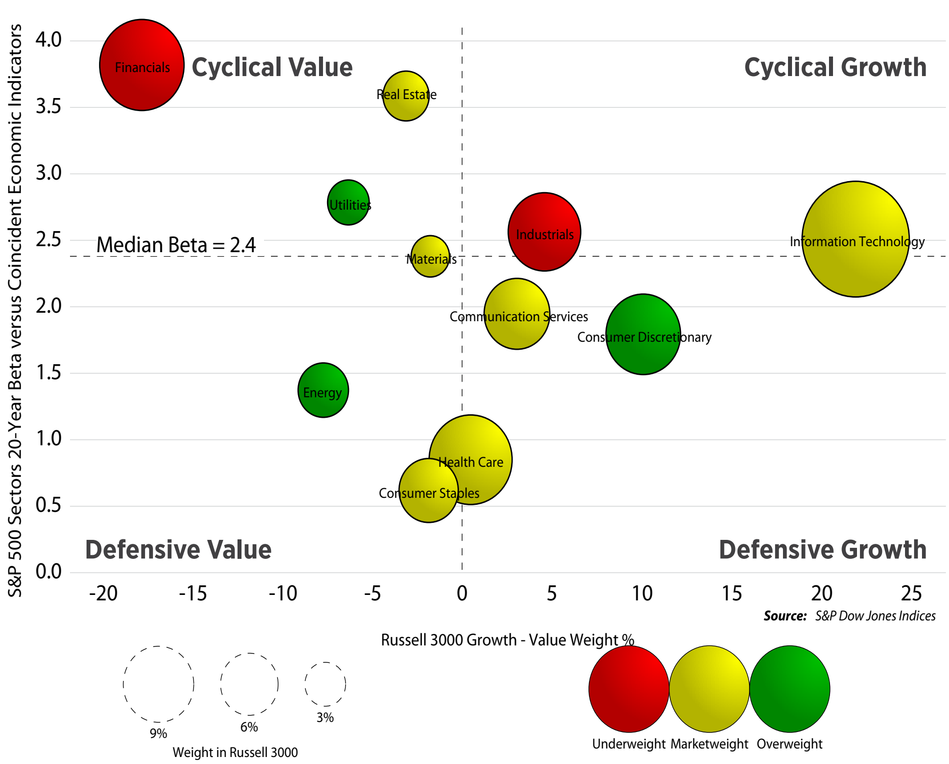
Pages 4 and 5 demonstrate that the factors used to classify stocks as Growth or Value mean that, paradoxical to their names, faster economic growth favors Value and slower economic conditions favor Growth.

The **chart below** demonstrates how Growth/Value relative performance depends on the economy via sector weights. The horizontal axis shows each sector's weight in the Russell 3000 Growth Index minus the Russell 3000 Value Index. A positive number, like Technology's, means a sector is Growth-oriented. A sector with a negative reading, like Financials, is Value.

Energy's Growth tilt a warning sign in 2008



Cyclical Value needs faster economic growth



The vertical axis is each sector's economic sensitivity. **The most economically sensitive sectors are Value**: Financials and Real Estate in particular.

The least economically sensitive sectors are also Value-tilted, but on balance Value benefits from faster economic growth.

Most of the middle-sensitive sectors, such as Technology, Discretionary, Communications, and Industrials, are Growth sectors.

If the economy is going to rip, the sectors that are going to benefit the most are cyclical Value sectors. **Until the U.S. economy can demonstrate that it can sustain 4% real GDP growth (escape velocity), cyclical Value should suffer.**

Four challenges for Value

#2 Financials needs a steeper yield curve

Since Financials is the biggest Value sector, it will be difficult for Value to mount a secular comeback without that sector at least participating. Financials faces a host of headwinds, including regulations after the financial crisis and lower returns on equity, but perhaps **the biggest issue facing Financials is the flat yield curve.**

The old adage about bankers is that they adhered to the 3-6-3 rule: borrow at 3%, lend at 6%, and hit the golf course by 3 pm. Banks can only take advantage of the carry trade if short-term interest rates are lower than long-term interest rates, also known as an upward sloping yield curve.

Fed policy and Financials' profits

One of the **unintended consequences** of quantitative easing (QE) and zero interest rate policies (ZIRP) is that the yield curve is flat. A few times in early 2019, parts of the yield curve inverted. A flat/inverted yield curve curtails Financials' profitability.

The Fed's normalization in recent years has led to expectations that the yield curve would steepen. Powell's pivot to a more dovish Fed policy in early 2019 renewed the lower-for-longer consensus on long-term interest rates. The ECB's extension of its version of QE and ZIRP has pushed German bund yields below 0%. How high can U.S. 10-year Treasury yield's climb if their competition is 0%?

The loosening of some regulations has lifted hopes that Financials can find alternative paths to profit growth, but those have not been enough to offset the yield curve.

Sector sensitivities to the yield curve

The **at right** is similar to the one on page 9, except that the vertical axis is each sector's sensitivity to the yield curve, specifically the 10-year Treasury minus the two-year Treasury yield.

Financials is by far the most positively sensitive sector to the yield curve, meaning that a steeping yield curve is bullish for Financials and a flattening yield curve is bearish.

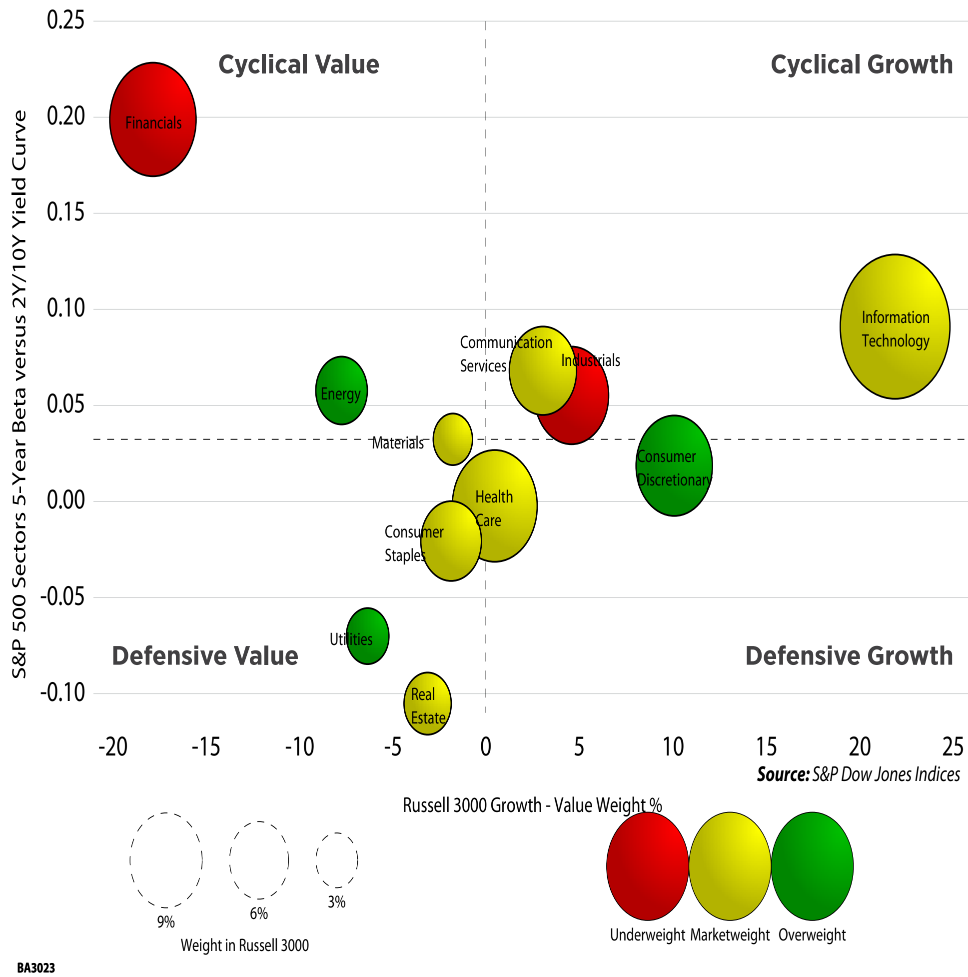
Bond proxies

The three sectors with the biggest negative sensitivities are Real Estate, Utilities, and Consumer Staples, also Value sectors. A flattening yield curve should support those three sectors, but they are not big enough to offset Financials.

Those three sectors have been dubbed bond proxies. Their high dividend yields have made them attractive alternatives to bonds in the ultra-low interest rate environment. They have usually been among the sectors with the lowest betas versus the yield curve, but before the financial crisis, their betas were not nearly as negative as they are today.

The upshot is that as long as the Value-oriented bond proxy sectors have negative sensitivities to the yield curve, a steepening yield curve will not be as bullish for Value as it has been in the past. **Value is in a box until the interest rate environment normalizes.**

Financials need steeper yield curve

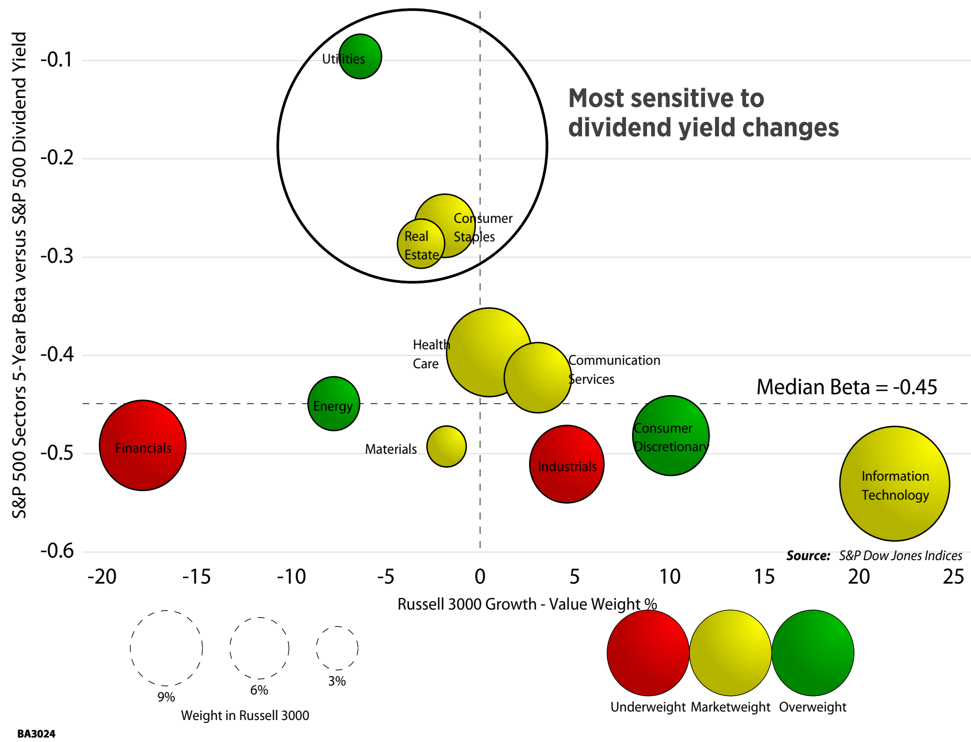


Four challenges for Value

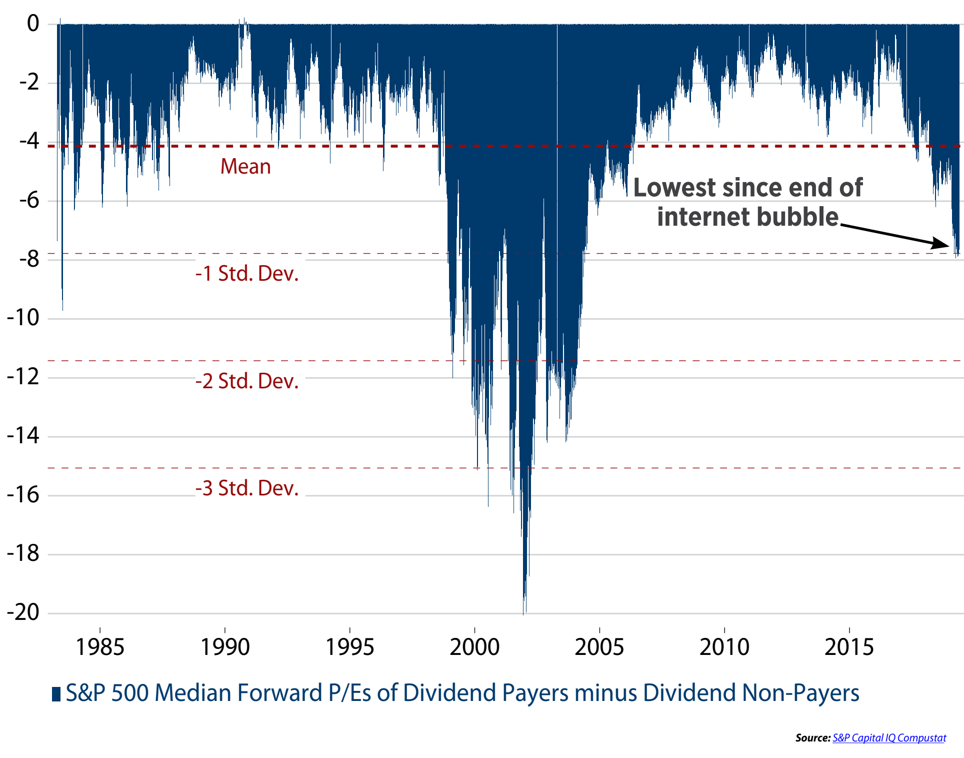
#3 Search for dividends

The third area of Value that has been facing a headwind for much of the past three years, but **may be getting a reprieve, are dividend stocks.** As discussed on page 10, high dividend yielding sectors such as Utilities, Real Estate, and Consumer Staples have functioned as bond substitutes during the Fed's ultra-low interest rate environment. They are also the most sensitive to changes in the S&P 500 dividend yield **(chart, right).**

Bond proxies are Value-oriented



Payers cheapest in 15 years vs. Non-Payers



Dividend stocks inexpensive

Unlike when the Fed ended QE in 2014, **Dividend Payers are cheap relative to Non-Payers.** Since 1983, Dividend Payers have almost always had lower forward P/E ratios than Non-Payers, but by the time the Fed was wrapping up QE in 2014, Payers were trading nearly on par with Non-Payers **(chart, left).**

Fed normalization led to Dividend Payers underperforming. As a result, they have gotten much less expensive. The median forward P/E of Dividend Payers versus Non-Payers is at a **15-year low**.

Ultimately, Fed normalization will be a headwind for the bond proxy segment of Value. But as long as the Powell pivot is in place, this is one section of Value that may benefit.

Four challenges for Value

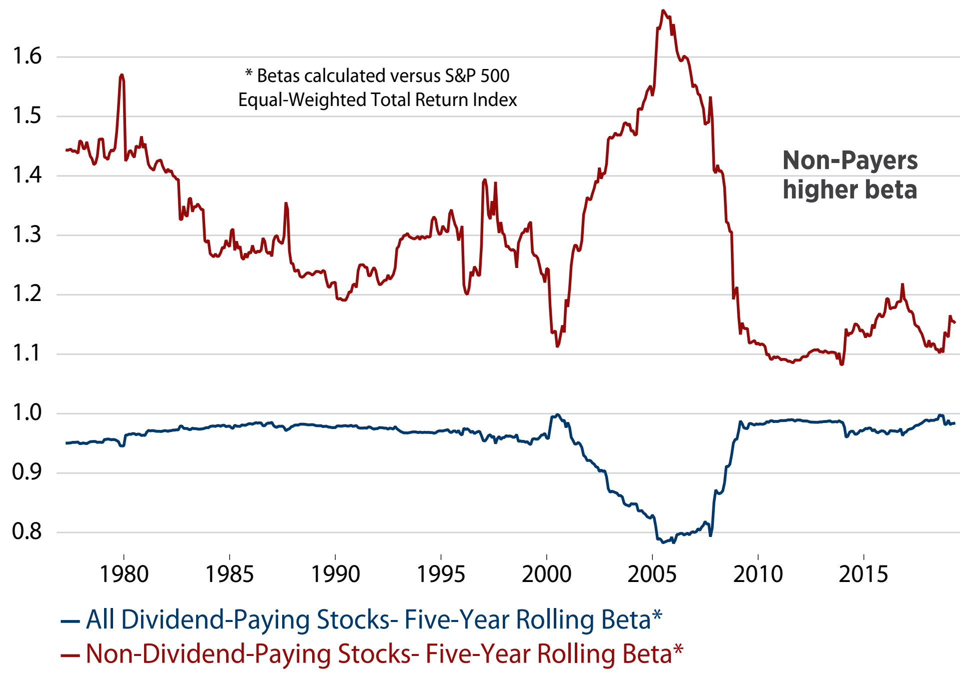
#4 Beta drag

While the interest rate environment is more favorable for bond proxies, the secular bull market in equities is not.

The broad U.S. stock market began its current secular bull market in 2009. The last two secular bull markets have lasted 18 and 24 years, so there are likely several years left in the current secular trend. Dividend Payers have lower betas than Non-Payers **(chart, right).** Their lower betas should work against Dividend Payers during secular bulls.

Secular bulls are marked by periodic cyclical bears, and Dividend Payers should benefit during those periods. But **Dividend Payers' best chance for a multi-year run of outperformance should come during the next broad market secular bear**.

Payers' low beta a drag in a broad market secular bull



Source: S&P Capital IQ Compustat

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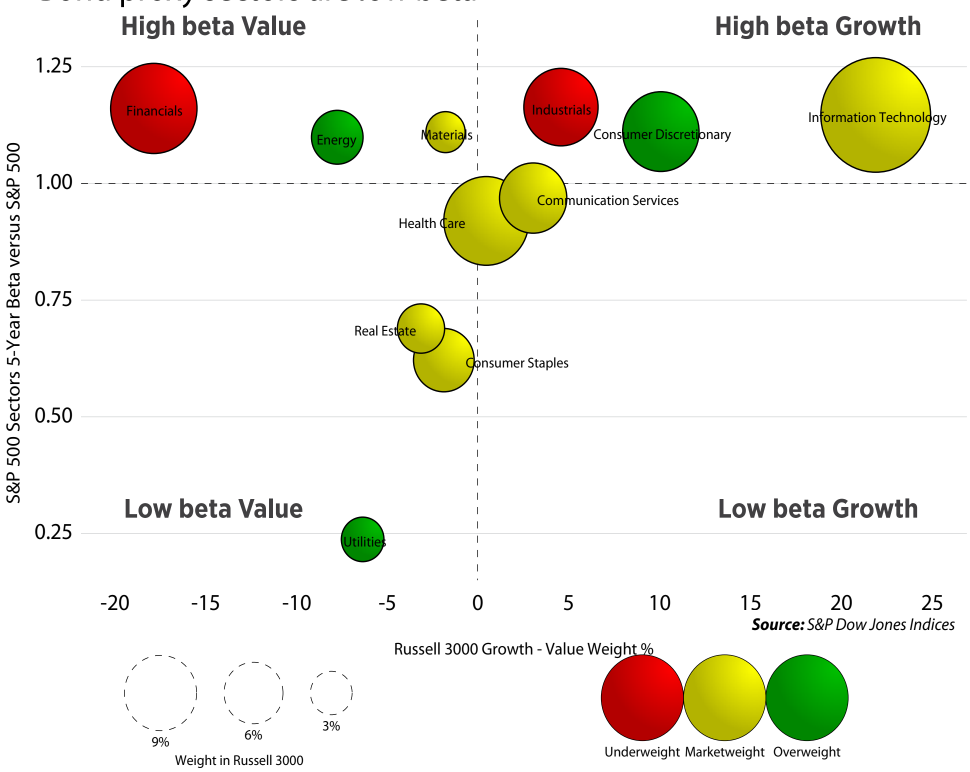
Bond proxy sectors are low beta



Source: *S&P Dow Jones Indices*

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The three lowest-beta sectors are also the three bond proxy sectors – Utilities, Consumer Staples, and Real Estate – that comprise defensive Value **(chart, left).** Note that unlike economic and yield curve sensitivities, there is no Value offset, as Financials are no higher beta than several Growth sectors.

Defensive Value/bond proxies may be in a better position than a few years ago due to the Powell pivot, but **the broad market secular bull likely makes them net underperformers over the next several years.**

Five areas to watch for Growth

Growth-specific drivers are elevated but not excessive

Buybacks are the most extreme factor

KEY TAKEAWAYS

Growth stocks are not nearly as overvalued as in the late-1990s.

Buybacks have boosted Growth, especially Tech. Watch for a reversal.

Despite FANG headlines, Growth is not over-owned versus Value.

#1 Valuations not extreme

Growth stocks tend to trade at higher valuations than Value stocks. As discussed on page 5, most index providers include at least one valuation metric in their Growth/Value classification system, and stocks with high price/earnings ratios or price/book ratios are classified as Growth. Since 1980, the NDR Multi-Cap Value Index's earnings yield has been 2.8% points higher than the NDR Multi-Cap Growth Index's earnings yield, on average **(chart below).**

Growth stocks are more expensive than normal, but not as extreme as seen at previous secular turning points.

The current earnings yield differential is 3.7% points, less than one standard deviation away from the long-term average. Growth stocks are more expensive than normal, **but not as extreme as seen at previous secular turning points.**

Value secular bull about more than Value

A secular bull market in one area versus another is, by definition, a relative game. While it is natural to focus on what will drive Value stocks to perform better, a change in the Growth/Value relative strength line **can be driven just as much by weakness in Growth** as it is strength in Value.

The last Value secular bull is a case in point: much of the strength in Value in 2000-02 was more due to the internet bubble bursting than to Value stocks appreciating.

Many of the macroeconomic factors discussed on pages 3-7 are two sides to the same coin. A shift from a headwind to a tailwind for Value is simultaneously a shift from a tailwind to a headwind for Growth. But some drivers are Growth-specific. This section focuses on five, the majority of which do not point to an overextension of Growth stocks.

Growth not extremely overvalued

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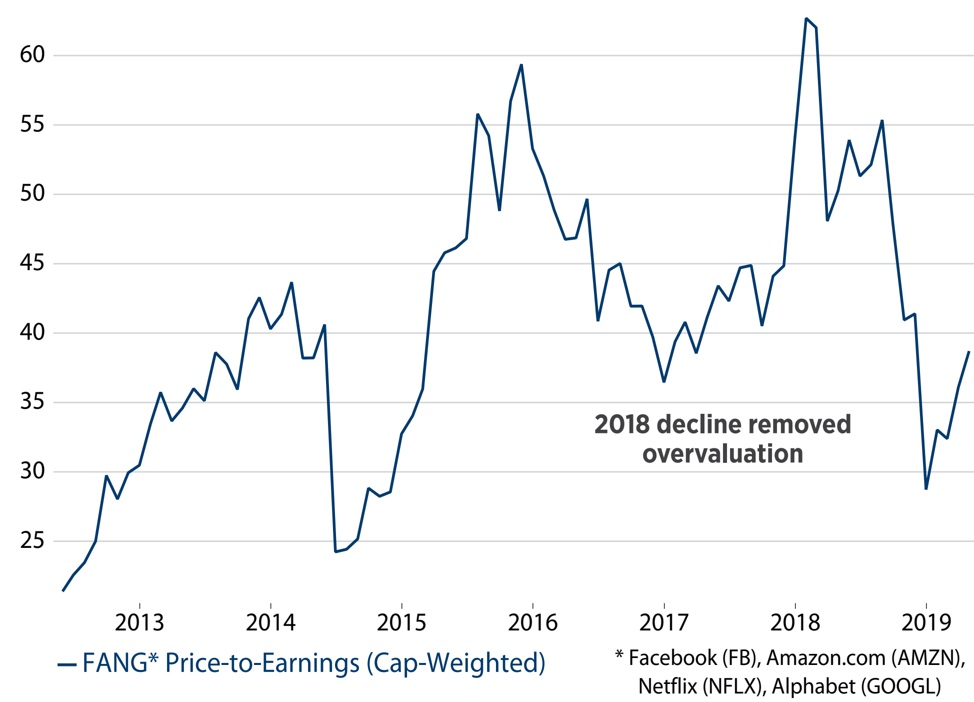
Five areas to watch for Growth

#2 FANGs not as expensive

While Growth as a whole is not extremely overvalued, some **pockets within Growth** have been in the recent past. The most vilified has been the so-called FANG stocks. The original FANGs were Facebook, Amazon, Netflix and Alphabet (parent of Google). The group has been expanded to include Apple, Microsoft, and other stocks, depending on which have rallied of late.

The P/E ratio of the original FANGs got as high as 63 in January 2018 **(chart, right).** The Q4 2018 correction cut the FANG P/E in half. It rebounded to 39 as of April 30. While roughly twice the S&P 500's P/E, **the FANG's valuations are not nearly as extreme as the internet bubble**, when stocks were being measured at price-to-eyeball ratios.

FANGs expensive, but not as expensive as recent past



Source: S&P Capital IQ Compustat

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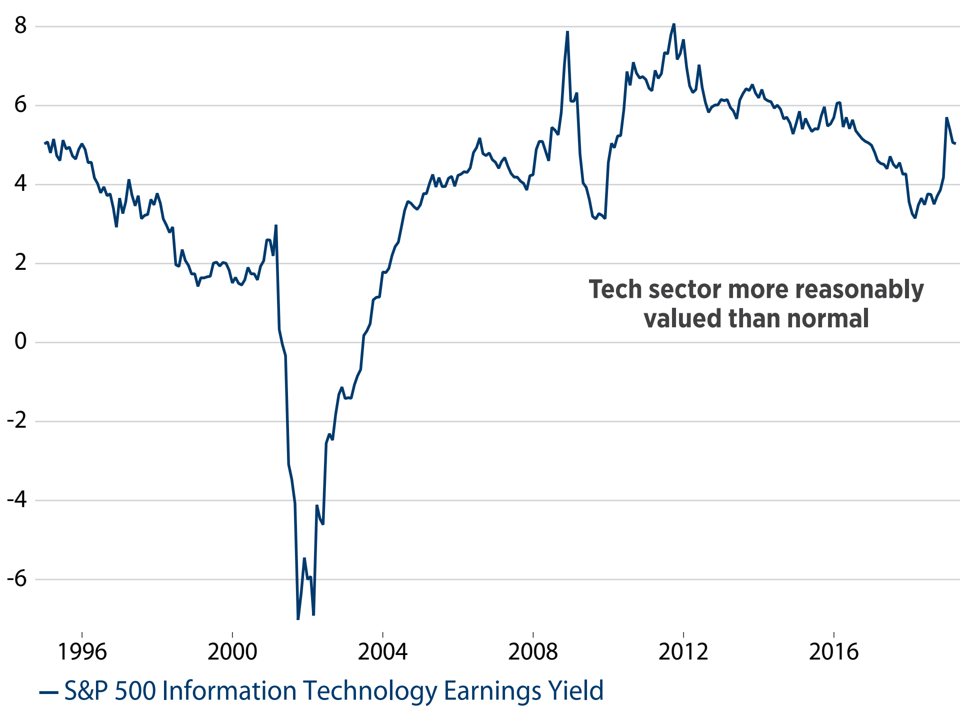
Tech sector not as overvalued as in internet bubble



Source: S&P Capital IQ and MSCI, Inc. (GICS)

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#3 Technology: sector for widows and orphans

Not all FANG stocks are classified as Tech, but as the biggest Growth sector, Technology's valuations should be monitored for the type of overvaluation that could result in a bubble.

Similar to the FANGs P/E, the Tech sector earnings yield (inverse of the P/E) hit a multi-year low in 2018, but rebounded sharply to a current reading of 5%. That is **a far cry from the bubble earnings yield of -7% in 2001 (chart, left).**

Five areas to watch for Growth

Tech embraces dividends

Another way to measure valuations is the capital returned to shareholders. Dividends are the traditional means of doing so, and as discussed on pages 11-12, many of the highest dividend yielding stocks are Value oriented.

The Tech sector does not avoid dividends the way it did in the 1990s, when returning capital was an admission of guilt by companies that they did not have a better use of cash.

The Tech sector has a lower dividend yield than the bond proxies, but due to the commitment to dividends by some of its mega-cap constituents, **Tech is the biggest contributor to S&P 500 dividends in dollar terms (table, right).**

Sector dividends as a percent of S&P 500 dividends

Sector	%
Information Technology	16.0
Financials	14.1
Health Care	12.2
Consumer Staples	11.6
Industrials	9.5
Energy	9.0
Consumer Discretionary	7.6
Communication Services	7.0
Utilities	5.3
Real Estate	4.8
Materials	2.8

S&P Dow Jones Indices launched the Real Estate sector on 2016-09-19 and replaced the Telecom Services sector with an expanded Communication Services sector on 2018-09-24; Financials excluding Real Estate. Prior data is an NDR estimate.

Sources: S&P Compustat and S&P/MSCI GICS.

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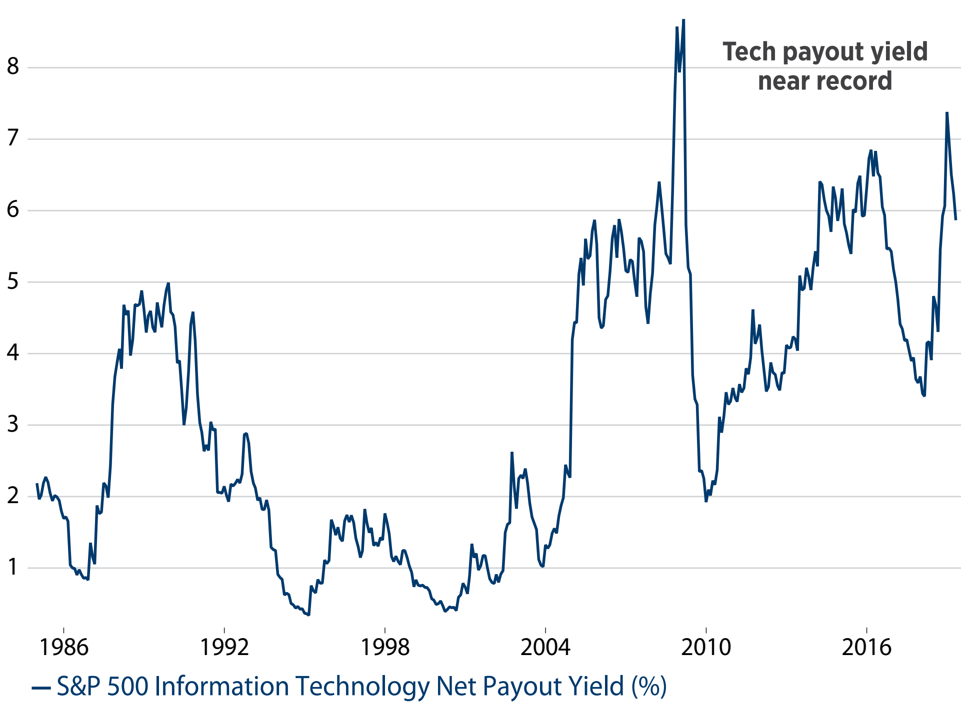
Tech more focused on shareholder return



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Tech shareholder friendly

Stock repurchases are another means of returning capital. By reducing the number of shares outstanding, the remaining shares own a bigger stake in the business. At $250 billion in 2018, Technology was by far the biggest share repurchaser in the S&P 500.

The combination of dividend yield and net repurchase yield is the net payout yield. Technology's net payout yield is nearly 6% **(chart, left). As long as Technology companies are committed to returning capital to shareholders, they should be able to find an investor base.** The risk to Tech, and in turn Growth, is if buybacks disappear.

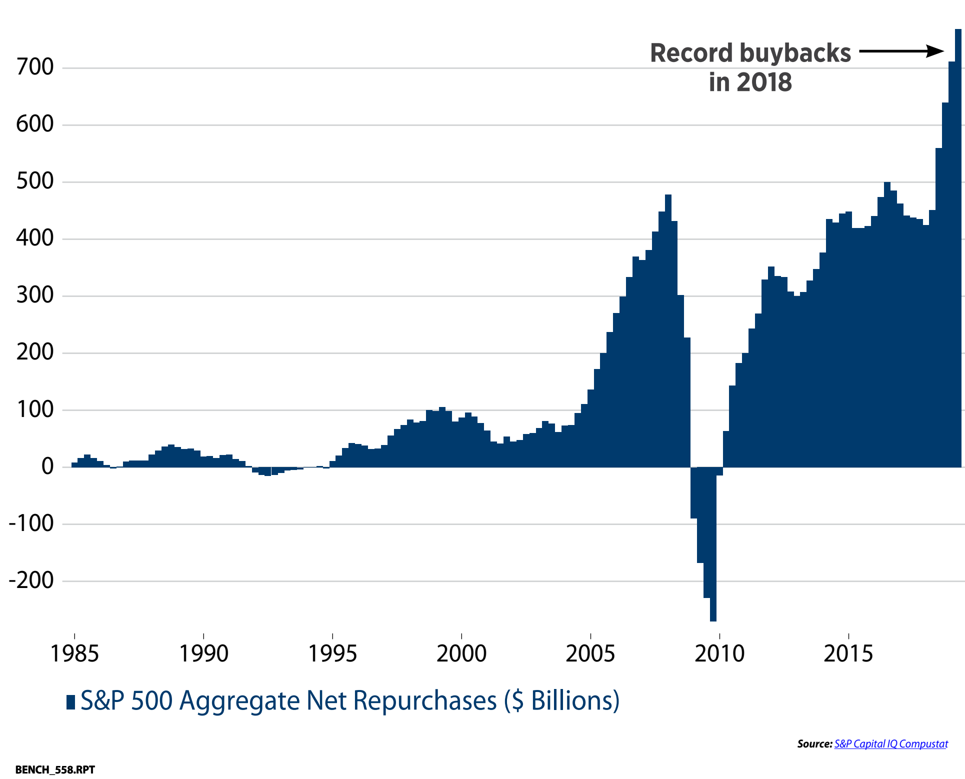
Five areas to watch for Growth

#4 Buybacks

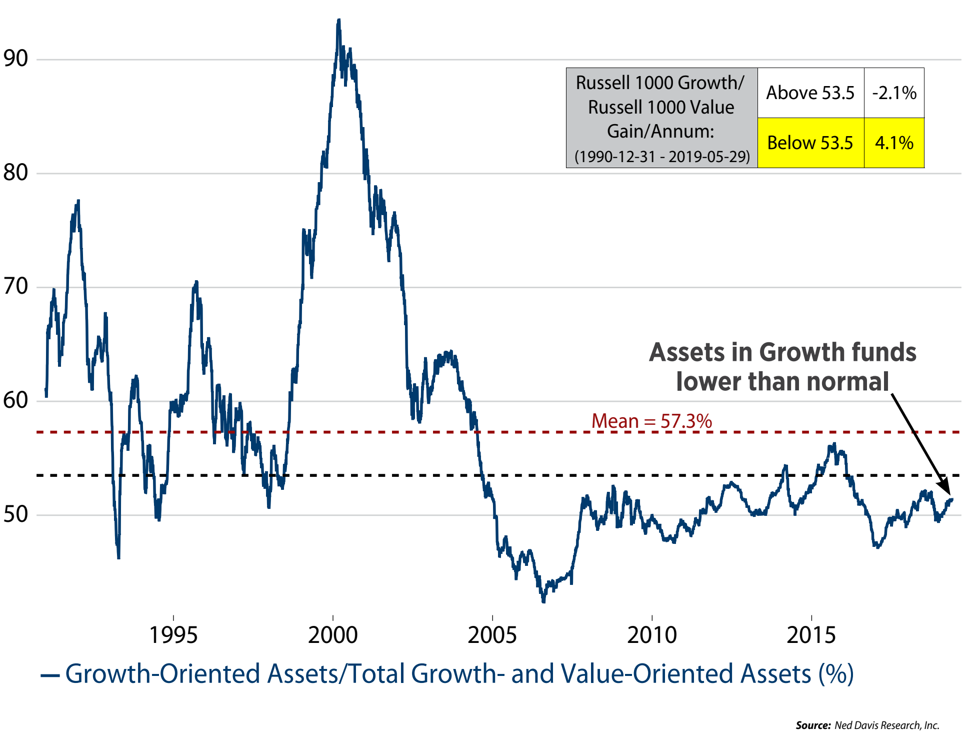
The buyback binge goes beyond the Technology sector. A record 329 companies in the S&P 500 have been net buyers of their own stock in the last year. The dollar amount of net repurchases also hit a record high of $711 billion in 2018, over 40% higher than the previous record **(chart, right).** Buybacks tend to be tilted toward Growth stocks. As long as buybacks are in vogue, they are a **tailwind for Growth.**

Buybacks have become a lightning rod topic to debate. Some concerns are that they crowd out other investments, reduce wage gains and economic growth, and are driven by management teams' bonus targets. On April 30, we offered a few objective measures of the impact of buybacks.

Buybacks are a risk to the Growth secular bull



Growth not overowned vs. Value



Regardless of the reason, if buybacks were to go out of style, then Growth sectors like Technology could lose a source of demand for their stocks (corporations), which could hasten a rotation into Value. **While not an immediate concern, buybacks are the most extreme of the five items discussed in this section.**

#5 Growth not over-owned

Another risk would be if Growth stocks became too popular. While mega-cap Growth stocks almost have to be owned by any portfolio manager tracking a broad benchmark for fear of missing out, **as a group, Growth stocks are not over-owned.**

The **chart at left** shows ETF and other Growth-oriented assets as a percentage of Growth and Value assets. The current reading of 51% is **below the long-term average** of 57%.

Rethinking Value

Value and Growth are artificial constructs

Data and technology make creating new factors easier

KEY TAKEAWAYS

Growth's record run has led investors to seek alternative measures of Value.

Quality, volatility, and momentum have emerged as alternatives.

A lack of industry definitions could limit the alternatives' adoption.

Our view is that Financials will eventually emerge from its decade-long malaise. But that may be years from now, too long for many investors' time horizons. Regardless, Financials' decade-long slump **is skewing the Value/Growth relationship.**

The equity benchmark industry is based on the **nine style framework, an invention of the mutual fund industry** in the 1990s to measure portfolio managers' performance. If mutual funds continue to lose assets to ETFs, then the traditional concepts of Growth and Value could diminish in utility.

A new approach

Throw in Growth's unprecedented 12.75-year run, and investors have **begun to question whether the concept of Value needs to be reinvented.**

Several concepts have emerged. We are focusing on three: **quality, volatility, and momentum.**

The new factors have their place, but they are **unlikely to replace Growth and Value for at least several years**. One problem is that they **lack industry-standard definitions** that make measurement difficult and could lead to confusion.
.

A vague concept

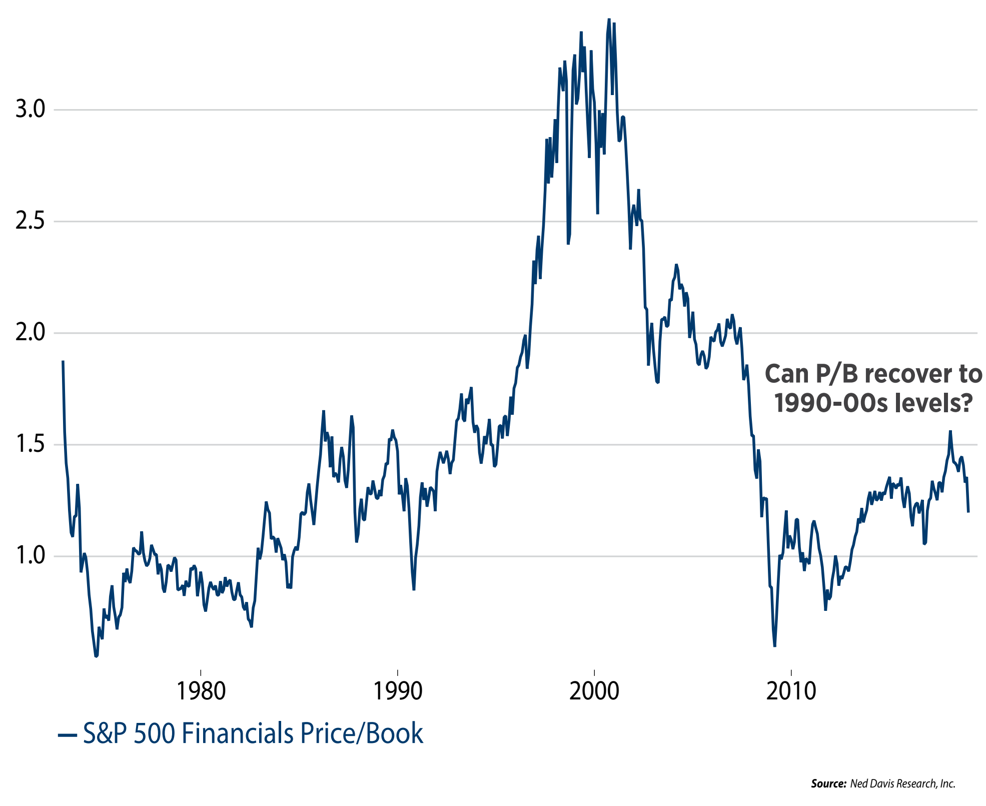
The concept of sector classification is intuitive. Organize companies by what they do. The concept of small/large is straightforward. Sort by how big companies are.

But the concept of style feels more arbitrary. Is it merely valuation? That is what Eugene Fama and Kenneth French used in their original three-factor model. Back then price/book was a logical measuring stick, but in an information-based economy book value is harder to measure. That is why index providers expanded the number of metrics.

Financials' conundrum

Dodd-Frank, the Volker rule, and more conservative lending practices have led to a revaluation of Financials. Their price/book ratios may be permanently lowered, prompting some to **wonder if Financials is the new Utilities (chart, right).**

Is Financials the next Utilities?



Rethinking Value

Style alternative #1: Quality

Quality is in the eye of the beholder. For equity indices, it's in the eye of the quants. The concept of quality has been around for decades. While there is a general idea that a quality company should produce more stable profits over time, there is no industry definition.

NDR created High Quality and Low Quality indices based on the S&P Quality Rankings. S&P rates publicly traded companies based on earnings and dividend stability. NDR classifies stocks in the top four categories as High Quality, and those in the bottom four as Low Quality.

Financials is the biggest High Quality sector **(table, right). Technology and Health Care** are tied for the biggest Low Quality sectors, but due to a higher weight in the NDR High Quality Index, Tech has a lower net low quality tilt. The implication is that High Quality has a Value tilt, while Low Quality has a Growth tilt.

S&P says Financials is high quality, Health Care low quality

Sector	High Quality %	Low Quality %	Spread % (HQ - LQ)
Financials	21.6	11.3	10.3
Consumer Discretionary	14.1	8.4	5.7
Utilities	7.1	3.4	3.7
Industrials	17.7	14.0	3.7
Consumer Staples	5.9	2.5	3.4
Materials	5.9	6.1	-0.2
Real Estate	7.1	9.0	-1.9
Communication Services	2.4	4.8	-2.4
Information Technology	10.0	16.5	-6.5
Energy	0.7	7.5	-6.8
Health Care	7.4	16.5	-9.1

Quality based on S&P quality stock rankings. Top half are classified as High Quality. Bottom half are Low Quality.

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iShares Edge MSCI USA Quality Factor ETF (QUAL) tilts toward Growth

	Value	Core	Growth
Large	19.23%	37.77%	34.76%
Mid	4.99%	2.35%	0.70%
Small	0.00%	0.20%	0.00%

Value based on % of the total constituent weight using NDR Broad Market Equity Series Classifications.

Source: iShares.

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A different definition

The iShares U.S. Quality Factor ETF (QUAL) selects stocks based on return on equity, stable earnings growth, and low debt/equity relative to each sector. As a result, its sector weights are closer to its benchmark, the MSCI U.S. Index.

QUAL's highest weight is in the large-cap core style box, but that is **closely followed by large-cap Growth (table, left).** Perhaps due to its sector-neutral approach, QUAL may not be as defensive as investors used to other quality definitions may expect.

Rethinking Value

Style alternative #2: volatility

One of the biggest drawbacks to equities as an asset class is its volatility. Over the past 30 years, the standard deviation of monthly returns of the S&P 500 Index has been 78% higher than that of the Bloomberg Barclay's Long-Term U.S. Treasury Index.

Focusing on lower volatility stocks could minimize this drawback for risk averse investors. The iShares Min Vol ETF (USMV) is one example of an ETF that selects low volatility stocks. **USMV's beta is 0.67**.

Similar to QUAL, USMV's biggest style box weight is large-cap core. But unlike QUAL, **USMV is slightly tilted toward large-cap Value.**

iShares Edge MSCI USA Min Vol ETF (USMV) slight Value tilt

	Value	Core	Growth
Large	25.2%	41.8%	21.7%
Mid	3.2%	5.5%	2.0%
Small	0.0%	0.4%	0.2%

Value based on % of the total constituent weight using NDR Broad Market Equity Series Classifications.

Source: iShares.

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iShares Edge MSCI USA Momentum Factor ETF (MTUM) slight Growth tilt

	Value	Core	Growth
Large	26.46%	40.05%	29.68%
Mid	0.89%	1.24%	1.60%
Small	0.07%	0.00%	0.00%

Value based on % of the total constituent weight using NDR Broad Market Equity Series Classifications.

Source: iShares.

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Style alternative #3: momentum

In some corners of the quant world, momentum has become synonymous with Growth. In fact, momentum is one of the factors S&P uses in its Growth/ Value classification.

The challenge with momentum is that **during periods of high volatility, high momentum stocks can quickly become low momentum.**

The iShares MSCI U.S. Momentum Factor ETF (MTUM) rebalances every six months based on price appreciation over six and 12 months as well as three-year volatility. Currently, MTUM has the highest weight in large-cap core, and slightly tilts to Growth **(table, left).**

The biggest sector weight is Health Care at 31%, even though it is the worst performing S&P 500 sector since the December 24 low.

Stock selection

The Growth/Value secular environment could impact stock selection

The criteria differs for Growth and Value universes

KEY TAKEAWAYS

For Value managers, focus on Growth factors, especially during Growth secular bulls.

For Growth managers, focus on Value factors, even during Growth secular bulls.

Growth and Value screens of roughly 30 stocks have been saved to the NDR stock screener.

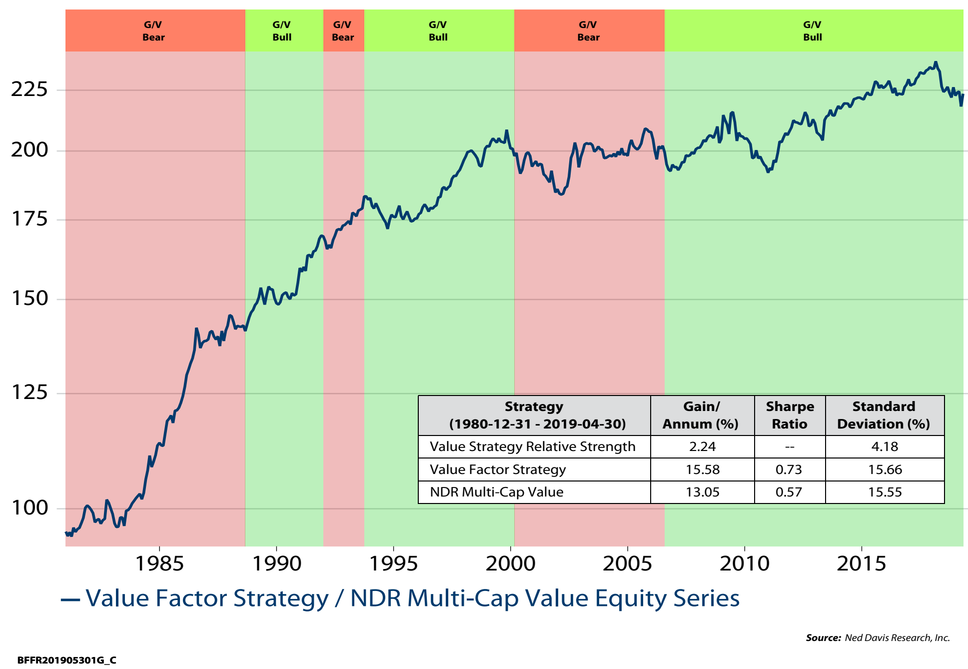
Most portfolio managers benchmarked to a style box spend much of their time on individual stock analysis. For portfolio managers who utilize a screening process, the explosion in data in recent years is a blessing and a curse. Where to start? For this study, we focused on the eight factors used to classify stocks as Growth or Value in the NDR universe.

Value at a reasonable growth (VARG)

If the Growth secular bull continues, **Value managers should focus on the growthiest stocks in their universe.** We created a sample portfolio of stocks in the top half of the NDR Multi-Cap Value universe in long-term (five-year) trailing EPS growth, long-term trailing sales growth, and one-year trailing earnings growth **(right)**.

The strategy has outperformed the NDR Multi-Cap Value persistently, but **by more in Growth secular bulls**. The screen and its current constituents have been saved to the NDR stock screener.

VARG has outperformed, esp. in Growth secular bulls



Value at a Reasonable Growth (VARG) portfolio statistics during Growth/Value secular bulls and bears

Value Secular Bulls				Growth Secular Bulls			
Start Date	End Date	Strategy % GPA	Multi-Cap Value % GPA	Start Date	End Date	Strategy % GPA	Multi-Cap Value % GPA
11/30/80	8/31/88	25.3	19.1	8/31/88	12/31/91	16.6	10.4
12/31/91	9/30/93	28.0	22.5	9/30/93	2/29/00	10.7	9.4
2/29/00	7/31/06	17.4	17.3	7/31/06	4/30/19	9.8	8.8

VARG beat Value in Growth secular bulls

Strategy consists of stocks in the top half of the NDR Multi-Cap Value universe by long-term (five-year) trailing EPS growth, long-term trailing sales, growth, and one-year trailing EPS growth. Portfolio rebalanced quarterly.

Source: S&P Compustat.

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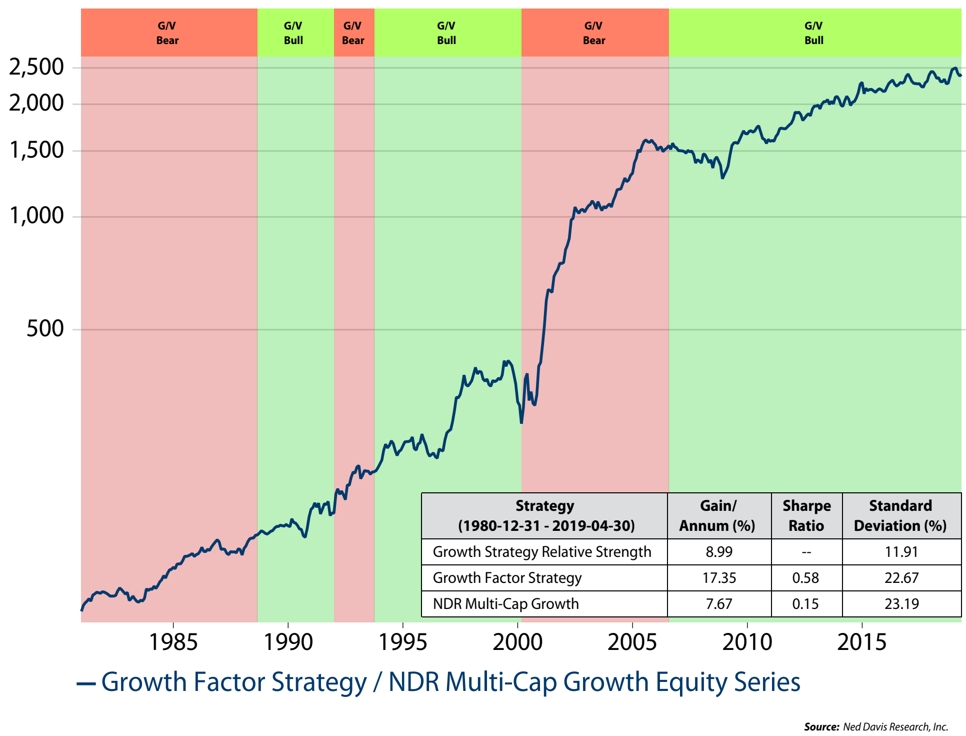
Stock selection

Growth at a reasonable price (GARP)
For Growth portfolios, we found that **stocks with Value characteristics within the NDR Multi-Cap Growth universe have outperformed the benchmark, even during Growth secular bulls.**

The strategy shown in **chart at right** and **table below** is based on stocks in the top quartile in three Value factors: sales yield, earnings yield, and free cash flow yield within the NDR Multi-Cap Growth universe. The screen has been saved to the NDR stock screener.

GARP has outperformed over the long run



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Growth at a Reasonable Price (GARP) portfolio statistics during Growth/Value secular bulls and bears

Value Secular Bulls				Growth Secular Bulls			
Start Date	End Date	Strategy % GPA	Multi-Cap Value % GPA	Start Date	End Date	Strategy % GPA	Multi-Cap Value % GPA
11/30/80	8/31/88	13.6	6.8	8/31/88	12/31/91	24.7	19.8
12/31/91	9/30/93	24.3	7.5	9/30/93	2/29/00	28.7	22.9
2/29/00	7/31/06	14.3	-12.4	7/31/06	4/30/19	13.1	9.3

GARP beat Growth consistently

Strategy consists of stocks in the top quartile of the NDR Multi-Cap Growth universe by sales yield, earnings yield, and free cash flow yield. Portfolio rebalanced quarterly.

Source: S&P Compustat.

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The strategy has consistently outperformed the Growth benchmark during both Growth secular bulls and Value secular bulls.

One conclusion from the study could be that over the long run, applying **valuation constraints to a Growth universe** helps maximize returns. Even though investors may not be thinking of valuations when buying a Growth fund, valuation screens could help portfolio managers outperform their benchmark.

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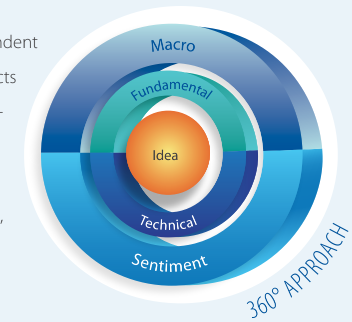

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