Quantitative Equities

Value investing: Now… but how?

- The attractiveness of the Value premium is at historically high levels
- Deep and consistent Value exposure is ideal to benefit from a Value rally
- Contrary to popular belief, Value can be harvested in a sustainable way

Value is one of the most well-known investment styles and its important role in diversified, multi-style portfolios continues to be widely accepted. Despite 'a lost decade' of underwhelming performance for Value investors, the recent upswing in returns is providing renewed hope of a comeback. In this article, we will briefly outline why we believe this is an opportune time to consider a Value allocation, and what to take into account when selecting a Value strategy: namely high Value exposure, style consistency, avoiding Value traps and embracing sustainability.

Value has never been this cheap

Growth has outperformed value over the past decade. The only real exception to this trend was in 2016 when value momentarily outperformed by double digits. Since then, growth has rallied strongly, driven primarily by a handful of mega-cap darlings. This has resulted in the widest valuation spreads between growth and value on record, largely triggered by the significant performance dispersion over the last two years as seen in Figure 1. However, this dominant streak comes with a caveat for growth stocks, as the rise in their valuations has outpaced the growth in their earnings and dividends. As a result, most of their outperformance can be attributed to multiple expansion, as illustrated in Figure 2 which shows the widening of valuation spreads between value and growth stocks across the globe.

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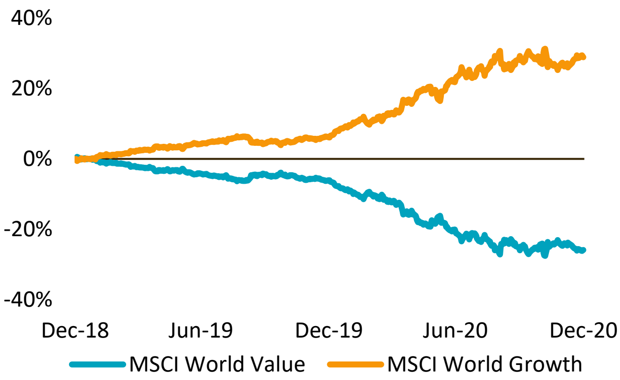
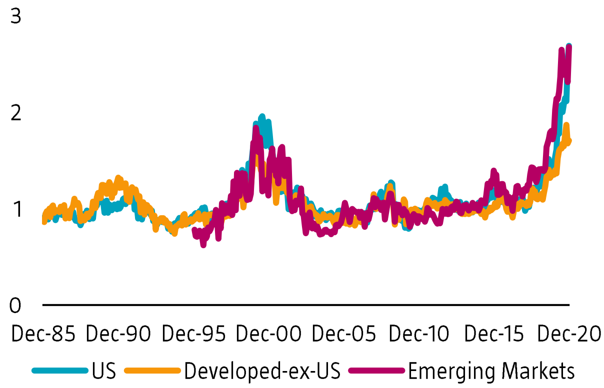
Over this period, growth stocks have become 50% more expensive, while their value peers have gotten increasingly cheaper. This is comparable to prior phases of multiple expansion, such as the Nifty Fifty and the dot-com eras, when growth stocks, such as Hewlett-Packard (HP) in the 1990s, surged. Since then, HP has matured into a value stock following a long, wintery period for its investors.

Figure 1 | Value versus growth



Source: Robeco, MSCI. Returns relative to MSCI AC World index, Gross of fees, in EUR over the period Jan 2019 – Dec 2020. The value of your investments may fluctuate. Past performance is no guarantee of future results.

Figure 2 | Widening valuation spreads



Source: Robeco, FactSet. For each multiple (B/P R&D adjusted, EBITDA/EV, and CF/P) and month, we calculate the median for both the cheapest and most expensive quintiles and compute the spread as the ratio between the two. For the composite valuation spreads, we first standardize the three time series by dividing them with their medians, then we average the three spreads.

Exuberance has led to frothy valuations in growth pockets of the market

Nowadays, people often refer to 'old economy' (AT&T, Ford Motor Company or Royal Dutch Shell, for example) and 'new economy' (Alibaba Group, Netflix, Nvidia and Tesla, for example) stocks when they unpack the divergence between growth and value. While these are apt analogies, we will refrain from using them, or any real stock examples, for two main reasons. First, we disagree with the notion that all value stocks are created equal (i.e. are old-economy businesses). Second, if we were to look at individual firms, we would risk losing sight of the bigger and more important picture, in our opinion.

If you were offered the chance to buy stock in a currently unprofitable, but disruptive company with bright future growth prospects, would you be tempted? Probably, and rightly so. However, what if this company was one among many competing for the same potential profits? Would you still be certain that your investment would be fruitful? This poses a difficult choice for an investor, which is further complicated by the expensive valuations some of these disruptive companies trade at, thus making the future return prospects on these investments quite dim, in our view. This is especially true now, given the frothy valuations of some growth companies, following their very strong performance in 2020.

We believe the dilemma of continuously picking the correct growth stock, in a market in which valuations have skyrocketed for years, puts growth investors in a tricky situation. In this scenario, the share prices of these potential future winners have continuously been bid up, as investors have tended to extrapolate their future earnings based on ambitious growth stories. But, for how much longer? In fact, we believe this dynamic plays favorably into the hands of long-term value investors with diversified holdings across a broad range of value stocks. These investors will likely be well-positioned for a mean reversion in share prices, when some of the growth stories fail to materialize, thereby boosting the relative returns of value investors.

The diversification benefits of Value

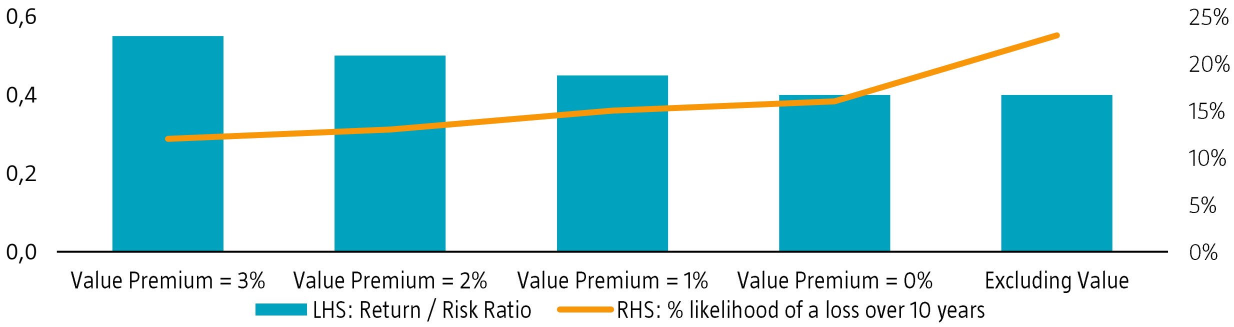
The value style is an effective diversifier in multi-manager portfolios. It has a negative historical correlation with trending markets and just a slightly positive historical correlation with high-quality or low-risk investing. Furthermore, research shows that value helps to reduce drawdowns in multi-style portfolios in the long run (i.e. value can function as 'bubble hedge') and improves risk-adjusted returns, even when we assume there is no positive value premium.[1] Figure 3 shows that with an assumed historical value premium of 0%, the probability of a negative return from a multi-style portfolio over the

[1] Please see: Van Vliet, P., and Baltussen, G., August 2020, "Will value survive its long winter?", Robeco article.

next ten years is 16%. This is a 7 percentage point improvement versus a portfolio that does not take valuations into account.

The prudent premium assumptions of 1% to 3% further illustrate the benefits of allocating to value as the likelihood of incurring negative returns over a ten-year period steadily decline from 16% to 12%. This is more than a 10 percentage point improvement compared to a portfolio that excludes value. Whether or not you are convinced by the overwhelming academic evidence in favor of value is not even the most important question. The question investors really need to ask themselves is: "Should I continue to bet against value?" In our opinion, the diversification benefit of allocating to value is reason enough to consider it in your portfolio.

Figure 3 | Impact of the value premium on the risk-return profile of multi-factor portfolios



Source: Robeco and Kenneth French's website. We use historical simulations of US value, momentum and low volatility factor returns and infer returns based on the historical volatility and an assumed 0.30 return/risk ratio for each style. Based on Van Vliet & Baltussen (2020). The value of your investments may fluctuate. Past performance is no guarantee of future results.

Deep and consistent Value exposure is key

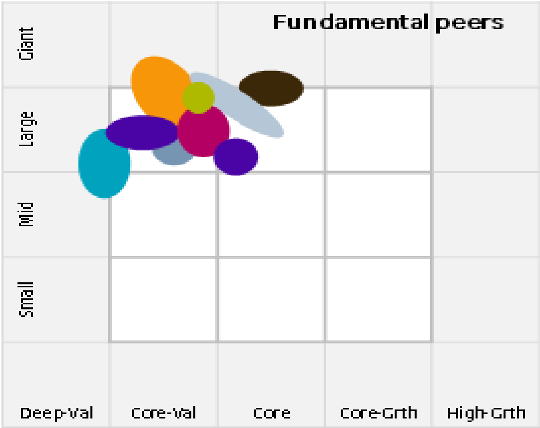
Beyond considering an allocation to value, it can be challenging to choose the correct value stocks or the appropriate value strategy for your portfolio. If you just search for large-cap funds with 'value' in their names in Morningstar, you will find an overwhelming number of 269 funds.[2] If we analyze their styles, however, we find that many of these funds do not actually offer high value exposure. Some may offer partial value exposure. Others might have offered it in the past, but experienced strong style drifts. Ultimately, many 'value' funds do not offer deep, and more importantly, consistent value exposure over time.

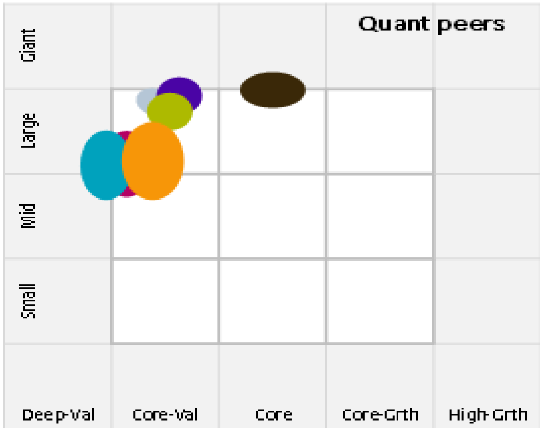
We believe, however, this is crucial when constructing a diversified, multi-style portfolio. When an investor builds one (consisting, for example, of a concentrated growth manager, a defensive equity manager and a value manager), they would allocate across managers and/or styles based on their preferred risk-return profile. However, their initial analysis of the optimal allocation would be rendered ineffective if the defensive manager were to start buying risky shares and the value manager were to purchase expensive stocks. Ideally, an investor would want to build a multi-style portfolio with reliable managers and consistent style exposures.

Figure 4 depicts a style-based peer comparison of global value strategies, both fundamentally and systematically managed. Over the last five years, the chart shows that the Robeco Global Value Equities strategy (turquoise/blue oval on the far left) has offered very consistent value exposure compared to its peers. Particularly in the fundamental space, we can see that some peer strategies have moved across the style axis from value to a more growth-like tilt (e.g. blend/core). This style drift means they might not always offer value exposure. Others, especially in the systematic space, have been more consistent. However, they do not provide the same depth of value exposure as Robeco does. Indeed, we construct deep and consistent value portfolios, but remain cognizant of potential value traps.

[2] Based on Morningstar Global Large Cap search on legal fund name containing 'value'.

Figure 4 | Morningstar style box analysis – Robeco versus fundamental (left) and quantitative (right) peers





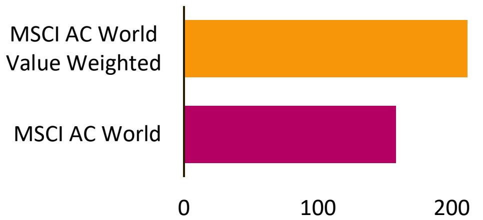
Source: Robeco, Morningstar. The figure provides a stylized overview of the Morningstar style box analysis from March 2015 till December 2020. The ovals depict the different scores of well-respected peers in the value large cap space through time. Turquoise/blue is Robeco Value Equities.

The Robeco Value Equities strategy implements a sophisticated approach to harvest the value premium, which results in a portfolio of well-diversified value stocks. Risk awareness is integral to the investment process. The investment team aims to steer clear of value traps (including unrewarded distress risk) by incorporating signals, such as the probability of default and profitability, as well as other indicators, like earnings revisions. Ensuring that our strategy avoids unrewarded risks helps us to avoid value traps, which might be more important than ever given the exuberance seen in equity markets today. Additionally, positive ESG screening is fully integrated in the investment process to mitigate the risk of being overexposed to less sustainable companies – another key differentiator versus many of our peers.

Value investing does not have to be detrimental to the environment

Generic value strategies are often considered unsustainable as they are typically tilted towards asset-heavy sectors such as energy and materials. For example, Figure 5 shows that the MSCI All Countries Value Weighted Index has a significantly larger carbon footprint intensity than the MSCI All Countries World Index. It is possible, however, to build sustainable value portfolios with reduced carbon footprints. At Robeco, we are proponents of sustainable investing and this is a key consideration in our Value Equities strategy. We are convinced that companies with sustainable business practices have a competitive advantage and are more successful in the long term.

Figure 5 | Carbon footprint of generic value approach



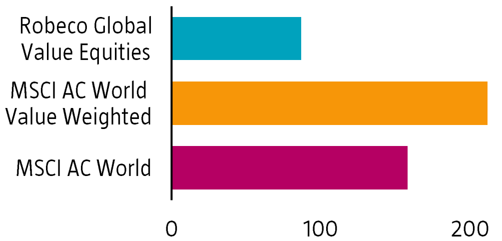
Source: Robeco, MSCI. Based on Robeco's sustainability reporting tools. Carbon footprint intensity measured as t CO2-eq/mUSD revenue. As per December 2020.

To avoid concentration in less sustainable companies, we incorporate ESG considerations in every step of the investment process. For instance, we establish that the portfolio's ESG score is higher than that of the market index. We also ensure that its footprint on carbon, waste and water is lower than that of the benchmark. These measures help to mitigate exposure to risks such as climate change. In fact, we implemented an innovative methodology in 2019 to reduce the environmental footprint of our portfolio. While conventional value strategies (e.g. using book-to-price measures) often have an environmental footprint that is more than 50% above their respective benchmarks, our enhanced valuation measures do not exhibit tilts to high emitters.[3] This methodology allows us to select value stocks that offer 'greener' value exposure.

[3] Please see: Swinkels, L., Ūsaitė, K., Zhou, W., and Zwanenburg, M., October 2019, "Decarbonizing the Value factor", Robeco article.

In 2020, we took another step by adding fossil fuels (e.g. arctic drilling, oil sands and thermal coal) to our exclusion list. Currently, the portfolio has a carbon footprint that is approximately 45% lower than the market cap-weighted index and around 60% lower versus the value-weighted index (the proxy for a generic value strategy). Lastly, we actively engage with companies on their sustainability performance. For example, our climate change engagement with Royal Dutch Shell led it to decarbonize its business operations – a major accomplishment with real-life impact.[4] Ultimately, we prefer to invest in stocks that are attractively valued as well as being more resource-efficient and sustainable.

Figure 6 | Carbon footprint of Robeco Value Equities

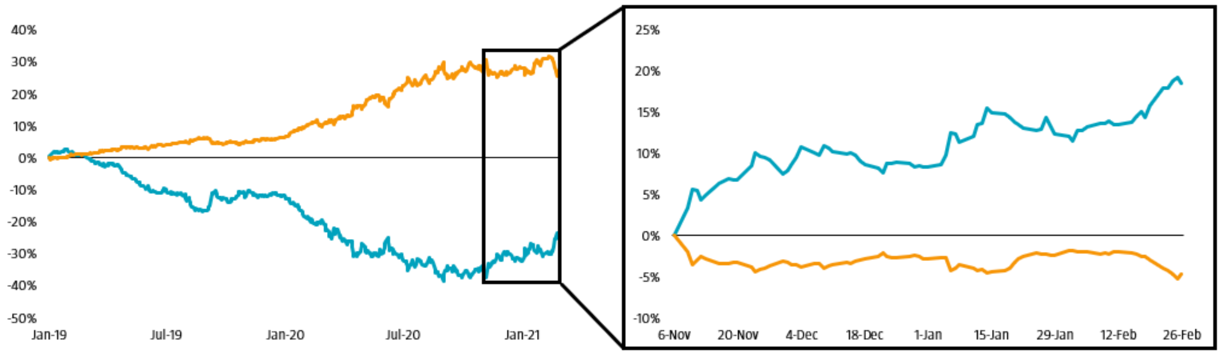


Source: Robeco, MSCI. Based on Robeco's sustainability reporting tools. Carbon footprint intensity measured as t CO2-eq/mUSD revenue. As per December 2020.

Outlook

Despite the protracted underperformance of value, there are good reasons to allocate to the style and ways to identify the appropriate strategy. Prolonged periods of value underperformance, due to the expansion of valuation multiples, are historically followed by sharp rallies. More recently, the announcement of successful Pfizer-BioNTech vaccine results on 9 November 2020 has triggered a broad rotation from growth into value as seen in Figure 7, perhaps signaling the start of the long-awaited value comeback. Although we believe that timing equity markets and factors is extremely difficult, the longer-term outlook for the value style is very attractive, in our opinion.

Figure 7 | Robeco Value Equities outperforming growth since the Pfizer-BioNTech announcement on 9 November 2020



Source: MSCI, Robeco. The orange line represents the MSCI AC World Growth Index and the blue line the Robeco QI Global Value Equities fund (Inception in December 2013). Both relative to the MSCI AC World Index. Cumulative returns in EUR, as of end of February 2021, gross of fees. In reality costs (such as management fees and other costs) are charged. These have a negative effect on the returns shown. The value of your investments may fluctuate. Past performance is no guarantee of future results.

The phrase 'this time is different' has been used a lot lately by value naysayers. Value investors are often assumed to only invest in 'old economy' stocks and have been labeled as being blind to progress. But while value strategies are still typically tilted towards well-established companies with stable cash flow streams that allow them to pay out favorable dividends, this does not mean that 'new economy' names are not taken into account. In fact, the Robeco Value Equities strategy is well positioned in innovative companies with strong future outlooks such as in health care or semiconductors. All in all, we believe this is an opportune time to invest in a deep and consistent value strategy, that also integrates sustainability, such as Robeco's Value Equities.

[4] Please see: https://www.robeco.com/en/insights/2020/11/engagement-case-with-shell-climate-change-engagement-to-reduce-carbon-footprint.html

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