THE EDGE

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A new series of thought leadership white papers about economic, investment and industry trends that shape how we live, think and invest

WHY INVEST IN VALUE STOCKS NOW?

A strange thing happened near the end of 2020. After more than 13 years of growth stocks outperforming value, value stocks overtook growth stocks. And they held that lead from September 2020 all through 2021 and 2022.

Then in the first half of 2023, growth stocks regained the lead. The question is: Is this just a short-term surge of growth stocks or will value stocks again take the lead and continue to dominate growth for years to come?

Trendline Economics conducted its own research, and we concluded that value stocks have indeed regained the lead on a long-term basis, possibly for years to come. We see the outperformance of value stocks continuing to lead growth over the next five years, with intermittent spurts of outperformance by growth stocks. However, we do believe the outperformance of value will be slight, and we remain bullish on the overall stock market this year. Our estimate is for value to post at least 30% total returns over the next five years, and for growth to post returns in the neighborhood of 20%.

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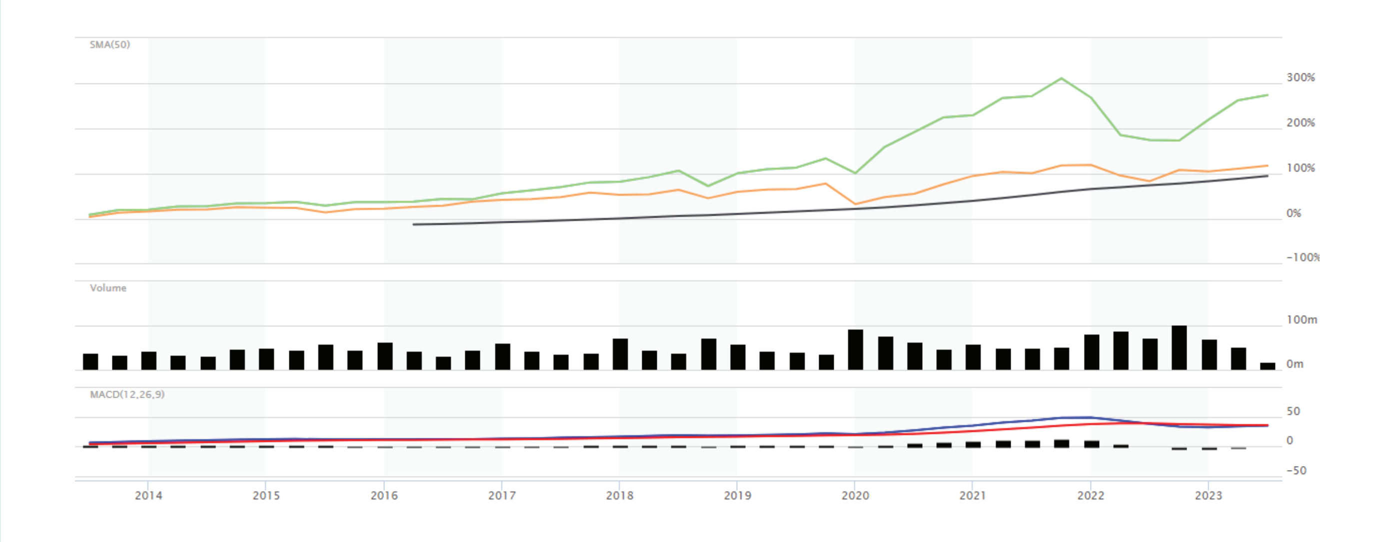
The definition of "value stocks," however, has changed, such that the old "growth vs. value" debate needs a revamp.

Growth stocks are shares of companies whose earnings or sales are growing faster than the market and are considered to have the potential to outperform over time because of their "future" potential. Value stocks are defined as shares that are trading at lower prices relative to their fundamentals like price-to-earnings, price-to-book value, or have dividends. In a nutshell, they are trading below what the shares are really worth, i.e. their "intrinsic value."

But nowadays, these definitions have become muddled. For example, you are just as likely to see growth companies like Apple, Microsoft, Google and Amazon in the portfolios of traditional value funds. Likewise, growth funds are just as likely to adopt value stocks like Exxon Mobil, UnitedHealth and Visa.

Growth stocks outperformed value over the past 10 years



Vanguard Value ETF (VTV) vs. Vanguard Growth ETF (VUG) between July 2013 and July 2023.
Value: Orange Line. **Growth**: Green Line. Source: MarketWatch.

But over the past three years, value stocks outperformed

Vanguard Value ETF (VTV) vs. Vanguard Growth ETF (VUG) between July 2020 and July 2023.
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"The post-pandemic environment of firmer inflation, higher yields and, until recently, above-potential growth has seen the resurgence of value investing … prompting many commentators to herald

The problem with both factor investing and smart beta is that they seek a one-size-fits-all approach, when in reality an investment portfolio depends as much on the individual's goals and aspirations as it does with the market.

the beginning of a long period of value dominance," says Simona Gambarini, Senior Market Strategist at Goldman Sachs. "Over the next year or so, we believe that the risks to the macro environment are skewed in favor of continued value outperformance."

We agree, but with a twist.

What has changed
The first is cash flow. The future cash flows of growth companies were always considered a selling point. But these days the "present value" of cash flows of value stocks is considered of equal value, allowing these companies to be less sensitive to interest rate changes and withstand recessions.

Another change is the value of intangible assets – assets that have no physical presence but have long-term value to a business. Software, data, internet expertise, social media, brand equity and more recently artificial intelligence (AI) are all examples of intangibles which have been undervalued. Companies like Microsoft, Google and Amazon all have that in droves.

More than anything, though, stability is the biggest change. Value stocks, either using the old definition of value or the new definition, are stocks with stable dividends; stable earnings, sales and cash flow; industry leadership, and are cheap relative to their peers. And risk, as defined by beta versus the overall market, also plays a role.

This is why factor investing and "smart beta" strategies have come into the limelight over the past several years. Both tend to mediate between growth and value, capturing the best of both worlds.

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Leading value ETFs
Let's take a look at some leading value ETFs. The first is the Fidelity Value Factor ETF (FVAL), which at a market cap of $500 million makes it one of the most popular value funds out there. Yes, it has the requisite value stocks in its portfolio like Berkshire Hathaway, Procter

& Gamble, UnitedHealth and Exxon. But its leading stocks are Apple, Microsoft, Google-parent Alphabet, and Amazon – all growth stocks.

FVAL gets away with including those because it describes itself as being "designed to reflect the performance of stocks of large and mid-capitalization U.S. companies that have attractive valuations." Those last two words: "attractive valuations," is where the fund gets its juice. The fund follows the Fidelity US Value Factor Index but that can change at whim, depending on the people that designed the index and can redefine "attractive valuations." In Fidelity's case, this mostly means it looks at four factors: free cash flow yield; earnings before interest, tax, depreciation, and amortization divided by enterprise value; tangible book value to price, and the company's earnings over the next 12 months.

And it's not just Fidelity that has redefined what value means. Even the Vanguard Growth Fund, the largest value ETF at a $99 billion market cap, admits growth companies like chipmaker Broadcom and Facebook-parent Meta Platforms.

Value tends to outperform when inflation is high, economic growth is strong, demand exceeds supply, and interest rates are high. Growth stocks often outperform when inflation is low, economic growth is weak and rates are low and falling.

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That's why value outperformed growth in 2021 and 2022 because it was led by industries like infrastructure, industrials, energy, and materials, and to a lesser extent financials. And that's also why growth stocks outperformed value in the first half of 2023 because they were led by technology and consumer discretionary.

Also, value stocks tend to be less sensitive to changes in interest rates.

So, where do I put my money?
The stock market has soared this year, and apparently still has room to grow as inflation has come down to an annual rate of 3% from a high of 8.5% last November. But the Federal Reserve has not put on the brakes yet. We see Fed interest rates continuing at or slightly above where they are now for the remainder of 2023.

People tend to forget that inflation can breed more inflation. We wouldn't be surprised to see inflation begin to rise again as it did in the mid-1970s and again in the late 1980s.

A recession is still a possibility, but after a mild downturn we see the economy continuing its robust pace next year.

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All of that favors a return to value.

For investments, we steer away from recommending individual stocks, although we see Warren Buffett's Berkshire Hathaway continuing to outperform. It has a portfolio that is the right blend of value but with innovation and growth mixed in.

We also like ETFs, in particular FVAL or the S&P 500 Value ETF (SPYV) or the iShares S&P Value (IVE). But investors who believe that small cap value will outperform large-cap over the long term, as we do, may also consider the Avantis US Small Cap Value ETF (AVUV). We also favor dividend ETFs, which we think we'll make a comeback after a lackluster first half of 2023. Investors may consider the ProShares Dividend ETF (NOBL) or the Vanguard High Yield Dividend ETF (VYM).

In the short run, we like sector ETFs like financials, infrastructure, industrials, consumer staples and telecommunications.

Of course, investors should spur growth entirely. Indeed, we expect growth to come close to value stocks, but trail slightly. That means your overall portfolio should consist of both growth and value, tilting slightly toward value.

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