U.S. Value Stocks: Neglected Opportunity

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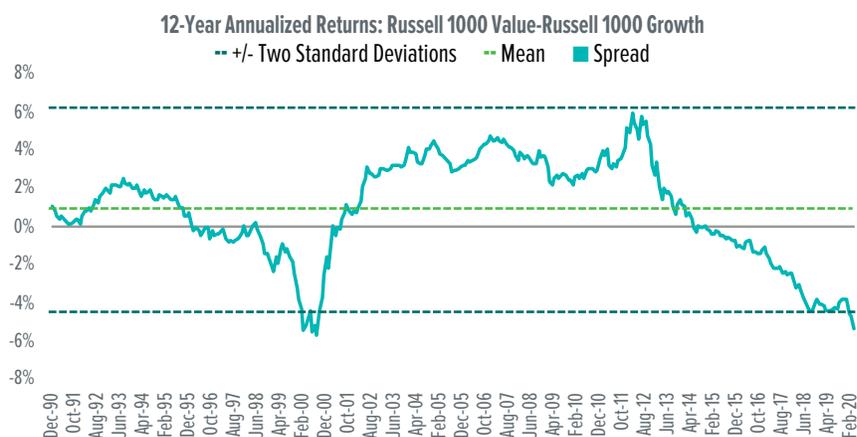**Snapshot**

› Growth stocks have outperformed value stocks for most of the past decade, causing many investors to lose faith in value.

› We believe the current performance gap between growth and value represents what may be the most attractive investment environment for value stocks that we have seen in over 20 years.

› To us, it is a question of when—not if—a value orientation will pay off.

U.S. value stocks, represented by the Russell 1000 Value Index, significantly outperformed growth stocks, represented by the Russell 1000 Growth Index, from the top of the tech bubble (March 2000) through the market top that preceded the global financial crisis (October 2007). This edge vanished during what has since largely been a decade-plus of outperformance by growth stocks. Historically low interest rates, muted inflation, moderate gross domestic product growth and the explosive revenues of technology, social media, and internet retail companies have propelled growth stocks, leading them to large gains relative to value stocks.

Value, on the other hand, has performed so poorly over the past dozen years (shown in Exhibit 1) that only about 5 percent of previous dozen-year periods have been worse (defined as a two-standard deviation event), according to our analysis. With only a few short-term wins since 2008 and staggering overall underperformance, many investors have lost faith in value.

Exhibit 1: Value Stocks Left for Dead

12-Year Annualized Returns: Russell 1000 Value-Russell 1000 Growth
-- +/- Two Standard Deviations -- Mean ■ Spread

Source: SEI, FactSet as of 3/31/20. Performance prior to 1/1/87 is backtested. Back-tested performance, which is hypothetical and not actual performance, is subject to inherent limitations because it reflects application of an Index methodology in hindsight. No theoretical approach can take into account all of the factors in the markets in general and the impact of decisions that might have been made during the actual operation of an index. Actual returns may differ from, and be lower than, back-tested returns. Past performance is no guarantee of future results.

Yet, even with the past dozen years of significant underperformance, value still has outperformed over the long term as indicated by data from famed academic

and author Ken French[1] (Exhibit 2)—which is why we maintain exposure to value stocks as part of our portfolio construction process.

Exhibit 2: Value has Still Outperformed in the Long-Term

High Book-to-Market Portfolio versus Low Book-to-Market Portfolio
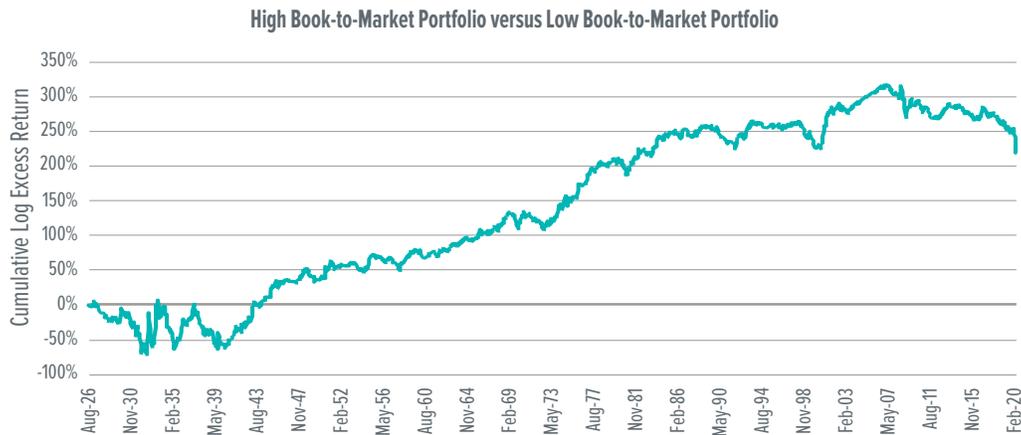
Source: Ken French's cap weighted U.S. equity data, 8/31/1926 – 3/31/2020, contrasting the cheapest 30% of the market with the most expensive 30% of the market.

> 66 There is a strong case to be made that value is a coiled spring just waiting to be released. The Russell 1000 Growth index is nearly 50 percent more expensive than the Russell 1000 Value Index and we are seeing similar valuation differences in small cap. Value is extremely cheap compared to growth, no matter which lens you look through. The quality has not deteriorated in the cheap stocks as both the large cap and small cap value indices offered about 2.0% advantage in dividend yield over their growth style index counterparts (as of 6/1/20). Expensive stocks have continued to get more expensive and cheap stocks have continued to get cheaper, which we believe is unsustainable. We are now seeing pockets of value starting to outperform. 99

Stephen C. Dolce, CFA
Portfolio Manager, U.S. Small Cap Equities

Furthermore, we believe the current performance gap between growth and value represents what may be the most attractive investment environment for value stocks that we have seen in nearly 20 years. In our opinion, it is a question of when—not if—a value orientation will pay off.

Historically, value typically mean reverts (or outperforms given the current environment) relative to growth after periods of prolonged underperformance. Accordingly, our domestic equity portfolios favor value managers—overweighting positions in value stocks in recognition of attractive earnings, cash flows, dividends and assets.

[1] Data Library, courtesy of Professor Kenneth R. French. Tuck School of Business, Dartmouth College

# Why Do Mean Reversions Happen—and What Do They Look Like?

Benjamin Graham—widely considered the father of value investing—said that "in the short run, the market is a voting machine; but in the long run, it is a weighting machine."

He argued that short-term popularity should not be confused with long-term value; that, eventually, a company's intrinsic value will be reflected in the price of its shares. Mean reversion is the vehicle by which that value recognition occurs.

Ken French data show that prolonged periods (defined as rolling five-year time horizons) in which value underperforms have historically been followed by significant outperformance by value over the following three years. Although recent returns may imply otherwise, value has rebounded and outperformed in more than 70 percent of these scenarios since 1927.

It's not just the frequency, but also the magnitude of the gains generated by these formerly unloved stocks. In about one-third of observations, value stocks outperformed by an average of 7 percent to 15 percent annually. In nearly 15 percent of instances, value's outperformance exceeded an annualized 15 percent.

Exhibit 3: A Whole lot of Value

Historical Value Rebounds
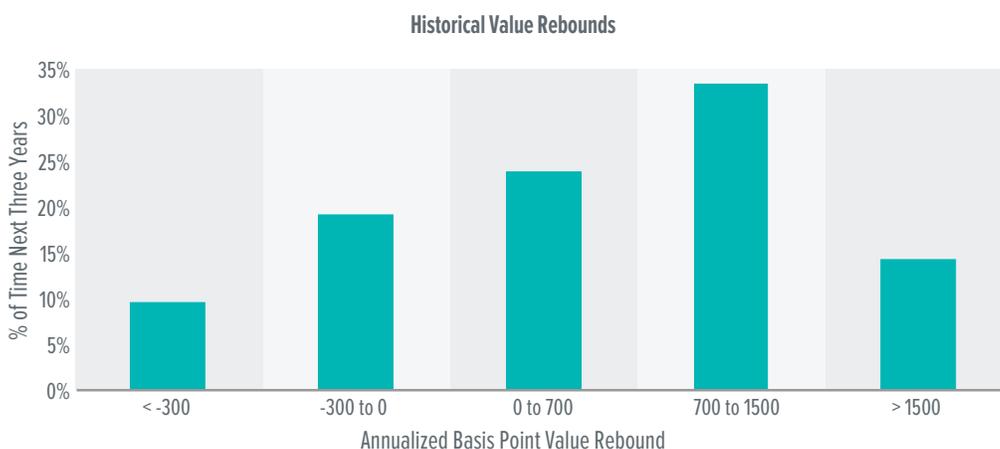
Source: Ken French's cap weighted U.S. equity data since 1927, contrasting the cheapest 30% of the market with the most expensive 30% of the market after 5 years of value underperformance. As of 3/31/2020.

While the returns in Exhibit 3 appear quite attractive, they also came after periods of underperformance. The current environment is one of the longest and most significant periods of value's underperformance on record.

Value's Uncomfortable Truth

Most investors believe buying low and selling high is a strategy that will generate long-term gains. But purchasing stocks when they're down tends to feel unnatural and uncomfortable. Holding cheap value stocks while growth-oriented technology stocks continue to soar also frustrates many investors. When it comes to value investing, however, patience really can be a virtue.

Our portfolios are diversified across a number of factors, including value, momentum, stability, size and quality. While our value tilt has detracted over the past decade, history shows that the times when value is hardest to embrace have been the times when it has provided the biggest subsequent payoffs.

When Will it Happen?

Everyone wants to know when value will return to favor and which catalyst will cause the turn.

The short answer is that value trades are notoriously hard to time, and investors risk missing out on potentially impressive gains by being late to the trade.

That said, we think a number of potential catalysts could turn sentiment in favor of value, including:

> Rising interest rates (extremely low now)
> Higher commodity prices
> Increased inflation
> Faster economic growth

> Sector performance differentials
> Technology stocks failing to meet investors' lofty expectations
> Economy emerging from recession

This is not an all-encompassing list of potential catalysts. It's also possible the catalyst that ultimately causes the turn toward value hasn't even been identified yet.

Being early to the trade eliminates the need to guess the correct catalyst; investors must simply be patient enough to wait for the market to turn. We acknowledge this may be a challenging mental exercise, given value's underperformance.

A Behavioral Bias

SEI is a pioneer in behavioral finance, and this field of study continues to influence our thinking today.

Consider recency bias. This describes an investor's ability to remember items that appear at the end of a long list of complex data, rather than those that appear earlier.

Evaluating conditions in the financial markets often involves reviewing long lists of complex information. Most investors do not have systems in place to automatically capture important data points going back many years or decades. Even those who do may not place sufficient weight on older data points.

There are many examples of recency bias throughout the history of financial markets. The last prominent example took place in early 2000. After four years of a raging bull

market in technology, media and telecommunications stocks lifted the market to new highs, investors—professional and amateur—believed that it was "different this time," and that stocks that soared during the Tech Bubble would continue to rise unabated despite the experiences of past boom and bust cycles. As we know now, this was not the case, and the Tech Bubble deflated in a tragic spectacle.

Looking back even further, the Nifty Fifty saw a few dozen companies drive market gains in the 1960s and early 1970s. Yet these same companies lagged the market in the 1980s.

Every market environment is different, but the parallels with the current market are easy to spot. The FAANG stocks (Facebook, Amazon, Apple, Netflix and Google) look quite expensive. These firms, along with a handful of other high-flying tech stocks, have led the bulk of the gains in the S&P 500 Index in recent years. Meanwhile, unloved value stocks have once again been left behind. It's worth noting that value stocks went on quite a run after the Tech Bubble burst. While past performance is not a guarantee of future performance, it's easy to imagine a similar environment if market leadership shifts.

Investors can fight recency bias by remembering that long-term relationships usually hold up for good reason. For example, the relationship between the cash flow that a firm can deliver and the stock price it supports do not vary by large degrees for long periods of time. Eventually, history shows it should revert toward the mean. Investors need to ask whether it's truly different this time. We don't believe that is the case.

A Look into Our Portfolios

Stocks with very high Price-to-Earnings ratios are concentrated in the information technology, consumer discretionary and communications sectors, so it's not a surprise that we are underweight those sectors in most portfolios. The consumer discretionary sector has a large variety of cheap stocks as well, but their weights tend to be much lower than the expensive stocks in the sector. Sectors that combine high quality with reasonable valuations include consumer staples and healthcare at this time, and we are overweight these sectors in most portfolios.

> 66 Active value managers find financial services stocks to be particularly attractive at this time. Many of these companies have much stronger balance sheets now than they did during the global financial crisis and managers expect them to continue to be profitable during the current economic downturn. 99

David Hintz, CFA
Portfolio Manager, U.S. Large Cap Equities

Our portfolio construction is not predicated on market timing. We believe trying to perfectly time trades to capture market inflection points is a futile exercise. Instead, we assess where it makes the most sense to invest the next incremental dollar, and make our decisions accordingly.

Why we Keep the Faith

We stand by our research indicating that value generates long-term outperformance relative to broad equity markets. Almost by definition, value companies are smaller from a capitalization perspective as their stock prices are trading at a discount (in terms of their fundamental valuations relative to broad equity markets). Investing in small and medium sized companies is also a hallmark of active management, and our managers certainly exhibit smaller-sized holdings than their benchmarks.

After assessing the current market environment, we remain firm in our belief—based on our research and empirical evidence—that, historically, value offers attractive long-term outcomes for patient investors. We intend to maintain our stance until a shift in sentiment lifts value—which, in our opinion, is inevitable.

Definitions

Alpha source: Our strategies are designed to capitalize on long-term drivers of market performance through exposure to persistent sources of returns such as mean reversion, trend-following and stability. We have refined our approach to identifying these alpha sources and the factor groups we employ as proxies to measure and capture their performance.

- **Momentum Alpha Source:** The investment manager seeks to benefit from investor under-reaction—due to anchoring. Such groups of stocks trend in price as perceptions change directionally and serially with incoming data, leading to herding behavior by investors.

- **Stability Alpha Source:** The investment manager seeks to benefit from investor tendency to undervalue lower-risk, higher-stability businesses—resulting from a focus on short time horizons and overconfidence in forecasts for momentum-driven stocks. Stability-oriented stocks have the power to exceed market expectations by consistently outperforming (rather than reverting to average market returns) and through the power of stable, long-term compounding.

- **Value Alpha Source:** The investment manager seeks to benefit from investor overreaction—resulting from aversion to loss. Such groups of stocks revert to the mean, as fear over the perception of the investment's risk dissipates.

Book to Market Ratio: Stock's book value divided by its capitalization, where book value is the value of an asset as it appears on a balance sheet, equal to cost minus accumulated depreciation. The value is the same whether the calculation is done for the whole company or on a per-share basis.

Price to Earnings Ratio: Equal to market capitalization divided by after-tax earnings. The higher the P/E ratio, the more the market is willing to pay for each dollar of annual earnings.

Standard Deviation: Statistical measure of historical volatility. A statistical measure of the distance a quantity is lies from its average value. It is applied to the annual rate of return of an investment, to measure the investment's volatility (risk). Standard deviation is synonymous with volatility, in that the greater the standard deviation the more volatile an investment's return will be. A standard deviation of zero would mean an investment has a return rate that never varies.

Index Definitions

The Russell 1000 Index includes 1000 of the largest U.S. equity securities based on market cap and current index membership; it is used to measure the activity of the U.S. large-cap equity market.

The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.

The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values.

Important Information