

VALUE STOCKS

At the cusp of re-rating





Value Investing, a Bottom-up Approach

Thematic Report By

Hitesh Jain

Senior Manager,
Investment Research
hitesh.jain@aranca.com

Avinash Singh

Senior Analyst,
Investment Research
avinash.singh@aranca.com

In December 2015, the US Federal Reserve decided to normalize interest rates, with an increase in the federal funds rate, for the first time since 2006. This reversal in interest rates is compelling investment managers to revisit their strategies. Traditionally, portfolio managers follow the growth and value investing approaches for stock selection. Under growth investing, a portfolio manager selects stocks with high bottom-line growth, return on equity (ROE), profit margin, and low dividend yield. Given their potential to generate high profit and cash, such businesses are typically sectoral bellwethers. On the other hand, value investing focuses on companies that operate on a robust business model but trade at a subdued valuation relative to their sound fundamentals. Although valuation multiples such as PE, EV/EBITDA, and P/BV are generally lower for value businesses, these offer high dividend yield. That said, one must follow a bottom-up approach while investing in value stocks. The focus should be on selecting individual stocks and not the sector, which may face headwinds due to macroeconomic factors.

MSCI World Growth vs. Value Growth Indices (average for 2004–15)

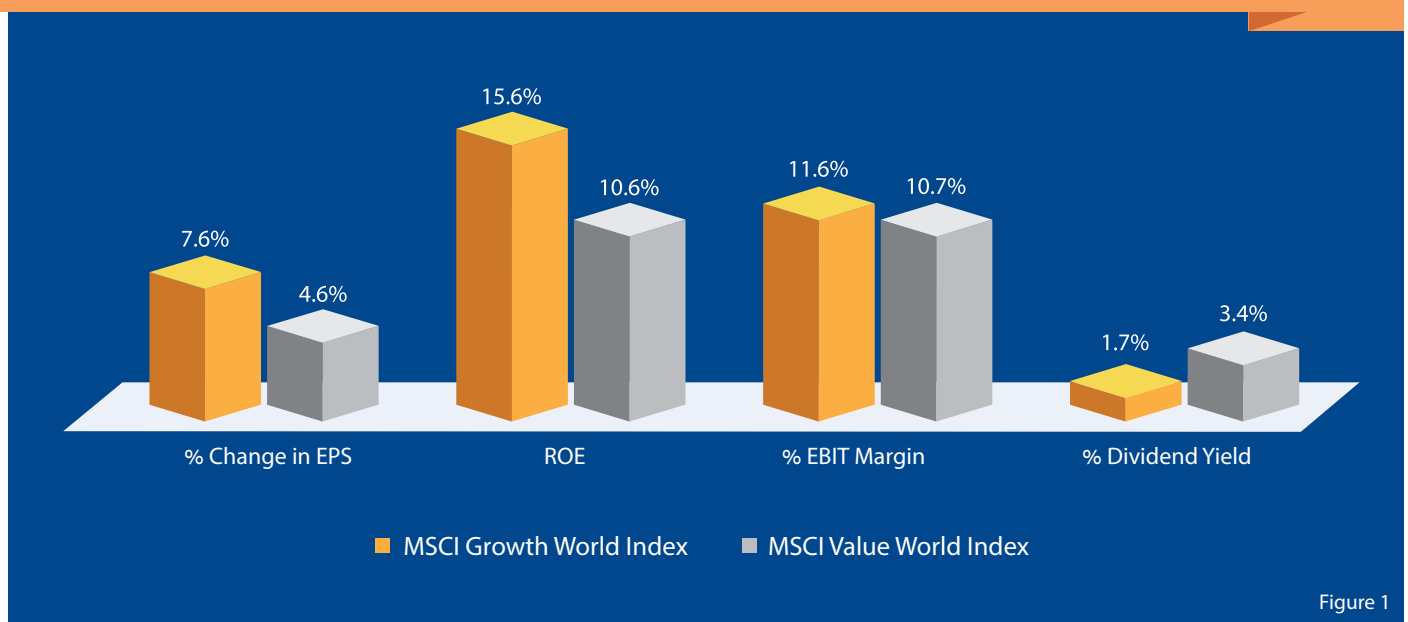


Figure 1

Source: Bloomberg

Value Investing Has Been Under-performing Since the 2008 Financial Crisis

MSCI World Growth Index reached its all-time peak by the middle of 2015.

Since the financial crisis of 2008, central banks in developed nations have adopted loose monetary policies. This has resulted in a decline in the bond yield from sovereign nations. The low-yield environment has encouraged portfolio managers to add risky assets with high growth potential to their portfolio, thereby increasing the valuation multiple of growth assets. Currently, the MSCI World Growth Index is trading at a PE multiple of 24.3x — its highest in over a decade — vis-à-vis the average of 19.8x from 2005-15. Meanwhile, the MSCI World Value Index is trading at a PE multiple of 16.5x vis-à-vis the average of 15.6x from the last 10 years (2005-15).

Interestingly, in 2008, both indices formed a trough when the interest rate cycle started trending downwards. During this year, all markets witnessed a contraction in earnings due to the global financial crisis. Consequently, the valuation multiple for Growth and Value indices peaked in 2009. After 2009 (when the interest rate dipped to its lowest level) the valuation gap between the MSCI World Growth and Value indices reached its highest level of 9.20x during mid-2015. Although the valuation gap corrected eventually, it remains way above the 10-year average of 4.27x. The MSCI World Growth Index has been outperforming the MSCI World Value Index since the financial crisis of 2008. The MSCI World Value Index's underperformance continued through 2015, owing to a widening valuation gap.

TTM PE Multiple of MSCI World Growth and Value Indices

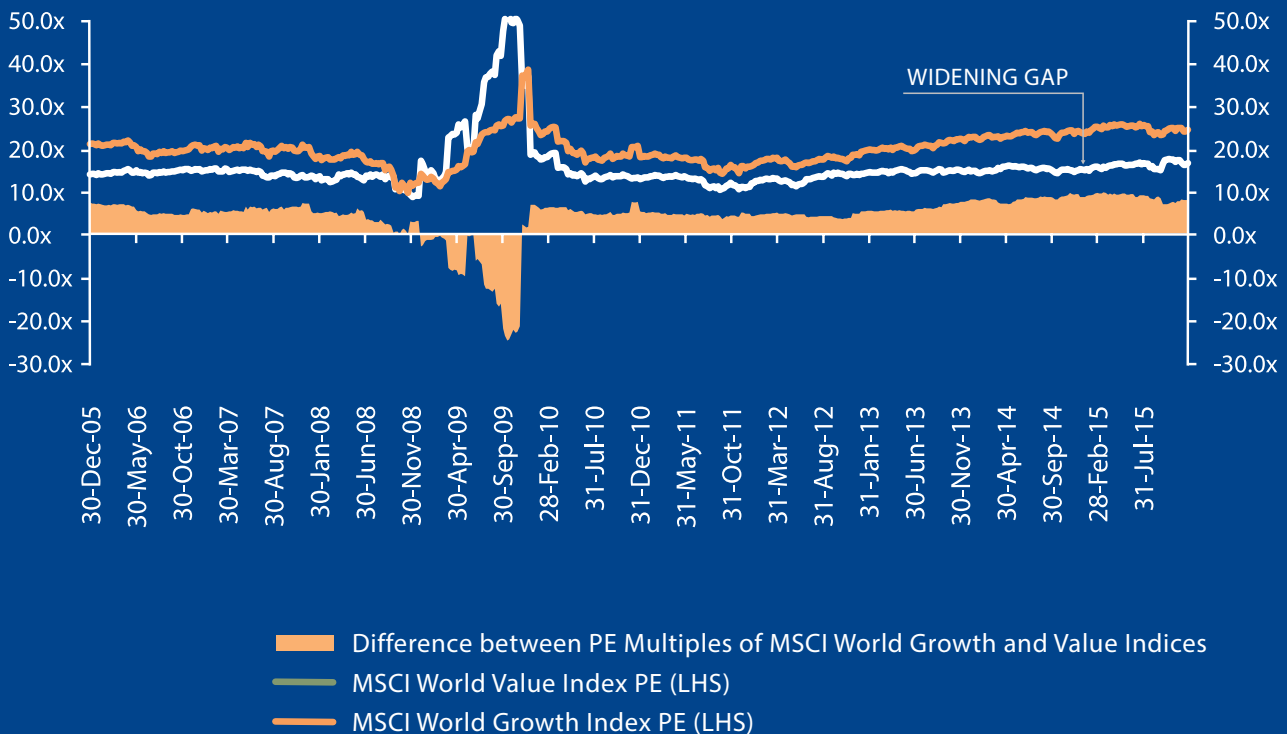


Figure 2

Source: Bloomberg

Value Investing Outperforms Growth Investing Amid Fed Rate Hikes

Value investing outperformed growth by 18.5% during 1992-94 and by 50.8% during 2000-06.

Since 1985, the relationship between growth and value investing has been consistent throughout the interest rate cycle. Value tends to outperform during periods of rising interest rates, while growth tends to outshine when loose monetary policies are adopted. All other factors being constant, declining interest rates benefit growth assets more than value assets. Central banks generally adopt a loose monetary policy in order to spur economic growth and counter low inflation. During this period, growth is unmanageable; hence, the performance and valuation of growth stocks exceed those of value stocks. The loose monetary policies adopted by developed nations in the aftermath of the 2008 financial crisis have boosted the global equity market. Value investing usually outperforms when the monetary policy is tightened, as witnessed after the recession in 1990 and during the dotcom bubble. Value investing outperformed growth by 18.5% during 1992–94 and by 50.8% during 2000–06; this is precisely when the monetary policy in the US was tightened.

Fed Fund Rate vs. Difference in Annual % Return Between MSCI World Growth and Value Indices

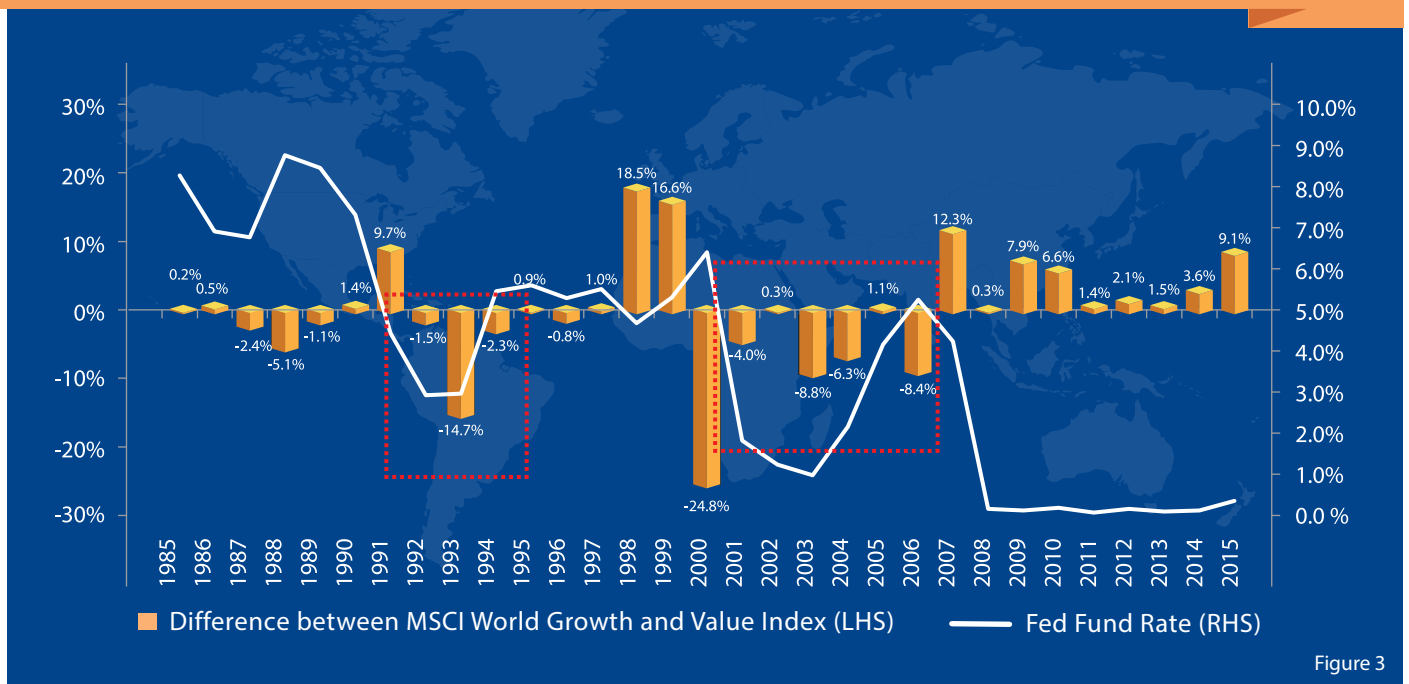


Figure 3

Source: Bloomberg

Under growth investing, a greater proportion of the value of a firm lies in its future. When interest rates rise, the discount rate at which free cash flows are discounted increases, leading to a decline in the value of the firm. In other words, lower discount rates increase a firm's value. On the other hand, under value investing, a firm is at a more mature stage in its lifecycle. Thus, the impact of changes in the discount rate on its free cash flows is lower.

During 2007–15, the MSCI World Value Index marked its longest period of underperformance vis-à-vis the MSCI World Growth Index; however, this is expected to change in the near future. Between 2004 and 2006, the US Federal Reserve raised interest rates 17 times to slow an overheated economy and curb escalating inflation levels. Despite the rate hikes, equities continued their strong performance. However, there was wide disparity in the performance of growth and value investing. In fact, although the valuation multiple contracted, value investing outperformed growth investing during this period.

Fed Fund Rate in Comparison to YoY % Change in MSCI World Growth and Value Indices

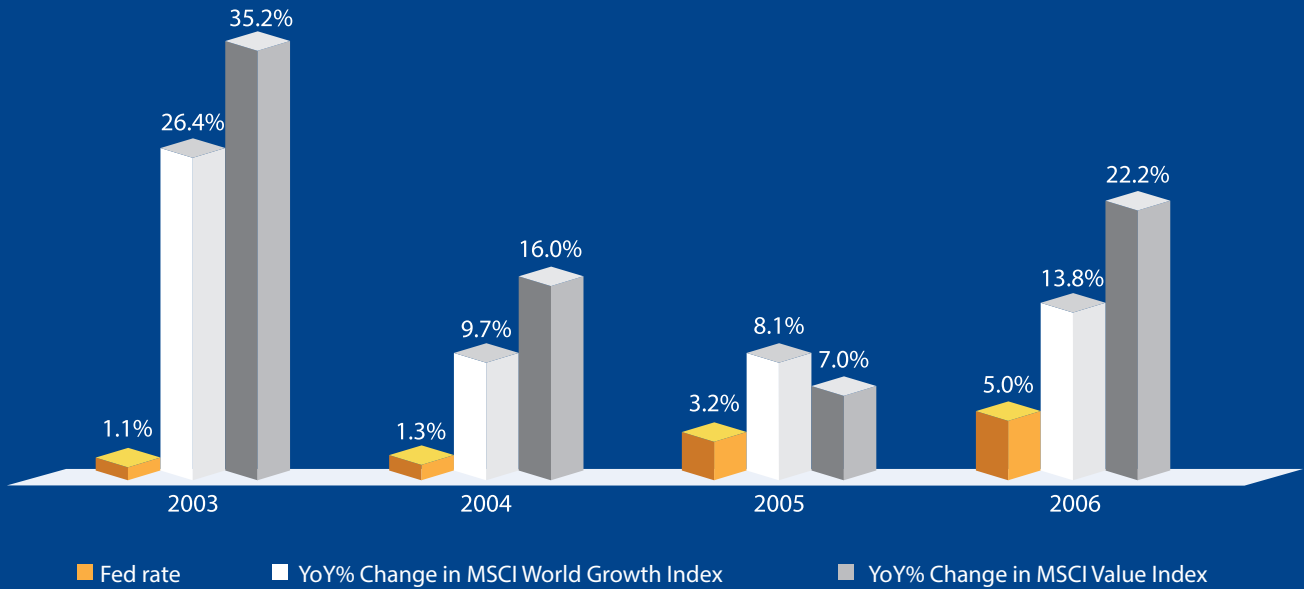


Figure 4

Source: Bloomberg

As evident in the chart, the MSCI World Value Index outperformed the MSCI World Growth Index during 2003-06.

Valuation Multiples of Growth Companies are More Susceptible to Changes in Monetary Policy

Although valuations for both growth and value companies are susceptible to fluctuating Fed rates, in a rising interest rate regime, growth companies witness a greater contraction in valuation multiples

Valuation multiples expand or contract in tandem with changes in the Fed's interest rates. We have demonstrated this relationship using a simple derivative of the justified PE multiple. The company's justified PE multiple is calculated using the $(ROE-G)/(ROE*(K-G))$ formula, wherein ROE is the return on equity, K is the cost of equity and G is the sustainable growth rate.

Financials such as ROE and the long-term growth rate are determined from the MSCI World Growth and Value indices. ROE is the average from 2004 to 2015 and the long-term growth rate is the CAGR from 2004 to 2015. While calculating the justified PE multiple, we have used the same cost of equity.

Based on our calculation, the growth company has a justified PE multiple of 24.0x, while the value company's corresponding multiple is 12.8x. The primary factor for the difference between the justified PE multiples is the higher ROE and long-term sustainable growth rate.

Sensitivity of Justified PE Multiple of MSCI World Growth and Value Indices as Compared to Interest Rate

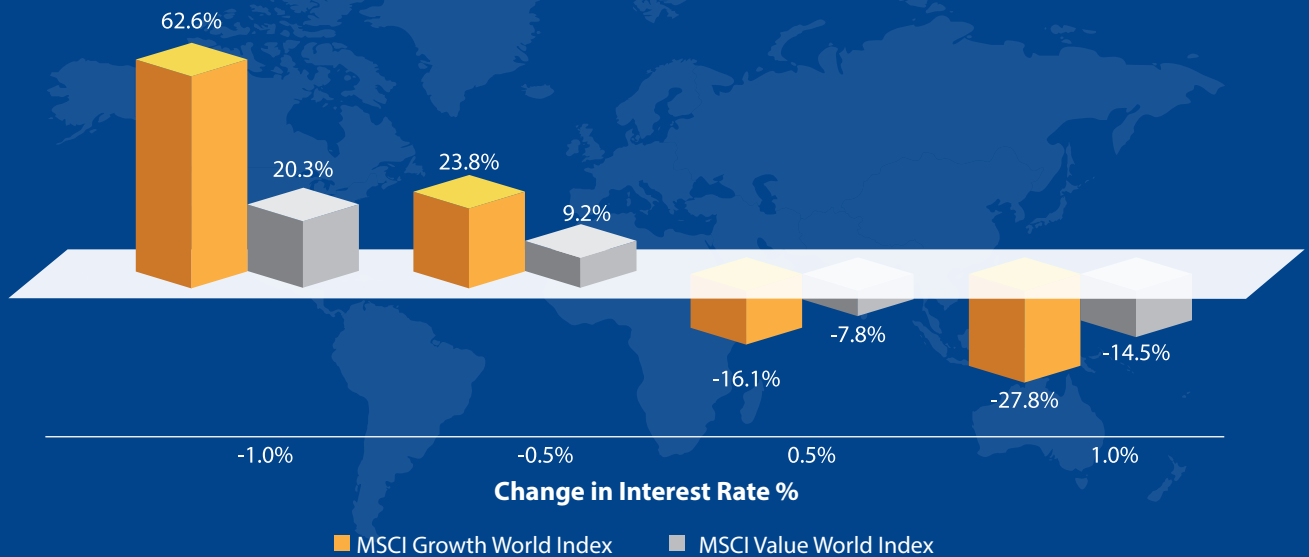


Figure 5

Source: Aranca Research

As seen in the chart, the growth company's PE is more sensitive to an increase in the interest rate as compared to the value company. The valuations of both companies decline; however, the valuation of the growth company decreases by a higher percentage point as compared to the value company.

BOTTOM LINE

Value Investing likely to revive in 2016

The US Federal Reserve's 25bps hike in the interest rate in December 2015 is just the beginning of a series of increases expected in 2016. Economists argue that the Federal Reserve could raise the interest rates by as much as 100bps during the course of the year, supported by lower unemployment rate, a marginal increase in wages, and a rise in inflation. However, recent turmoil in the Chinese stock market may delay these rate hikes. Despite the risks, interest rates are likely to rise in 2016. This would act as a catalyst for re-rating value stocks and drive their outperformance over the next few years.

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Ati Ranjan Kumar

Head
Investment Research

✉ ati.ranjan@aranca.com

Ashish Sethi

Global Head
Sales & Business Development

✉ ashish.sethi@aranca.com

Kannan Sivasubramanian

Executive Vice President

✉ kannan.siva@aranca.com

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