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Marketing Material

BEWARE A VALUE ROTATION TRAP

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IN A NUTSHELL

_ The case for rotating to value from growth appears weak to us.
_ Growth stocks are long duration assets: low rates justify bigger premiums.
_ Observed premiums to steady-state P/Es are below history at growth.
_ Acceleration remains absent: value outperforms on strong acceleration.
_ Trends and themes likely to persist even longer than usual.

THE CASE FOR ROTATING TO VALUE FROM GROWTH APPEARS WEAK TO US

Russell Large Cap Growth substantially outperformed Russell Large cap Value each of the past three years, including and to the surprise of many in the fourth quarter of 2019. In the autumn, many investors argued that a rotation in style leadership was finally upon us. Some argued for a shift in performance leadership from growth to value in 2020 on, supposedly: 1) an excessive valuation premium at growth vs. value, 2) an in progress or imminent acceleration of economic growth, manufacturing activity, earnings growth, 3) various mean-reversion arguments given wide return differentials between the two styles, the record stretch in duration of growth's outperformance, and some investor positioning or sentiment indicators perhaps too favoring of growth. However, we argued against rotating from growth to value late last year, or to at least maintain a balanced style strategy, and we still stick with this view. This note reviews why we think the growth- to value-rotation thesis is weak and why growth stocks deserve higher valuation premiums than history vs. the broad equity market, vs. value stocks and vs. their steady-state valuations when interest rates are far below history.

GROWTH STOCKS ARE LONG DURATION ASSETS: LOW RATES JUSTIFY BIGGER PREMIUMS

When looking at a spectrum of securities arranged in terms of growth prospects – from high growth on one end to cyclical value on the other – our analysis based upon intrinsic valuation or discounted-cash-flow (DCF) models shows that companies with the best growth prospects are the greatest beneficiaries from lower interest rates. As interest rates decline, future growth is worth more to investors, while risk-free rates continue to be a larger portion of the cost of capital for defensive stocks. To borrow bond terminology, growth stocks have higher durations and convexities than their value counterparts. This makes high growth stocks the most sensitive to declines in interest rates (and value stocks the least), and thus, growth stands to benefit the most from a reduction in the real S&P 500 cost of equity. Low rates will likely continue into the future, and this is why we believe paying bigger premiums for growth makes sense in today's "lower for longer" interest-rate environment.

OBSERVED PREMIUMS TO STEADY-STATE P/ES ARE BELOW HISTORY AT GROWTH

We believe, secularly lower interest rates justify higher steady-state price-to-earnings ratios (P/Es) for the S&P 500 than history and even more so for growth stocks. While we use simple and more complex DCF models to estimate fair P/Es under various interest-rate and explicit growth scenarios, we also evaluate the observed S&P 500 P/E and that of sectors by comparing them to estimated fair steady-state P/Es. This reveals any premium or discount to steady-state value today, which we then compare to what's normal for the S&P 500 and its sectors back in time. Despite multi-year outperformance of growth vs. value, we see that the growth sectors and mature growth stocks are just beginning to trade with a positive premium to steady-state value for their growth potential. While now positive, this growth premium remains below history, despite today's low interest rates justifying a higher premium than history, if all else is the same, including if their long-term economic profit growth potential is similar to history.

ACCELERATION REMAINS ABSENT: VALUE OUTPER-

FORMS ON STRONG ACCELERATION

Acceleration arguments for tactically favoring value over growth, generally rest on the notion that current profits at value are far below normal earnings potential and that a powerful recovery is imminent. This often occurs when exiting recessions. We do not expect a profit surge at key value sectors such as Energy, Materials, most Industrials, Auto, Retailers or most Financials in 2020. Not in the United States or abroad. And because P/Es are not depressed and rather elevated vs. norms at value (big banks the exception), we are skeptical that moderate acceleration is enough for value to outperform. Earnings-per-share (EPS) growth at growth and value are likely similar in 2020 and 2021, but the growth at growth is higher quality and more sustainable.

TRENDS AND THEMES LIKELY TO PERSIST EVEN LONGER THAN USUAL

As we have long argued, we expect this expansion's longevity to shatter prior records. As such, we think economic trends, themes and areas of leadership in financial markets are likely to last longer than previously seen. We also think that when value has outperformed over long stretches of time or strategically that it was compensation earned for bearing uncertainty in controversial industries or companies. When growth outperforms over the long-term we think it is compensation for being patient. We think the combination of patience in a long expansion with the economy increasingly shifting toward services and knowledge based businesses favors growth.

GLOSSARY

Convexity describes a non-linear relation of a dependent variable from a variable that approaches asymptotically a certain value. The relationship of a bond price from a change in interest rates or of volatility from the remaining time period are two examples.

Cost of equity (CoE) is the return (often expressed as a rate of return) a firm theoretically pays to its equity investors, to compensate for the risk they undertake by investing their capital.

Cyclical is something that moves with the cycle.

Defensive stocks are stocks from companies whose sales are expected to fluctuate less than the market average as the demand for their products are less tied to business cycles.

Discounted cash flow is a method used to gauge the value of a company by finding the present value of projected future cash flows.

The discount rate is the interest rate charged to commercial banks and other depository institutions for loans received from the country's central bank's discount window.

Duration is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Growth stocks are stocks from companies that are expected to grow significantly above market average for a certain period of time.

The intrinsic value is the one that comes closest to the value that an objective fundamental analysis would ascribe to an asset.

Mean reversion is a theory that prices and returns eventually move back toward the mean, or average.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

In economics, a real value is adjusted for inflation.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The Russell 1000 Growth Index states the performance of the companies included in the index that have higher price-to-book ratios and are forecasted with higher growth.

The Russell 1000 Value Index states the performance of the companies included in the index that have lower price-to-book ratios and are forecasted with lower growth.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

A valuation premium is the excess a buyer is willing to pay for one asset relative to other assets.

Value stocks are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

APPENDIX: PERFORMANCE OVER THE PAST 5 YEARS (12-MONTH PERIODS)

	12/14 - 12/15	12/15 - 12/16	12/16 - 12/17	12/17 - 12/18	12/18 - 12/19
Russell 1000 Value	-6.2%	14.3%	10.9%	-10.6%	23.2%
Russell 1000 Growth	4.0%	5.3%	28.4%	-2.8%	34.7%

Past performance is not indicative of future returns.
Sources: Bloomberg Finance L.P., DWS Investment Management Americas Inc. as of 1/16/20

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