Understanding the behaviour of Growth and Value investment strategies

Introduction

Growth or value? This question rarely escapes any discussion about investment philosophy, strategy or process, particularly when it comes to equity investing. To have a meaningful discussion on this, investors must have a deep understanding of how these two strategies perform in different market environments and the drivers of their returns. This article seeks to address these questions.

Long term performance

A large body of research shows that, globally, value has outperformed growth over the long term. However, this finding has not gone unchallenged, as a number of authors have pointed out that this outperformance is a result of the use of a wrong definition for growth in many of these studies. They argue that if growth is defined as it is normally defined in practice that the reported outperformance by value is not as clear-cut, e.g. Brush (2007). Brush points out that there is a widespread convention of defining growth as 'bad value' in academic research, i.e. as stocks with high price-to-book or high price-to-earnings ratios. This definition is disconnected from reality as it is highly implausible that a growth portfolio manager will primarily search for overpriced stocks in constructing a portfolio. We think a definition that uses growth variables such as earnings growth, sales growth, etc, is more appropriate in capturing the risk and return characteristics of a growth strategy. For example, the MSCI growth index uses a combination of variables with a focus on growth such as forecast earnings per share growth, historical earnings per share growth, sales per share growth and current internal growth rate. Using this definition, contrary to Brush's findings, the MSCI indices show that, globally, value has significantly outperformed growth since 1974 (see figure 1). However, evidence of this differs from region to region. At this point all we can say is that the debate regarding the long-term performance of value versus growth rages on!

Be that as it may, there is very little disagreement amongst academics and investors that the relative performance of the two strategies is very cyclical, with wide performance swings relative to each other over time. The last few years have been notably different though; growth experienced its strongest and longest period of outperformance relative to value (see figure 2). From January 2009 to December 2018, the MSCI World Growth index, which is representative of the growth style, outperformed the MSCI World Value index by an annualised 2.4%.

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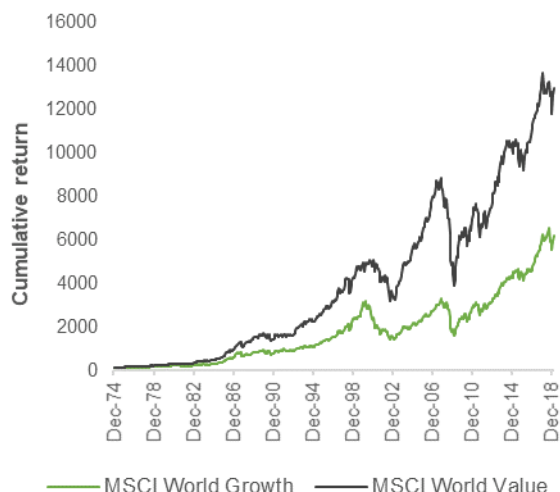
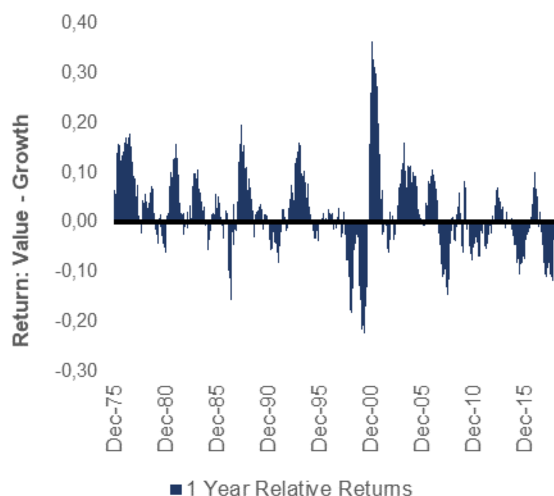
Figure 1: Cumulative returns – MSCI World Value vs. Growth



Source: Bloomberg, Lima Mbeu

Figure 2: 12-month Relative returns - MSCI World Value - Growth



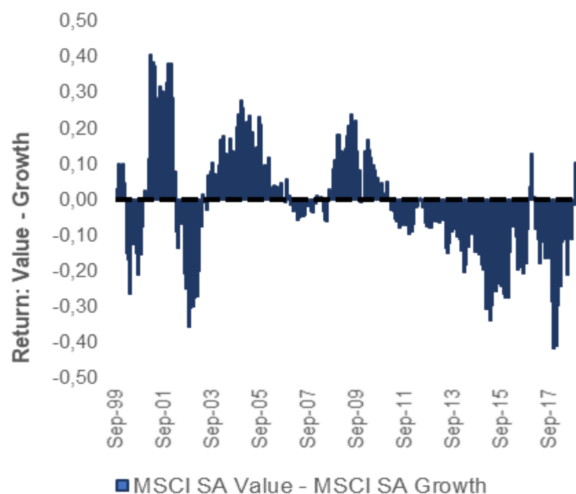
Source: Bloomberg, Lima Mbeu

Locally, data on the MSCI indices for value and growth only starts in 1997. From inception until the end of December 2018, the indices show that growth has marginally outperformed value in SA, particularly due to the stellar performance by growth over the last decade (see figure 3 & 4). From beginning of 2009 to end of December 2018, the MSCI SA Growth index outperformed the MSCI SA Value index by an annualised 6.9%.

Figure 3: Cumulative returns - MSCI SA Value vs. Growth

Source: Bloomberg, Lima Mbeu

Figure 4: 12-month Relative returns – MSCI World Value – Growth



Source: Bloomberg, Lima Mbeu

Performance drivers

The outperformance by growth over the last decade is in part a result of a very supportive environment for growth relative to value since 2009. In the wake of the global financial crisis (GFC) of 2008-2009, the world economy was plunged into a recession. The post-recession period has generally been a low growth one, filled with rising macro, political and policy uncertainty, creating a very challenging environment for riskier assets and riskier investment strategies such as value. In their paper entitled 'Risk and Return of Value Stocks' published in 1998, Chen and Zhang found that value stocks are riskier because they are usually firms under distress, have high financial leverage, and face substantial

uncertainty in future earnings. Additionally, Zhang (2005) found that in contrast to their more flexible, growth counterparts, value firms have less flexibility to adapt to adverse economic environments like the one experienced in SA over the last decade.

To demonstrate the effect of the recent environment on value and growth, we turn to the return decomposition framework proposed by Grinold and Kroner (2002). The framework decomposes the single period return into income return (dividend yield), nominal earnings growth and repricing (the change in price/earnings ratio (P/E)). The tables below show the decomposition of the MSCI SA index, the MSCI SA Growth index and the MSCI Value index over the last decade and the last 22 years, respectively.

Table 1: Return decomposition (2009 to 2018)

Decomposition of returns	MSCI SA Index	MSCI SA Value Index	MSCI SA Growth Index
Dividend yield (%)	3.0	4.2	1.9
Earnings growth (%)	2.2	-7,3	5.6
Change in PE ratio (%)	6.4	12.4	7.1
Total Return (%)	**12.1**	**8.6**	**15.4**

Source: Bloomberg, Lima Mbeu

From January 2009 to December 2018, the 12.1% total return generated by the MSCI SA index was driven by a 3% dividend yield, a 2.2% nominal earnings growth, and a 6.4% PE expansion. It is interesting to note that the PE expansion experienced during this period far exceeded the growth in earnings. The PE grew from 9.3 in December 2009 to 17 in December 2018, largely driven by quantitative easing. This means that investors were willing to pay R9.30 for a rand of earnings in 2009 but R17 for a rand of earnings in 2018. The dominance of the PE expansion in the last decade is in contradiction with evidence that shows that earnings growth is the most dominant driver of returns in the long term.

Table 2: Return decomposition (1997 to 2018)

Decomposition of returns	MSCI SA Index	MSCI SA Value Index	MSCI SA Growth Index
Dividend yield (%)	3.1	4.0	2.3
Earnings growth (%)	7.5	2.8	8.3
Change in PE ratio (%)	1.5	4.6	1.5
Total Return (%)	**12.8**	**12.1**	**12.7**

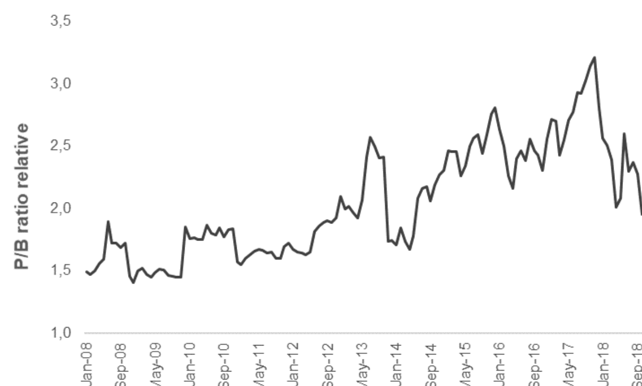
Source: Bloomberg, Lima Mbeu

Looking at a longer history (Table 2), the growth in earnings of 7.5% generated by the MSCI SA index between January 1997 and December 2018 was by far the biggest contributor to the 12.8% total return of the index over that period; dividend yield and the change in the PE multiple contributed far less, 3.1% and 1.5%, respectively. Compared to the longer-term earnings growth of 7.5%, the disappointing earnings growth over the last decade is indicative of the low growth environment experienced in recent years.

Turning the focus to the decomposition of value and growth indices, we see very divergent experiences. From January 2009 to December 2018, as expected, value generated better income return (4.2% versus 1.9%) and multiple expansion (12.4% versus 7.1%) than growth. However, it seems that the low growth environment and uncertainty experienced during this period created a very challenging operating environment for value companies, resulting in negative nominal earnings growth of -7.3% for the value index. This corroborates Zhang's point that value companies have less flexibility to adapt to adverse economic environments. In contrast, the growth index recorded nominal earnings growth of 5.6% over the same period. This significant difference in earnings growth was enough to overcome growth's underperformance in dividend yield and multiple expansion and deliver overall outperformance of an annualised 6.8% for the growth strategy versus value in total return terms (15.4% versus 8.6%).

The low growth period experienced over the last decade generally favours growth companies. In this type of an environment, in which growth opportunities are scarce, investors are willing to pay a premium to own growth stocks. As shown in figure 7 below, the trend of the relative price-to-book rating of growth over value in the last decade was generally upwards, i.e. growth stocks were becoming more expensive relative to value (mainly as a result of the scarcity of growth). However, 2018 saw a big reversal of the relative rating, chiefly due to a pull back in the price performance of growth relative to value.

Figure 5: Price to Book ratio relative (MSCI SA Growth Index / MSCI SA Value Index)



Source: Bloomberg, Lima Mbeu

Could this recent trend be suggestive of a rebound in the performance of growth relative to value in the short term or the return of value after a decade of disappointing performance? This is a tough question to answer. Whilst at an overall level it appears that growth's valuation has come down quite a bit from its high of the last 10 years, we need to keep in mind that growth is typically dominated by many stocks for which earnings disappointments or other setbacks could result in sharply negative returns. At the same time, if the low growth environment persists, value companies might find it difficult to sustain their recent gains. In the light of this, how should investors be positioning their portfolios?

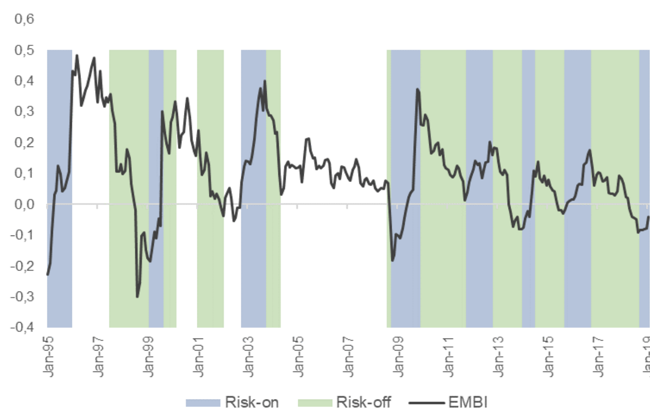
Peformance across various environments

To answer the above question, it is critical to understand market conditions under which these strategies are expected to outperform or underperform. First, let us start by understanding the theoretical explanation of why these strategies perform the way they do. In academic circles, there are two main competing arguments put forward to explain the divergent performance between value and growth. The risk-based explanation and the behavioural explanation. Under the risk-based explanation, it is argued that value companies must attract higher returns as compensation for the high risk they bear. For example, Fama and French (1995, 1996), found that the value effect (the outperformance of value over growth) is related to the higher distress risk associated with value companies. The behavioural explanation on the other hand, attributes the difference in performance to the systematic mispricing of value versus growth stocks. For example, Lakonishok, Shleifer, and Vishny (1994), show that value stocks are those that have performed poorly and are expected to continue to underperform. They attribute the difference in performance to the overreaction of investors to past performance and the over-extrapolation of historical growth too far into the future.

In the section that follows, we focus on the risk-based explanation and provide some evidence using SA data of when the two strategies are expected to perform better. Investor sentiment towards risk varies over time and oscillates between risk-on and risk-off all the time depending on the market's outlook. Value tends to perform well during risk-on periods when investors are likely to pay up for riskier assets. "Risk-on" environments are typically characterised by periods during which credit, commodities, and other riskier themes rally. On the other hand, growth companies are scarce during late economic expansions or early to mid-slowdowns (Risk-off periods); these are periods during which investors are more cautious and safer asset such as US treasuries, US dollar and other safe-haven asset classes benefit from a flight to safety - investors are therefore more likely to pay up for the more stable and less riskier quality growth companies during these periods.

To demonstrate the behaviour of these two investment styles during the periods described above, we have used the returns for MSCI SA Value and Growth SA indices. Firstly, we partitioned the historical periods according to whether they were "risk-on" or "risk-off". For this, we used the JP Morgan Emerging Market Bond Index (EMBI) as shown below.

Figure 6: JP Morgan EMBI index (12-month return)



Source: IRESS, Lima Mbeu

Periods during which the 12-month return of the EMBI index is rising, represent environments during which global investors are risk seeking and are generally buying riskier assets such as value, we characterised these periods as "risk-on" periods. Periods during which the EMBI index is falling, signal flight to quality by investors. It is during these periods that we would expect investors to go after safer asset classes, these are the periods we classified as "risk-off". The returns shown in table 4 below confirm that in risk-on environments value has outperformed growth in SA, delivering outperformance of 5.7%, annualised. In risk-off environments, growth has had an upper hand, outperforming value by an annualised 4.4%.

Table 4: Annualised returns in risk-on/off regimes

Regime	MSCI SA Value Index (%)	MSCI Growth Index (%)	Return differential (%)
Risk-on	14.4	8.6	5.7
Risk-off	6.8	11.1	-4,4

Source: Bloomberg, Lima Mbeu

Summary

The relative performance of value and growth is very cyclical with the two strategies performing differently at different points in time. The last 10 years have been remarkably different; growth recorded its strongest and longest outperformance relative to value in SA and globally. Is this likely to continue or will value stage a great comeback? This is difficult to answer. What is more important to understand are the drivers of returns and the conditions under which these strategies are likely to perform. From our analysis, it is clear that the performance of these strategies is very differentiated in different market environments. Value tends to do well in risk-on environments whilst growth does better in risk-off environments.

We have a growth philosophy as we believe that buying companies whose earnings are growing much faster than average leads to outperformance of the market in the long run. This is supported by evidence that shows that earnings growth is the most important driver of equity returns in the long run [1]. Growth investing does not come without risks though; earnings disappointments by growth companies can lead

to significant falls in share prices. We believe that implementing a risk conscious growth investing process can help avoid some of these risks.
More importantly, there is very little doubt that the pendulum of performance will continue to swing between these key investment strategies; we think it is advisable to construct and hold portfolios that are balanced with respect to these approaches.

References

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