Why can "value" outperform in the long term?

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After several false starts in recent years, the outperformance of the "value" style [1], which began in November, has investors questioning the sustainability of this rebound. Is it going to last? What are the short and medium term catalysts that are favourable to the "value" style? Beyond this horizon, are we witnessing a paradigm shift that would justify a more substantial share of "value" stocks in long-term investments? These are the questions investors are asking today.

We believe that the consequences of the health crisis and subsequent fiscal responses have led to a reduction in deflation fears, triggering the beginning of a normalisation of the fixed income markets in favour of the "value" style. This will result in a necessary recalibration of the "market software" which should lead to a long-term shift towards "value" sectors. The "value" will also benefit from flows linked to a strategic repositioning towards this theme by investors who no longer have any reason to abandon it in this new market environment. In the short and medium term, these flows will also be supported by a relative valuation discount, which appears excessive.

Reassuring factors in the short and medium-term

Despite the recent rebound, we can identify several reasons that should allow "value" to continue to outperform:

- Solid fundamentals:
  - Analysts' earnings per share (EPS) growth expectations in the Eurozone stand at 49% in 2021. This growth is driven in particular by the cyclical and financial sectors that suffered notably in 2020, and offers favourable bases of comparison. The results for the first quarter were very encouraging in these sectors, leading to further upward revisions of EPS, and making it possible to post, despite the recent rebound, ever more attractive valuations relative to growth sectors. Beyond that, the EPS growth expected for 2022 remains significant, at around 15%, and again, it is the cyclical and financial sectors that are driving this uptrend.
  - Subject to a normalization of the health situation, which appears to be well underway thanks to a vaccination campaign that is accelerating in Europe, the dynamic of results and an attractive valuation constitute important supports for the "value" sectors. By way of illustration, while the P/E 2022 [2] of the Eurozone market stands at 16.7x, the valuation of the automotive (7.8x), commodities (11.3x) and banking (9.6x) remains very attractive. This should be compared to much richer valuations for growth sectors such as consumer goods (35.4x) or technology (25.9x), sectors that could suffer in a phase of rate normalization.

(1) Value refers to the management style of investing in securities with discounted valuations.
(2) P/E: Price earning ratio.

- A return of flows to Europe and a *momentum* that becomes “value”
  - Europe, which was lagging behind in the recovery, should benefit from the EUR 750 billion stimulus plan, which is arriving late, but which will support growth. This should allow us to witness a phenomenon that has not been seen for 17 years: the growth of EPS in Europe is expected to exceed that of EPS in the United States. Every time this has happened, Europe has outperformed the United States, and each time it was the European cyclical aspect that investors were looking for. European “value” outperforms other styles in these phases, just as it outperforms “value” in other geographic areas.
  - Another new trend, the *momentum* (which consists of buying stocks that performed well over the past 12 months) becomes favourable to “value”, due to the outperformance of the last 7 months. This should help with repositioning on the “value” style and is another factor of support, via the fluxes. Europe remains underweight when it comes to allocations and flows to equities remain limited in the zone, which gives hope for significant support potential.

A long-term paradigm shift

In the longer term, other factors, which are more structural, should promote the return of “value” in investor allocations:

- The end of the headwind of lower interest rates, the driving force behind the performance that has prevailed in recent years
  - We know the correlation between rates and “value”. This is one of the main reasons for the strong underperformance of “value” compared to “growth” for more than 10 years. It is first of all interesting to note that, despite the historic health crisis that we experienced in 2020, the German 10-year rate has hit a low point at -0.8%, and has generally rebounded to a level of - 0.6%. This leads us to consider the level of -0.6% as a floor rate, after a drop of 400 basis points in 10 years.
  - Without considering that rates will rebound sharply, the mere fact of seeing the fears of deflation recede implies that we no longer have this headwind of lowering rates. The health crisis has probably been the trigger for this paradigm shift. This is a real change for the performance of the “value” style, allowing the conditions for a fresh start, by putting the two styles, namely “value” and “growth”, on an equal footing. Investors will therefore refocus on fundamentals and probably reconsider the valuation gap. This is all the more true since, as we mentioned previously, the relative valuation discount of “value” has further amplified in recent months, due to the higher earnings growth of the cyclical and financial sectors.
- A political context in the Eurozone is conducive to more ambitious investment budgets, generally favourable to industrial sectors. This should allow the market to realize the considerable catch-up potential that remains for “value” stocks, the main beneficiaries of the stimulus packages and the possible return of inflation.
- The end of the crisis was accompanied by multiple stimulus packages and a strong rebound in demand, which led to higher inflation expectations. More structural elements should take over, resulting in a normalization of rates, which would benefit the “value” sectors:
  - Environmental constraints requiring investments, which will have to be reflected in the prices.
  - On the social level, the discourse intended to reduce inequalities and contain populism should encourage the rise of low wages.
  - The end of the levers which have enabled companies to preserve their margins and which, therefore, make future price increases more and more inevitable: (i) the end of the fall in interest rates, (ii) the end of the fall corporate tax rates, (iii) the end of the beneficial effects of globalization.
- In addition, in this long-term perspective, there is the possibility of more agile management, making it possible to arbitrate towards more defensive sectors or sub-sectors, completely compatible with this “value” bias. Within sectors such as telecommunications, food/drink, distribution or health, certain stocks have the characteristics to play this theme. Their potential for appreciation appears less important in the short term but, in a second phase, it offers the opportunity for a more defensive positioning on these securities, which have a very attractive valuation.

In conclusion

After a marked underperformance in “value” for more than 10 years, the economic environment is arguing for a normalization of sovereign rates and a gradual recovery in inflation, two elements that will benefit this style of management. In view of the valuation differences mentioned between growth and “value”, the market does not seem to have yet integrated these structural elements, and it seems dangerous to us not to be exposed to long-term “value” in an allocation.

To do this, we believe that credible players on this topic should be favoured, through a pure “value” approach. Many funds claiming to be “value” in the past have surrendered in recent years, which is not the case with R-co Conviction Equity Value Euro. ■

Past performance is not a reliable indicator of future performance and is not constant over time.

R-co Conviction Equity Value Euro

Recommended investment period: 5 years

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