Why Value Stocks Are Becoming More Competitive Again

The investment environment has undergone a decisive shift.

March 2023

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After a decade of dominance by growth stocks, value stocks came back with a vengeance last year: The MSCI World Value Index outperformed its growth counterpart by more than 20 percentage points. This does not necessarily mean that value investing is set to dominate growth for the next decade, but it supports my view that the headwinds facing value stocks are easing and that, at the very least, value is set to become more competitive than at any time since the global financial crisis (GFC).

Why did growth stocks dominate for so long? Partly because, following the GFC, there was a long period of low interest rates, which have tended to favor growth stocks that promise stronger cash flows in the distant future. Bond math suggests that lower interest rates cause longer-dated cash flows to have higher present values. Value stocks are not helped as much by lower interest rates because value firms are typically expected to generate profits over a shorter time horizon.

While interest rates have been a factor, we believe the main reason for the dominance of growth stocks is that disruptive technology, including online shopping and digital marketing, really delivered for investors. The market was slow to understand the potential of many of these stocks, which then substantially exceeded expectations. As the potential of some of the new technology became clear, investors piled in, fueling a boom period for growth stocks.

I believe the period ahead will be different. For one thing, a return to very low interest rates is very unlikely in the foreseeable future. While inflation will likely come down from current levels, the onshoring and "near shoring" of supply chains means we may be heading into a new epoch in which inflation remains elevated for an extended period as deglobalization makes it more difficult for companies to reduce labor and raw material costs. If that happens, rates, too, will remain high compared with recent history. In higher rate environments, current earnings tend to become more valuable and future earnings less valuable, which favors value stocks.

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Past performance is not a reliable indicator of future performance.

The Investment Environment Is Changing

(Fig. 1) Valuations will matter more in the period ahead

What's Changing	Possible Features of the Next Decade
Interest Rates and Inflation Likely to Be Higher ▪ Increased nationalism and "near shoring"/onshoring of supply chains could lead to a different inflation epoch, putting upward pressure on interest rates. **Innovation Better Understood** ▪ Incumbents in key industries are responding, creating competition for disruptors (e.g., direct-to-consumer media, battery electric vehicles, retail). **Value Has Done Well in Wake of Speculative Excess** ▪ Value outperformed after the "Nifty-Fifty" and "dot-com" bubbles as high embedded expectations did not match actual fundamentals.	**Equity Has to Compete With Other Asset Classes** ▪ "There is no alternative" (TINA) concedes to "there are numerous alternatives" (TANA). **Value Investing Is More Competitive** ▪ Valuation matters more, as investors demand cash flow over revenue growth. ▪ Higher inflation and interest rates create broader earnings growth in equity markets. ▪ Disruption continues but is better understood. **Dividends Matter More** ▪ Down or sideways market makes dividend yield a bigger part of total return. ▪ Higher-yielding dividend stocks are currently unusually cheap.

As of January 31, 2023.
Source: T. Rowe Price.

> "...higher interest rates and the maturing of the recent period of disruptive technology may establish a better environment for value stocks.

In addition, while the era of technological disruption is not over, we believe we have entered a more mature phase in this process. We are circumspect about our ability to predict the future, but we think it likely that in 10 years' time people will still be streaming videos, shopping on the internet, and driving more electric vehicles. However, these industries are likely to become more competitive. Early innovators may not be the best long-term companies from here: Netflix and Tesla, for example, will both face stiff competition as other companies innovate and catch up. Over the next 10 years, the most attractive investments may be in older incumbents that have been hit hard by disruption but can also leverage the new technology and effectively compete in the new categories. For example, if Volkswagen, which currently has an extremely low valuation, ultimately produces electric vehicles that are competitive with the high standard set by Tesla, expectations for both companies may be wrong.

In the past, value has performed well following periods of speculative excess (for example the "Nifty-Fifty" and "dot-com" eras) as high embedded expectations turned out not to match actual fundamentals. If the current period of speculative excess comes to an end as the era of disruptive technology matures, value companies may benefit once again.

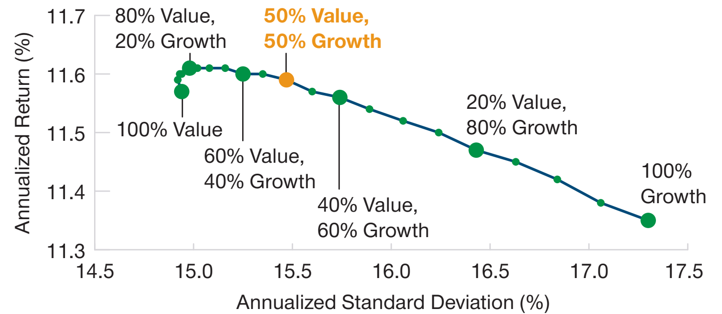
Combined, I believe that an extended period of higher interest rates and the maturing of the recent period of disruptive technology may establish a better environment for value stocks. This is not to suggest that value will dominate the next 10 years in the way that growth has dominated the past 10, but it does mean that value investing is likely to play a more important role in investor portfolios as higher rates create broader earnings growth and investors focus more on cash flows.

The specific securities identified and described are for informational purposes only and do not represent recommendations.

Value Is a Key Component of Portfolio Construction

(Fig. 2) Portfolios can benefit from holding both growth and value stocks

	Total Return (Annualized)	Standard Deviation (Annualized)	Sharpe Ratio
Russell 1000 Value	11.58%	14.94%	0.49
Russell 1000 Growth	11.35%	17.30%	0.41
↓	↓	↓	↓
50/50 Portfolio*	**11.59%**	**15.47%**	**0.48**



From January 1, 1979 to December 31, 2022.

Past performance is not a reliable indicator of future performance. For illustrative purposes only, not representative of an actual portfolio. The index performance shown is not indicative of any specific investment. The illustration does not reflect fees and expenses associated with an actual investment. The hypothetical portfolio in different percentage weights for the value and growth indexes assumes monthly rebalancing. Investors cannot invest directly in an index. Actual results experienced by investors may vary significantly from the results shown. Changing the time periods shown may result in different outcomes.

Standard deviation measures volatility. **Sharpe ratio** is a measure of return relative to risk, calculated as an asset's return above the risk free rate, divided by the standard deviation of the asset's excess return.

*50/50 Portfolio represents a mix of 50% within both the Russell Large Value and Russell Large Growth representative indices.

Source: Analysis by T. Rowe Price.

Although expectations and valuations for growth stocks have fallen to a degree, they remain elevated compared with value stocks. With higher expectations, the downside risk associated with disappointment in the trajectory of company fundamentals is considerable; conversely, there is a relatively lower expectation of value stocks.

I will explore these ideas in more depth in further blogs over the coming months. For now, it is worth reiterating my view that the current investment climate for value stocks is as favorable now as at any time since the GFC.

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ID0005712 (03/2023)
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