Factor Revival

COMMENTARY
January 2022

While it's true that we fancy smaller, less-expensive and more profitable companies, those preferences have not been shared among the bulk of investors over the past decade. With relative performance as testament to that fact, investors have been rather more interested in pulling forward the longer-term potential of growthier names. But history generally has been hostile to a growth focus, and we expect the longer-term future to prove little different:

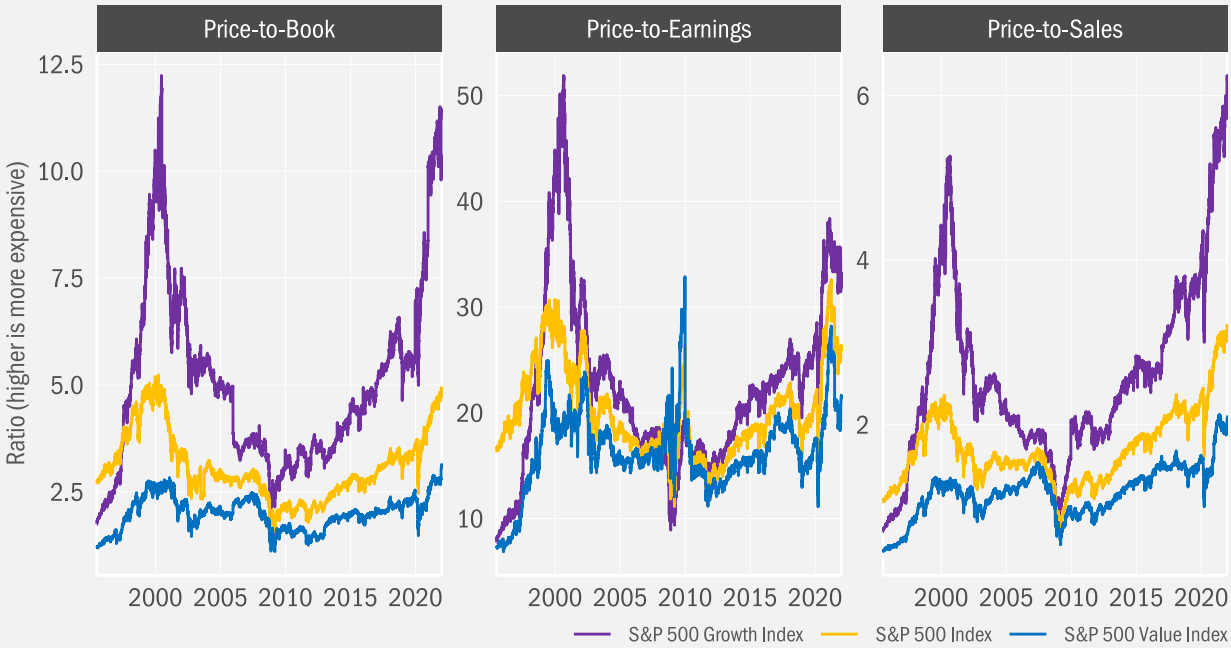
- If companies ultimately are worth their long-term earnings, richly valued stocks present a much higher bar for future excess return relative to the broader market than do less-expensive stocks
- Much of the recent performance difference has come from expanding multiples for large-cap and Growth stocks
- The relative valuations of small-cap and Value stocks have trailed those of their peers by a growing margin, bolstering support for positioning in favor of those characteristics

Value of Expectations

A company's stock price should represent collective investor expectations of future earnings, brought forward to the present. Valuation metrics (for example, price-to-book value and price-to-earnings) are reflective of those estimations: the higher the multiple, the greater the expectations for future improvement in fundamentals. It should seem rather obvious where that setup might go wrong. Certainly, some companies for which investors have high hopes may achieve those expectations, perhaps even exceed them. But it's important to know that, where high valuation multiples are involved, the achievement of those lofty expectations is already embedded in the stock price. For future returns to prove exceptional, future fundamentals likely must improve upon current expectations. Flip that thinking on its head and you arrive at one of the fundamental reasons for preferring Value stocks: relatively conservative expectations.

Figure 1: Valuation Metric Comparisons

By definition, Growth stocks are more expensive than Value stocks. But, the gap in valuations has widened considerably over the past decade



From 06.30.95 through 01.05.22. SOURCE: SRCM using data from Bloomberg

Expanded Opportunity?

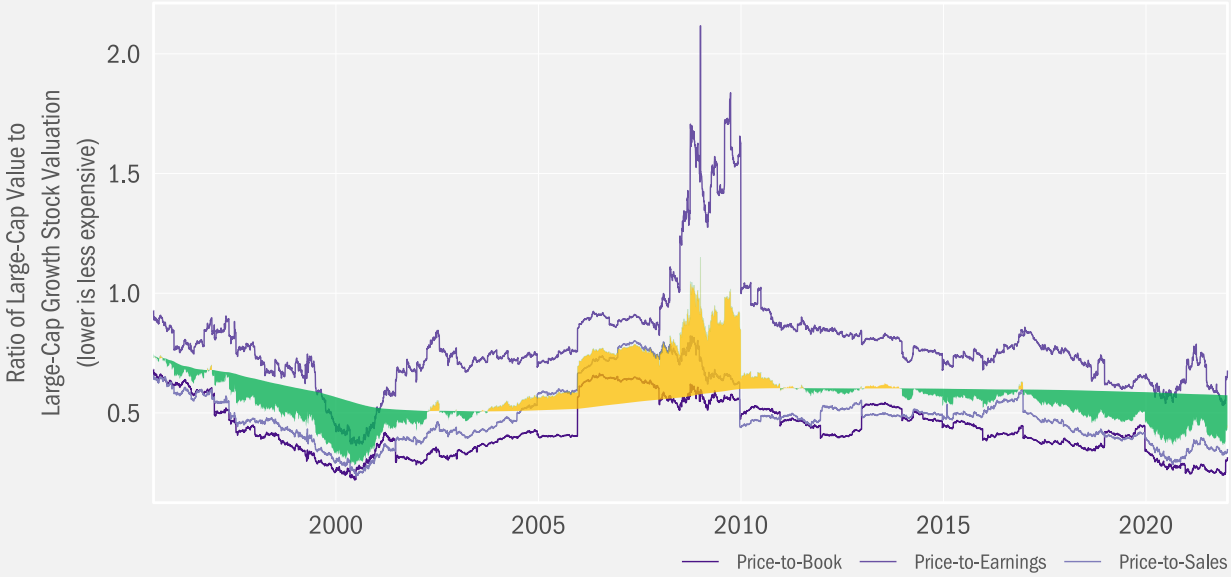
Coming out of the depths of the COVID crisis, just about the time we penned our last few "focus on the factors" commentaries, we were enthused to see the relative performance of our favored factors markedly improve. That outperformance lasted through the first half of 2021, only to wane in the following months (thanks to Delta, among other reasons). Even so, performance among our favored allocations proved mostly inline or better-than-benchmark for the full year, in particular those allocations targeting non-U.S. stocks.

Despite the generally stronger relative performance of the factor mixes we tend to include in our portfolios since the market bottom in March 2020, we find that the expanding gap in valuation metrics between Value and Growth still leaves opportunity for continued strength in a Value orientation. While we show the absolute levels of a few standard valuation metrics in Figure 1, Figure 2 details those metrics on a relative basis as a ratio between the Value-stock metric and the corresponding Growth-stock metric. Except for earnings downturns, when Value stocks tend to become temporarily more expensive on a price-to-earnings basis than growth names, Value stocks are definitionally always cheaper than Growth stocks when one considers an array of valuation metrics. And such combinations, which we have done in a very simple way in Figure 2, show that Value stocks have become increasingly less expensive than Growth stocks since the Great Financial Crisis ("GFC").

What's notable is that the decade prior to the GFC saw Value stocks outperforming Growth stocks coming out of the bursting of the Technology Bubble. While we believe a focus on Value stocks is preferable regardless the market and macroeconomic environment, present market conditions seem incrementally more attractive, given the rhymes with conditions experienced in 1999-2000. Back then, too, the domestic market was dense with overvalued stocks that also happened to be concentrated in the Technology Sector. Though the excess is neither as broad nor as extreme now as it was then, we find such excess exuberance exists. And while we don't expect such a dramatic burst, we'd think a marginal shift in investor attention toward relatively unloved stocks should find increased traction.

Figure 2: S&P 500 Value Index Valuation Relative to S&P 500 Growth Index

As the gap in valuation between Value and Growth stocks has expanded, we think the relative opportunity for Value stocks has increased



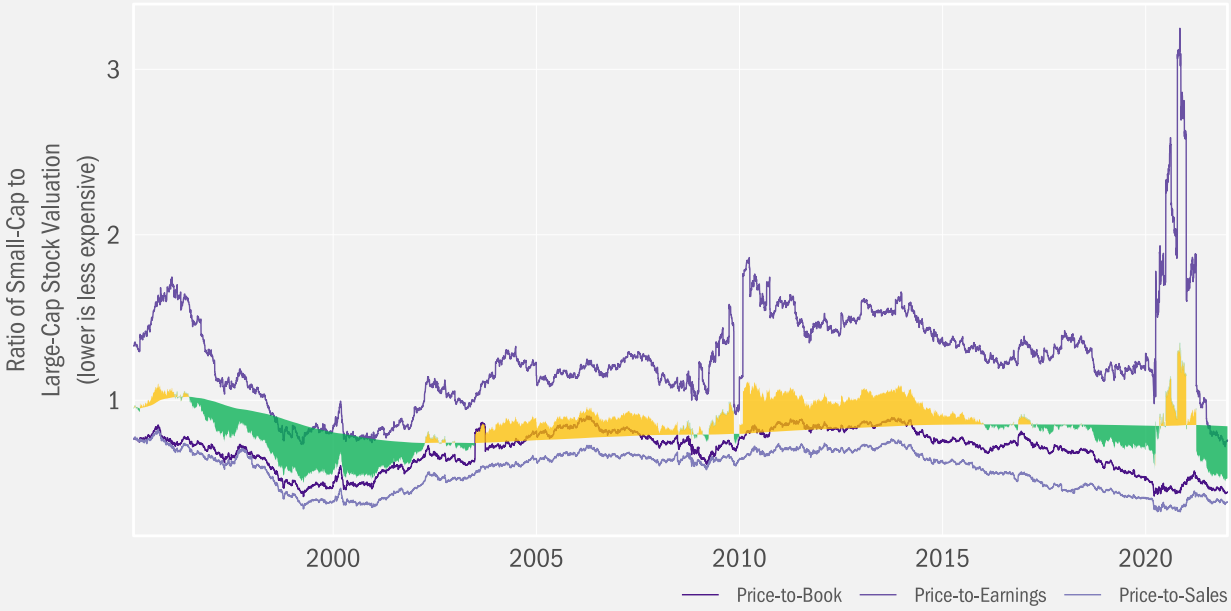
From 07.01.95 through 01.05.22. Green (orange) denotes relatively under- (over-) valuation, calculated as the daily average of all three relative metrics (composite average), versus the long-term average of that composite average. The dataset considered in the composite average expands as data are added through time (expanding average). Index used for large-cap value and large-cap growth stocks are the S&P 500 Value Index and the S&P 500 Growth Index, respectively. SOURCE: SRCM using data from Bloomberg

Small Kids Left Behind, Too

Many theories exist to support the relatively stronger performance of small-cap stocks through time, among them the thinking that smaller companies are inherently risker, so investors have higher expectations for returns (meaning they are less willing to pay up for future expected growth). As we see in Figure 3, it would seem that willingness has waned over the past few years, leaving the stocks of small companies to underperform the big caps and find their relative valuation weaken in comparison.

Figure 3: S&P Small-Cap 600 Index Valuation Relative to S&P 500 Index

Like Value stocks, small-cap stocks have become increasingly less expensive relative to large-cap stocks



From 02.01.95 through 01.05.22. Green (orange) denotes relatively under- (over-) valuation, calculated as the daily average of all three relative metrics (composite average), versus the long-term average of that composite average. The dataset considered in the composite average expands as data are added through time (expanding average). Index used for small-cap and large-cap stocks are the S&P Small-Cap 600 Index and the S&P 500 Index, respectively.
SOURCE: SRCM using data from Bloomberg

Refocus on Factors

Early days in 2022, but Value stocks and small-cap stocks—variously and not yet in a sustained manner—have begun to spark. What's helped is that macroeconomic growth is still on the rise as progress toward more normal life continues, albeit haltingly as consequence of Omicron. Meantime, a more hawkish Federal Reserve expressing interest in moving more quickly to lift rates has challenged the math of the present valuations of future earnings that have supported loftier multiples on "growthier" names. So, we're back to Track 1 on the Factor Album, but the familiarity of the tune leaves it no less in harmony with our efforts to tune portfolios to client financial goals.

P.S.

Some readers might look at Figure 1 and appropriately note that all stocks are more expensive than they have been over the past nearly twenty years. We will share our thoughts on the matter in next month's commentary.

Important Information

Statera Asset Management is a dba of Signature Resources Capital Management, LLC (SRCM), which is a Registered Investment Advisor. Registration of an investment adviser does not imply any specific level of skill or training. The information contained herein has been prepared solely for informational purposes and is not an offer to buy or sell any security or to participate in any trading strategy. Any decision to utilize the services described herein should be made after reviewing such definitive investment management agreement and SRCM's Form ADV Part 2A and 2Bs and conducting such due diligence as the client deems necessary and consulting the client's own legal, accounting and tax advisors in order to make an independent determination of the suitability and consequences of SRCM services. Any portfolio with SRCM involves significant risk, including a complete loss of capital. The applicable definitive investment management agreement and Form ADV Part 2 contains a more thorough discussion of risk and conflict, which should be carefully reviewed prior to making any investment decision. Please contact your investment adviser representative to obtain a copy of Form ADV Part 2. All data presented herein is unaudited, subject to revision by SRCM, and is provided solely as a guide to current expectations.

The opinions expressed herein are those of SRCM as of the date of writing and are subject to change. The material is based on SRCM proprietary research and analysis of global markets and investing. The information and/or analysis contained in this material have been compiled, or arrived at, from sources believed to be reliable; however, SRCM does not make any representation as to their accuracy or completeness and does not accept liability for any loss arising from the use hereof. Some internally generated information may be considered theoretical in nature and is subject to inherent limitations associated thereby. Any market exposures referenced may or may not be represented in portfolios of clients of SRCM or its affiliates, and do not represent all securities purchased, sold or recommended for client accounts. The reader should not assume that any investments in market exposures identified or described were or will be profitable. The information in this material may contain projections or other forward-looking statements regarding future events, targets or expectations, and are current as of the date indicated. There is no assurance that such events or targets will be achieved. Thus, potential outcomes may be significantly different. This material is not intended as and should not be used to provide investment advice and is not an offer to sell a security or a solicitation or an offer, or a recommendation, to buy a security. Investors should consult with an advisor to determine the appropriate investment vehicle.

The S&P 500 Index measures the performance of the large-cap segment of the U.S. equity market. The S&P Mid-Cap 400 Index measures the performance of the mid-range segment of the U.S. stock market. The S&P Small-Cap 600 Index measures the performance of selected U.S. stocks with a small market capitalization. S&P measures Value stocks using three factors: the ratios of book value, earnings, and sales to price. S&P Style Indices (e.g., the Value and Growth Indexes) divide the complete market capitalization of each parent index into Growth and Value indices.

One cannot invest directly in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio.

Investing in any investment vehicle carries risk, including the possible loss of principal, and there can be no assurance that any investment strategy will provide positive performance over a period of time. The asset classes and/or investment strategies described in this publication may not be suitable for all investors. Investment decisions should be made based on the investor's specific financial needs and objectives, goals, time horizon, tax liability and risk tolerance.

Publication: 01.06.22 2022-SRCM-02