The Case for Value

Artisan Partners U.S. Value Team

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Insights

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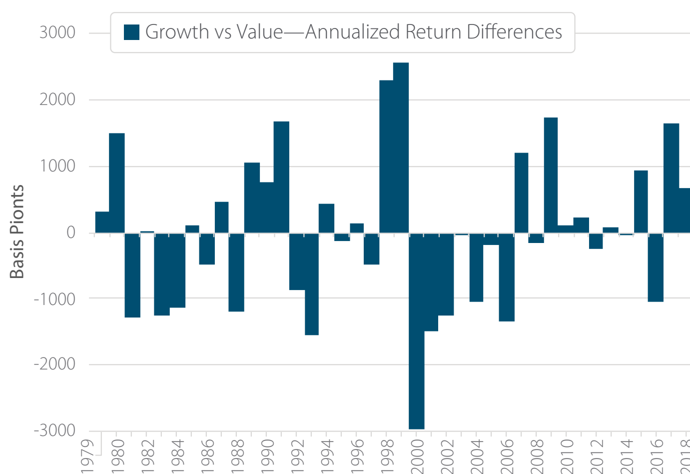
A Reason Not A Season

The value investing style can be a source of competitive risk-adjusted returns over time, relative to the growth style and a core index. But value's performance over the past decade has lagged growth's, and the style has fallen out of favor. From 2009 through 2018, growth—as represented by the Russell 1000® Growth Index outperformed the Russell 1000® Value Index in 7 of 10 calendar years. While this has been a difficult period for value investors, we don't believe this trend will last forever. Not that long ago, the situation was reversed: From 1999-2008, value beat growth in 8 of 10 calendar years. Historically, this see-saw between growth and value is quite balanced. Over the 4 decades since Russell incepted its style indices, growth has outperformed value in 20 calendar years, and value outperformed growth over 20 years (Exhibit 1).

Exhibit 1: Russell 1000 Indices—Growth vs Value



Source: Russell/Artisan Partners. **Past performance is not a reliable indicator of future results.**

What follows is a case for value, not a case against growth. These investment styles are not mutually exclusive in your portfolio, so any argument that investors ought to trade one for the other—in total—presents a false choice. Because sentiment and valuations can ride waves of momentum, they will tend to swing too far in one direction before enough investors recognize the extremes and reverse the trend. This is a natural market phenomenon. However, just because a phenomenon occurs naturally does not mean it adheres to any hard rules for frequency, duration or magnitude.

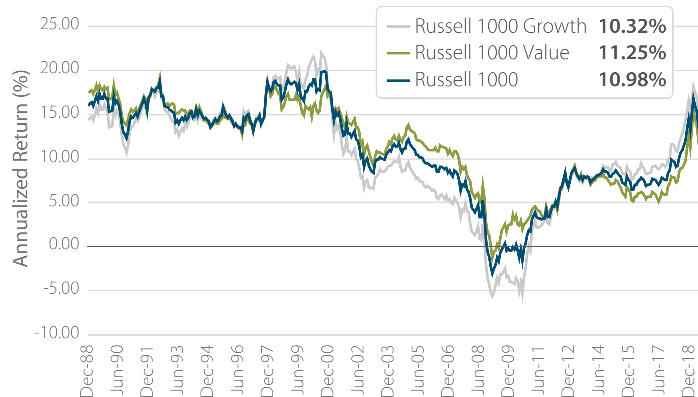
Growth and value have split outperformance evenly over the last 40 years. This 50-50 outcome is similar to one you might expect from flipping a coin. But in the short run, there's no guide for knowing how many heads you'll see in a row before you see tails. And unlike a coin flip, financial markets are dynamic social systems; human factors are driving investment outcomes, and investors should be prepared for periods where psychology seems more relevant than fundamentals.

The case for value as we present it is a case for prudence, moderation and balance, particularly in a market driven by momentum, excess and imbalance. There are good reasons to have exposure to growth and value styles at any given time, but investors should be aware of the historical relationship between them.

The current economic expansion and the equity bull market have been in place for a decade, so it's useful to think about returns in decennial terms. From this broader perspective we can get a clear sense of the trends coursing through the value and growth investing styles. Looking at a long history of 10-year trailing total returns—from the 1978 inception of the Russell 1000 Index—a couple key trends emerge. First, over the longer term, the style indices ultimately offered core index-like returns (Exhibit 2).

Exhibit 2: Style Sub-Indices and Core Index-Like Returns

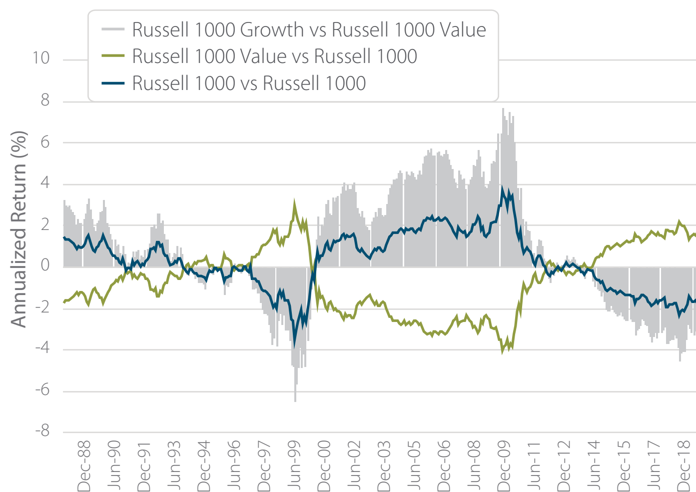
Trailing 10-Year Annualized Total Return—Average 1988 to Present



Source: FactSet/Russell/Artisan Partners. As of 31 Jul 2019. **Past performance is not a reliable indicator of future results.** Trailing ten year annualized total returns for the Russell 1000 Index, Russell 1000 Value Index and Russell 1000 Growth Index.

Second, in some periods, the value style underperformed the core index. In other periods, it outperformed. But over time, it trended back toward the core. Although past performance is not indicative of future results, with these style indices cycling around the core index, it's useful to think about the core index as a type of mean and consider the style indices as mean reverting. Crucially, there's nothing consistent about the duration or magnitude of these cycles, but over time, a mean-reverting pattern clearly emerged (Exhibit 3).

Exhibit 3: Value and Growth Mean Revert

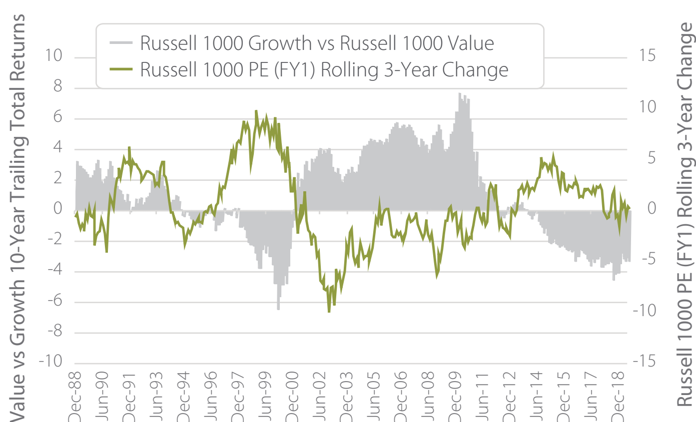


Source: FactSet/Russell/Artisan Partners. As of 31 Jul 2019. **Past performance is not a reliable indicator of future results.** Trailing ten year annualized total returns for the Russell 1000 Index, Russell 1000 Value Index and Russell 1000 Growth Index.

Identifying historical patterns is a necessary but not sufficient condition for making the case for value. Perhaps it's true that to everything there is a season, but simply extrapolating from past experience is an unreliable way to comprehend the present. There must be reasons why the value and growth styles cycled around the core index over time. One telling measure is the market's changing expectations on forward earnings. While the market's price-to-earnings (PE) multiple at any given time is a useful valuation tool, the relationship between changes in forward PEs and value's performance suggests we may be nearing an inflection point.

As Exhibit 4 illustrates using a rolling 36-month change in the Russell 1000 Index's 1-year forward estimated PE ratio, we see value historically outperformed growth when multiples were contracting. In other words, whenever earnings growth has slowed, the market has been more likely to re-rate, reducing the premium given to growth stocks. In these periods of weak earnings growth, one of which we may be entering, value has tended to benefit relative to growth.

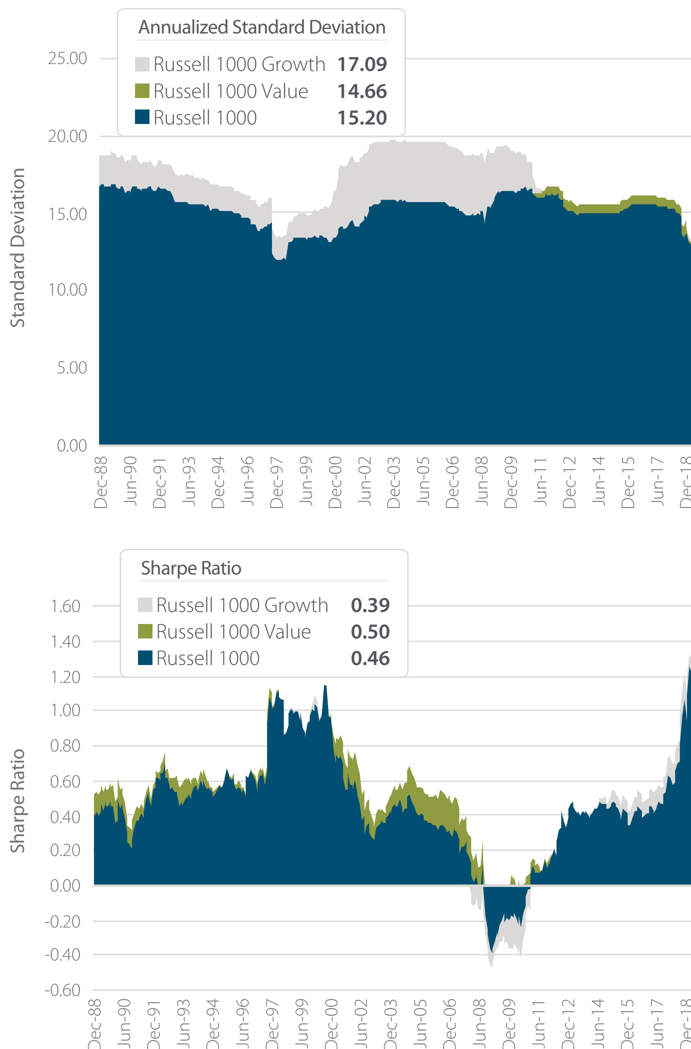
Exhibit 4: Growth, Value and PE Cycles—(Rolling 10-Year Total Returns, Rolling 3-Year Changes in Russell 1000 Weighted Harmonic Average PE)



Source: FactSet/Russell/Artisan Partners. As of 31 Jul 2019. **Past performance is not a reliable indicator of future results.** Trailing 10-year annualized total returns for the Russell 1000 Value Index and Russell 1000 Growth Index. Russell 1000 weighted harmonic average PE ratio, excluding negative earners, calculated as a rolling 3-year change.

Finally, it's worth noting that the case for value is a perpetual one. Even with periods of sustained underperformance relative to growth, value has offered competitive risk-adjusted returns over time (Exhibit 5). Since the return profile of the value index and the growth index have approximated the core index in the long run, value has been a lower-volatility play as compared to the growth index. Of course, the global financial crisis of 2008-2009 plays an outsized role in this long-run outcome, as value posted some very strong relative returns in some of the worst investing environments on record. But this is precisely why investors should consider maintaining value style exposure, especially when it seems most out of favor.

Exhibit 5: Volatility and Sharpe Ratio



Source: FactSet/Russell/Artisan Partners. As of 31 Jul 2019. Trailing 10-year annualized standard deviation and sharpe ratio for the Russell 1000 Index, Russell 1000 Value Index and Russell 1000 Growth Index. Data in the table is monthly frequency of the trailing 10 years, averaged over the period Dec 1978 to Jul 2019.

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Price-to-Earnings (P/E) is a valuation ratio of a company's current share price compared to its per-share earnings. **Russell 1000® Index** measures the performance of roughly 1,000 US large-cap companies. **Russell 1000® Growth Index** measures the performance of US large-cap companies with higher price/book ratios and forecasted growth values. **Russell 1000® Value Index** measures the performance of US large-cap companies with lower price/book ratios and forecasted growth values. **Sharpe Ratio** is a measure that indicates the average return minus the risk-free return divided by the standard deviation of return on an investment. A larger value generally indicates a more attractive risk-adjusted return. **Standard Deviation** measures the volatility of returns. Higher deviation indicates higher volatility. **Weighted Harmonic Average** is a calculation of weighted average commonly used for rates or ratios.

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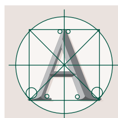
A R T I S A N  P A R T N E R S

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