The Compelling Case for Value

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> NEWSLETTER

We argue that now is precisely the time to emphasize value, especially with growth stocks trading at extreme premiums to value stocks and dispersion in market multiples well above long-term averages.

After the extraordinary performance of growth and momentum stocks in 2017, many investors are asking why bother with value stocks? In a late-stage global bull market exhibiting global synchronized gross domestic product (GDP) growth, why should value – often associated with early-stage economic recovery – succeed? We argue that now is precisely the time to emphasize value, especially with growth stocks trading at extreme premiums to value stocks and dispersion in market multiples well above long-term averages. History has also indicated that maintaining a value discipline, particularly when valuations are high and interest rates have reached a floor and turned upward, has produced stronger relative returns than a growth orientation over full market cycles.

The mere existence of economic cycles and corresponding fluctuations in interest rates constrain investor enthusiasm for equities. Stock prices do not completely disconnect from underlying fundamentals since active managers, private equity funds, and strategic buyers have ultimately taken advantage of mispricing and closed the valuation gap. In the long run, a value style bias has been rewarded. As illustrated in Exhibit 1, the MSCI World Value Index has "clobbered" the MSCI World Growth Index, outperforming by 2% annually since 1975 (the

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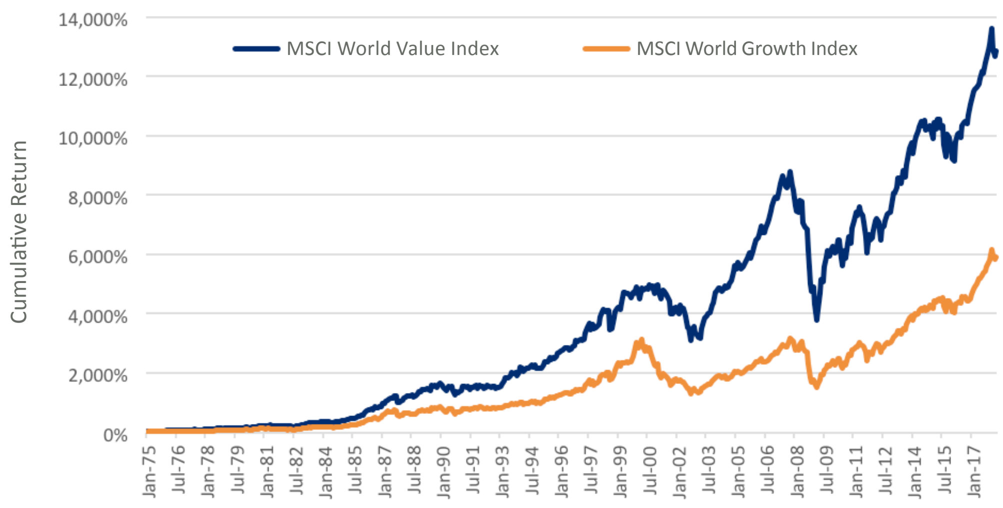
inception of these indices). Remarkably, this superior value return has exhibited lower volatility (14.4% annualized) than the growth return (15.3% annualized volatility). We observe a narrower value advantage (but still outperforming by 0.4% annually) if we view this in an All-World (including Emerging Markets) context, though the MSCI Emerging Markets Value and Growth indices only extend back to 1997.

While it is clear that value has outperformed growth over the long run, most investors do not have the luxury of a 40+ year investment horizon. However, a value investor has not

Value stocks have outperformed growth stocks over the long run.

EXHIBIT 1. CUMULATIVE PERFORMANCE OF MSCI WORLD VALUE AND GROWTH INDICES SINCE THEIR INCEPTION

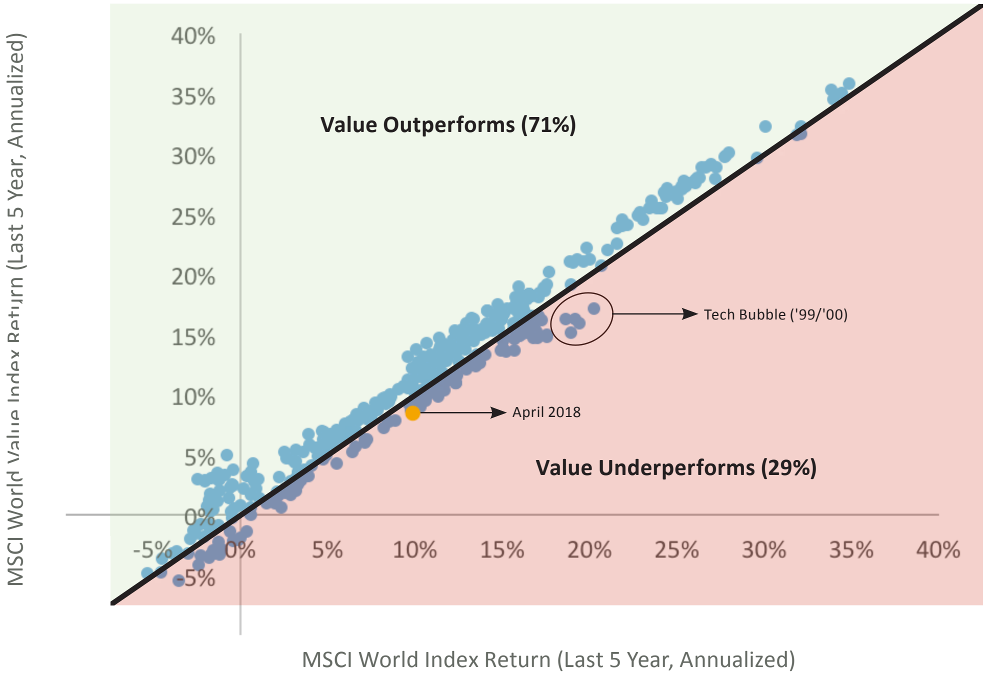


Note: Cumulative returns represent the compounded gross US Dollar (USD) performance of the MSCI World Value Index and MSCI World Growth Index from January 1975 to April 2018. Source: MSCI, FactSet required one. Exhibit 2 shows the performance of the MSCI World Value Index versus the MSCI World Index over rolling 5-year periods since 1975. 71% of the observations show positive relative performance of the MSCI World Value Index. Due to the construction methodology of the Value and Growth indices, the chart below would look nearly identical if we judge Value's performance versus Growth (rather than the MSCI World itself).

Admittedly, the MSCI Value and Growth indices are not perfect – they fail to completely isolate their respective namesake style effects. This is because any index constructed around one

MSCI World Value Index has outperformed MSCI World in 71% of rolling 5-year periods.

EXHIBIT 2. ANNUALIZED 5-YEAR ROLLING PERFORMANCE OF MSCI WORLD VALUE INDEX VS. MSCI WORLD INDEX



Note: 5-year cumulative returns represent the rolling compounded gross USD performance of the MSCI World Value Index and MSCI World Index, from January 1975 to April 2018. Source: MSCI, FactSet

The direction of the market or economy tells us little about how value will perform, and therefore value has the potential to outperform growth even if the bull market of the past nine years continues.

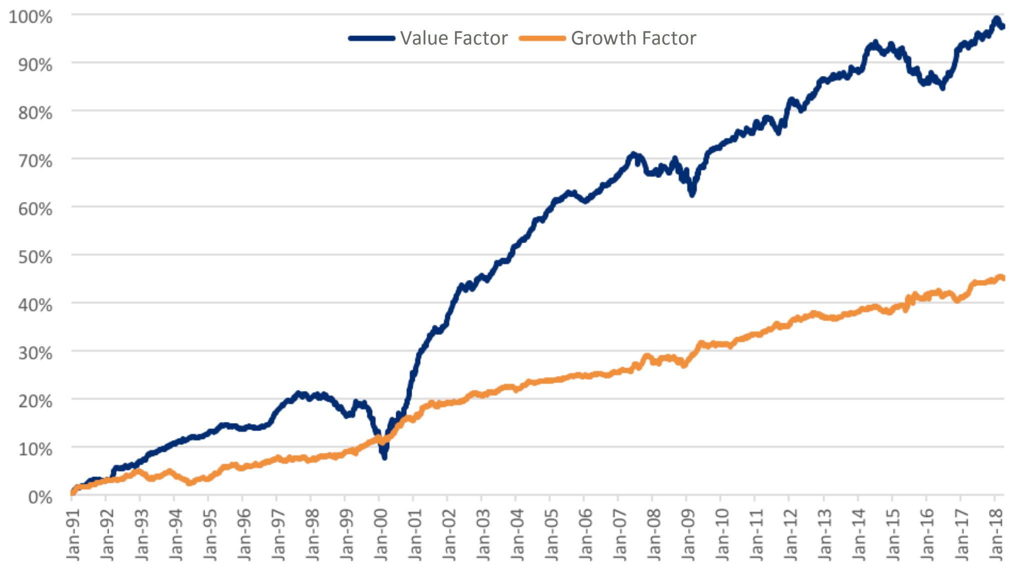
dimension may bring with it many other risks and biases such as country, currency, sector, and style allocation effects. We can utilize the proprietary Causeway Risk Lens to disaggregate these effects and uncover which active risks drive the greatest differences between the MSCI World Value Index and the baseline MSCI World Index. Our Risk Lens currently estimates annual tracking error of the MSCI World Value Index at approximately 2%. Style exposure differences (overweight to value and underweight to momentum and growth) drive 57% of this active risk, sector differences (underweight to information technology and overweight to financials) drive 29%, with the remaining portion explained by differences in stock-specific risks. MSCI matches the country/currency weights between its Value/Growth and baseline indices, so these are not factors.

Even after controlling for these effects, however, we find the same long-term outperformance of value over growth. To arrive at the return streams for "pure value" and "pure growth," we utilize the style returns from Causeway's multi-factor risk model, which disaggregates cross-sectional returns into those attributable to the broader market and those attributable to specific countries, sectors, currencies, and styles. After isolating value and growth in Exhibit 3, the total returns fall from those in Exhibit 1 since we have now stripped out the market's returns, but the cumulative effect has been very similar – over twice the return by investing in value versus growth (though growth briefly surpassed value during the height of the late 1990s/early 2000s tech bubble). And this outperformance is just since 1991 (the start of our risk modeling) versus 1975 in Exhibit 1.

It is difficult to argue with the historical long-run outperformance of value over growth, but how does an investor time the value

"Pure Value" has similarly outperformed "Pure Growth."

EXHIBIT 3. CUMULATIVE PERFORMANCE OF THE CAUSEWAY RISK MODEL'S VALUE AND GROWTH FACTORS

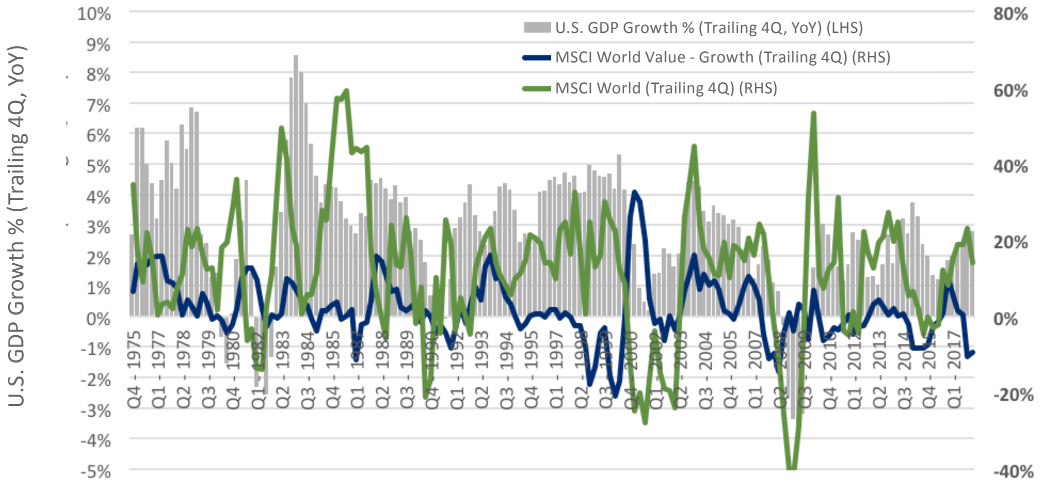


Note: Lines represent the cumulative performance of the Causeway risk model's Value and Growth factors, after controlling for market, country, currency, sector, and other style effects, from January 1991 to April 2018. Source: Causeway Analytics

cycle? Why is now the time to emphasize value? Popular perception suggests that late in a bull market, the relative valuations granted to earlier-stage growth stocks will vastly eclipse those of more mature companies. However, as shown in Exhibit 4, there has been actually very little connection between value's long-term performance (in blue) and the broader market's performance (in green) or economic growth (in gray). The -0.10 correlation with the MSCI World Index suggests that value has performed better in down markets, and the +0.13 correlation with GDP growth suggests some pro-cyclical disposition for value, but both of these relationships have been very weak. The data indicate that the direction of the market or economy tells us little about how value will

The value cycle is largely uncorrelated with the market cycle or economic cycle.

EXHIBIT 4. COMPARING VALUE'S PERFORMANCE TO THE MSCI WORLD INDEX AND U.S. GDP GROWTH



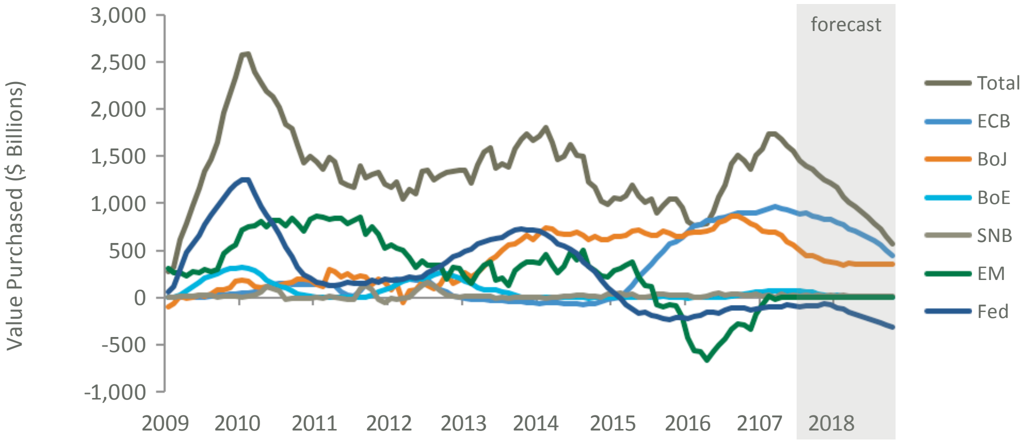
Note: Q4 1975 – Q1 2018. Source: MSCI, Federal Reserve Economic Data (FRED), Causeway Analytics

perform, and therefore value has the potential to outperform growth even if the bull market of the past nine years continues.

Central banks in the US, China, Europe, and Japan have taken quantitative easing to new heights following the 2008 global financial crisis (GFC). This enormous global wave of monetary liquidity dragged down interest rates and inflated asset prices. Many investors argue that today's high market valuation multiples are perfectly acceptable given the low interest rates. However, the U.S. Federal Reserve is now actively reducing the size of its balance sheet, a trend that other major central banks will likely follow (see Exhibit 5). Benchmark yields are on the rise, and negative rates now seem destined to become a temporary quirk for the economic history books.

Global central banks are now preparing their exit strategies.

EXHIBIT 5. SECURITIES PURCHASED BY GLOBAL CENTRAL BANKS (ROLLING 12 MONTHS)



Note: European Central Bank (ECB), Bank of Japan (BoJ), Bank of England (BoE), Swiss National Bank (SNB), Emerging Markets (EM), US Federal Reserve (Fed). Source: Citi Research

Since growth stocks tend to have more of their cash flows expected in years far in the future, higher interest rates should have a more negative impact on the present value of growth stocks relative to value stocks.

Rising interest rates have an important implication for the relative performance of value. Increasing the discount rate applied to cash flows will necessarily reduce their present value. Since growth stocks tend to have more of their cash flows expected in years far in the future (i.e. longer duration), higher interest rates should have a more negative impact on the present value of growth stocks relative to value stocks. Exhibit 6 provides evidence of this effect. Isolating the 20% most extreme quarterly changes (up or down) in the U.S. 10-year treasury yield since 1975, we observe a positive relationship (+0.35 correlation) between the quarterly change in the U.S. 10-year and the quarterly performance difference between the MSCI World Value Index and the MSCI World Growth Index.

A rising rate environment should cause growth stocks to underperform value stocks.

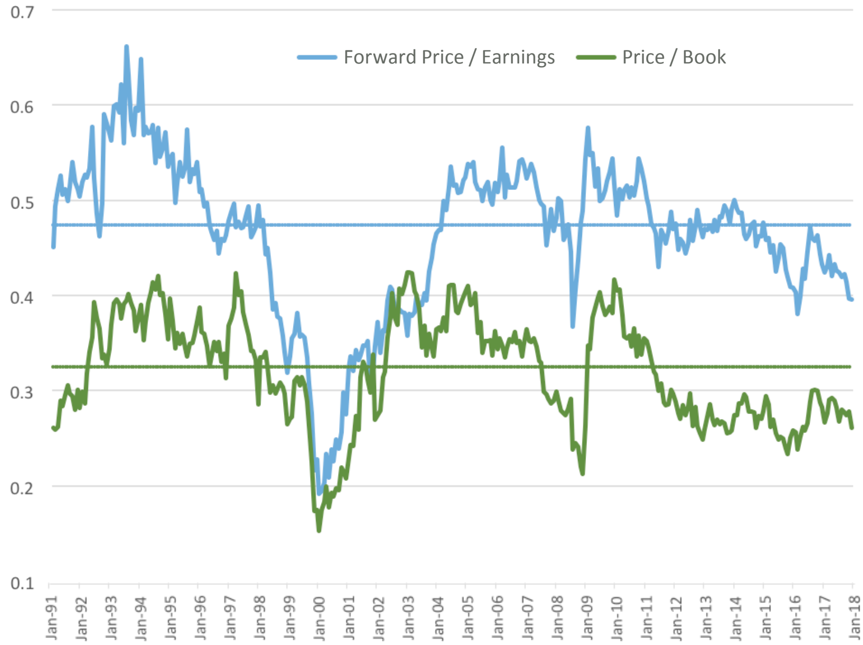
EXHIBIT 6. MOST EXTREME 20% OF QUARTERLY CHANGES IN U.S. 10-YEAR YIELD VS. QUARTERLY PERFORMANCE OF (MSCI WORLD VALUE INDEX – MSCI WORLD GROWTH INDEX)

Note: Each data point represents a quarterly observation, using the 20% of most extreme 10-Year U.S. Treasury yield changes (up or down) from Q1 1975 to Q1 2018. Returns to the MSCI World Value Index and MSCI World Growth Index are gross USD returns. 10-year U.S. Treasury Yield changes calculated as end of quarter yield minus average yield over last four quarters. Source: Federal Reserve Economic Data (FRED), MSCI

Another way to approximate our current position in the value cycle is to examine the level of dispersion in valuation multiples across all stocks in the market. The more spread out market multiples become, the more incentive investors have to abandon the most expensive stocks in favor of the cheapest. Value has been mean-reverting, and the level of value dispersion is currently elevated relative to history. In Exhibit 7, we observe that cheap stocks in the MSCI World Index are now trading at a larger-than-average discount relative to their expensive peers (the solid lines are now well below the dotted medians), and this discount increased in 2017 after growth's dominant performance.

Value stocks are trading at a large valuation discount to historical averages.

EXHIBIT 7. RATIO OF VALUATION MULTIPLE OF LEAST EXPENSIVE QUINTILE / MOST EXPENSIVE QUINTILE OF STOCKS IN THE MSCI WORLD INDEX

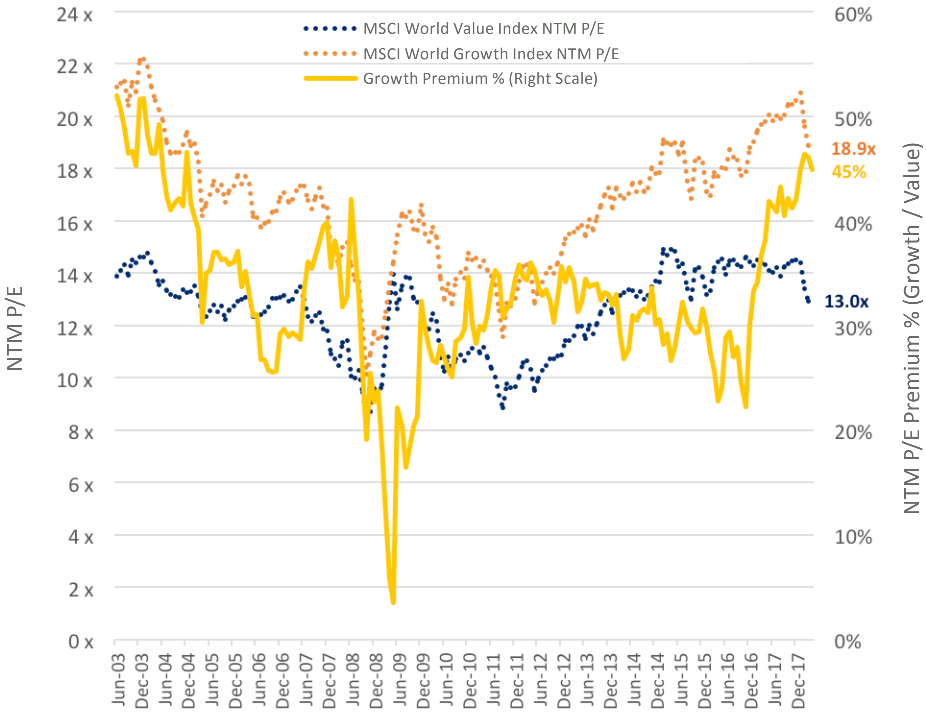


Note: Measures the ratio of valuation multiples, next 12 months (NTM) Price/Earnings ratio (P/E) and Price/Book ratio (P/B), between first and fifth value quintiles from January 1991 – April 2018. Source: Causeway Analytics

In addition to examining cross-sectional variation in market valuations, we can also simply examine the trading multiples for the Value and Growth indices themselves. Exhibit 8 plots the forward (next 12 months) earnings multiples (as forecasted by analysts) of the MSCI World Value and Growth indices as well as the valuation premium of the Growth index over time (the yellow line). Having climbed significantly in 2017, the P/E premium of the MSCI World Growth Index over the Value index is now 45%. This is higher than it was pre-GFC and the highest it has been since the tech bubble in the late 1990s/early 2000s. This current premium represents a rare 1.6 standard deviation event; the premium has been this high (or higher) in only approximately 5% of the history of the style indices.

On a forward P/E basis, the MSCI World Growth Index is trading at the largest premium to the MSCI World Value Index since just after the technology bubble of the early 2000s.

EXHIBIT 8. NTM P/E MULTIPLE OF THE MSCI WORLD GROWTH AND VALUE INDICES AND THE % PREMIUM

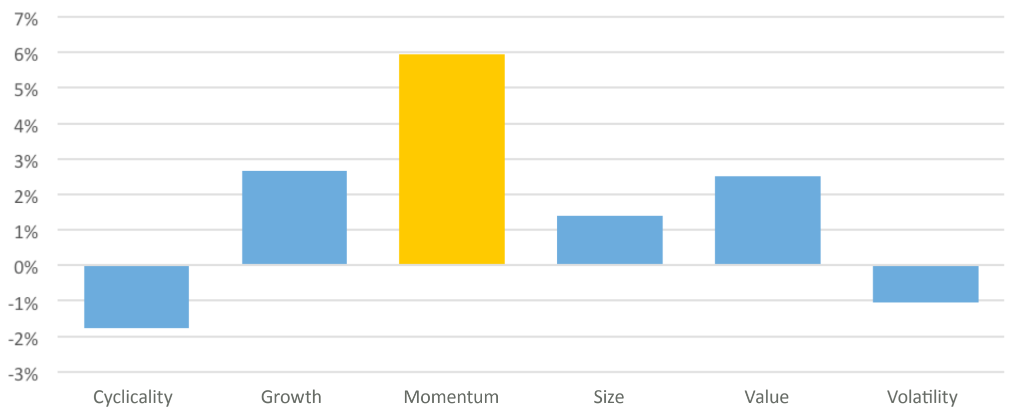


Note: June 2003 (inception of MSCI NTM P/E data) - April 2018. The "NTM P/E" or "Forward P/E" of a stock is its price divided by the consensus earnings per share (EPS) estimate for the next twelve months. "Growth Premium %" is the forward P/E ratio (or Price / Book Value ratio) of the MSCI World Growth Index divided by the forward P/E ratio (or Price / Book Value ratio) of the MSCI World Value Index, less 100%. Source: Factset, MSCI

In analyzing the style trends of 2017, it is important to remember that it was not that value performed poorly; rather, growth – and especially momentum – performed exceedingly well. In fact, if you disaggregate the negative drags on simple value using Causeway's risk model, it was the negative exposure to high-flying momentum that hurt the performance of value stocks the most (see Exhibit 9). We believe that jumping on the momentum bandwagon now may be especially painful. Isolating historical returns to value and momentum, we examine the structure of past drawdowns in Exhibit 10. The table in the bottom left breaks

Negative exposure to top-performing momentum drove value's disappointing 2017...

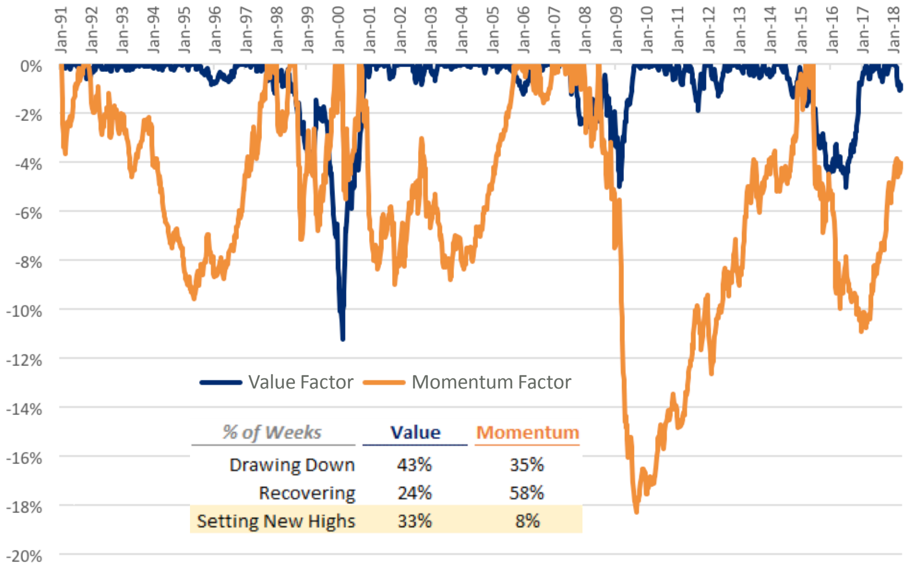
EXHIBIT 9. 2017 RETURNS TO CAUSEWAY RISK MODEL'S STYLE FACTORS



Note: 2017 returns to selected style factors from Causeway risk model. "Cyclicality" is a measure of a stock's sensitivity to market cycles, "Growth" is a measure of a stock's historical growth in income statement metrics, "Momentum" is a measure of a stock's relative price performance, "Size" is a measure of stock's market capitalization, "Value" is a measure of a stock's relative cheapness, and "Volatility" is a measure of a stock's historical variability. Source: Causeway Analytics

... but Momentum has tended to draw down quickly and has not been a reliable source of style returns.

EXHIBIT 10. DRAWDOWNS OF CAUSEWAY RISK MODEL'S VALUE AND MOMENTUM FACTORS CONTROLLING FOR STYLE, SECTOR, COUNTRY, AND CURRENCY RETURNS (JANUARY 1991 – JANUARY 2018)



Source: Causeway Analytics

Whereas value has drawn down relatively slowly and recovered quickly, momentum has tended to draw down very quickly and recovered slowly.

down the percentage of time spent drawing down, recovering, and setting new highs (not in a drawdown). While value is making new highs about one-third of the time, the same can be said of momentum in only 8% of historical periods. It has been prone to abrupt reversals, especially in regime shifts. And those reversals are very hard to predict: Whereas value has drawn down relatively slowly and recovered quickly, momentum has tended to draw down very quickly and recovered slowly.

One final thought on value is that Causeway's International and Global Value Equity strategies are not inextricably linked to the value cycle because our portfolio candidates do not always conform to simple definitions of value. Causeway's definition of value derives from our multi-year investment horizon. As part of our stock selection process, we thoroughly evaluate all aspects of the investment case seeking to identify stocks trading at discounts to fair value. In contrast, static, short-term definitions of value would miss stocks where value is not readily apparent. Those buy candidates may look expensive on current or next year multiples, but look compelling with a cyclical upturn and/or operational recovery. Such is the case with several of our "self help" portfolio constituents that are undergoing multi-year transformations.

Summary

Value investing requires discipline to have a realistic estimate of a stock's fair value and to not overpay relative to fundamentals. Even though the market chose not to reward such discipline in 2017, the long-term performance track record has heavily favored value compared to growth, and we believe there is an increasingly strong case to be made for allocating to value-oriented strategies in 2018. Value's performance has tended to be disconnected from economic and market cycles, so yes, value can outperform growth in a late bull market. Moreover, growth stocks are trading at extreme premiums to value stocks, the dispersion in market multiples is well above the long-term average, and momentum has been susceptible to abrupt reversals. Add to that the global monetary backdrop of normalizing central bank liquidity and increasing rates, and we believe there is a confluence of dynamics favoring value over growth.