

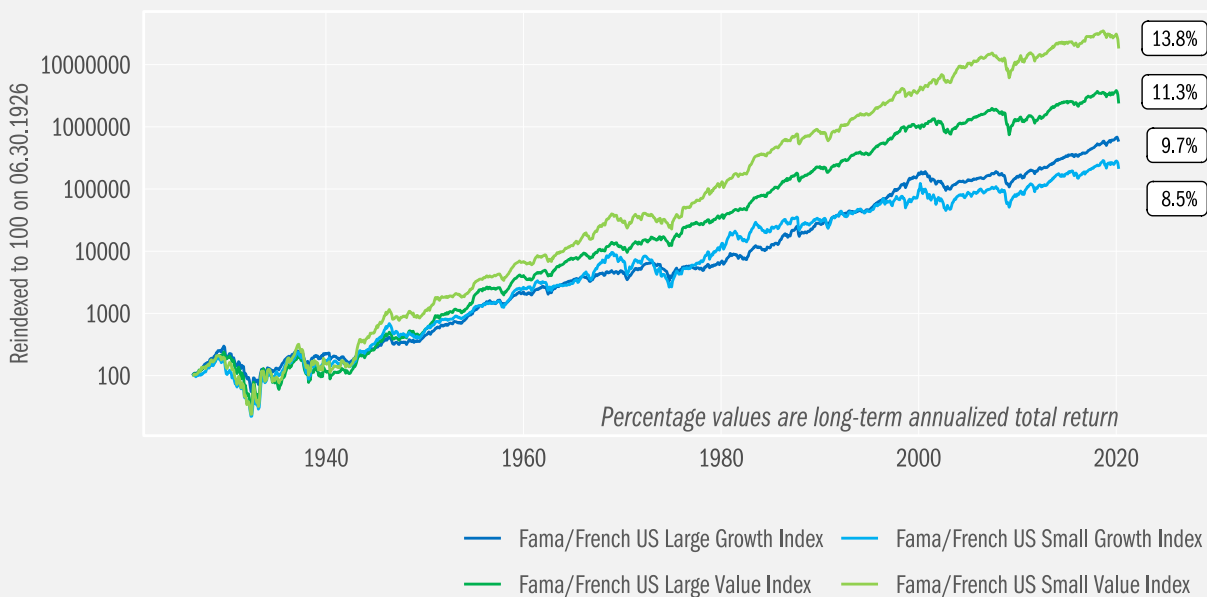
TIME FOR VALUE...NOW?

Value stocks have underperformed their Growth peers by a gap never wider in history, leaving some to suggest it's time to throw in the towel. But history shows that when the performance on a long-held strategy is at its relative worst, generally speaking, it's best to stay true to your defined approach. More than hope drives that view. Both the basic premise for Value investing remains applicable, while the vastly expanded valuation gap between the two groups of stocks bolsters our outlook. We thus remain committed to Value as one of the factors we incorporated into our multifactor approach.

The Value Backdrop

Over a range of measurement periods and valuation metrics, stocks that measure less-expensive based on some ratio of price to company fundamentals have outperformed stocks more expensive by those same metrics. There is still great debate with regard to why this historical pattern exists. Could be Value stock outperformance is a premium that has been rewarded to investors for having taken on incremental expected risk. One also could believe investors often are incorrect in their optimistic assumptions for Growth companies and pessimistic concerns for Value companies, with subsequent performance eventually proving so. We tend to find both explanations plausible and defensible.

Figure 1: Long-Term Performance of Large-Cap, Small-Cap, Value and Growth Stocks

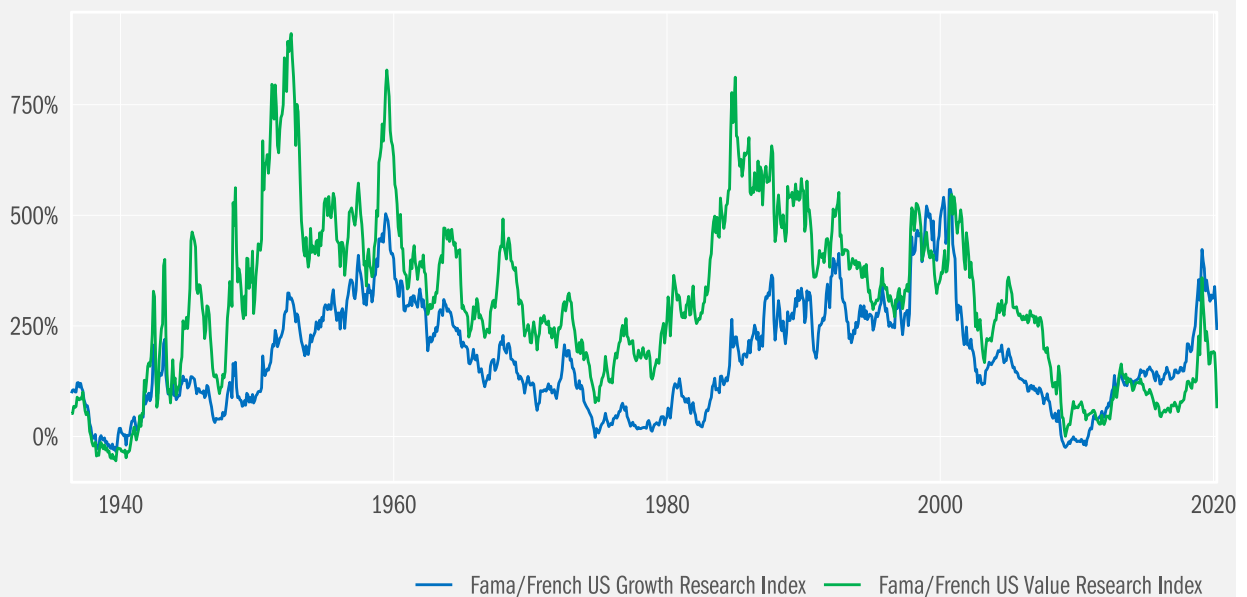


From 06.30.1926 to 03.31.2020. Logarithmic scale. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Indexes are unmanaged. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from the Data Library of the Web site of Professor Kenneth R. French

Either rationale, the data tend to support a tilt towards Value stocks for the long term. But with medium-term performance of the Value factor so poor (we will cover the Size factor, which sees us favoring smaller-capitalization companies in our portfolios in another commentary), we wouldn't criticize those who might think enough is enough. Before accepting defeat, however, we'd offer a reminder of what we find to be a more powerful rationale for Value investing. Definitionally, a company's stock price is meant to represent the present value of all the future expected earnings. A range of estimations factor into that present value. And one can read into current valuation metrics (for example, price-to-book value and price-to-earnings) as reflective of those estimations. To wit, the higher the multiple, the greater the expectations for future earnings. Given that no one can see into the future, and that human estimations have a tendency for directional extremes, we think that the Value premium exists in part because the optimists tend to be a bit too enthusiastic and the pessimists a bit too dour. Over time, the universe conspires to prove both extremes inaccurate, resulting in Value stocks performing a bit better than Growth stocks.

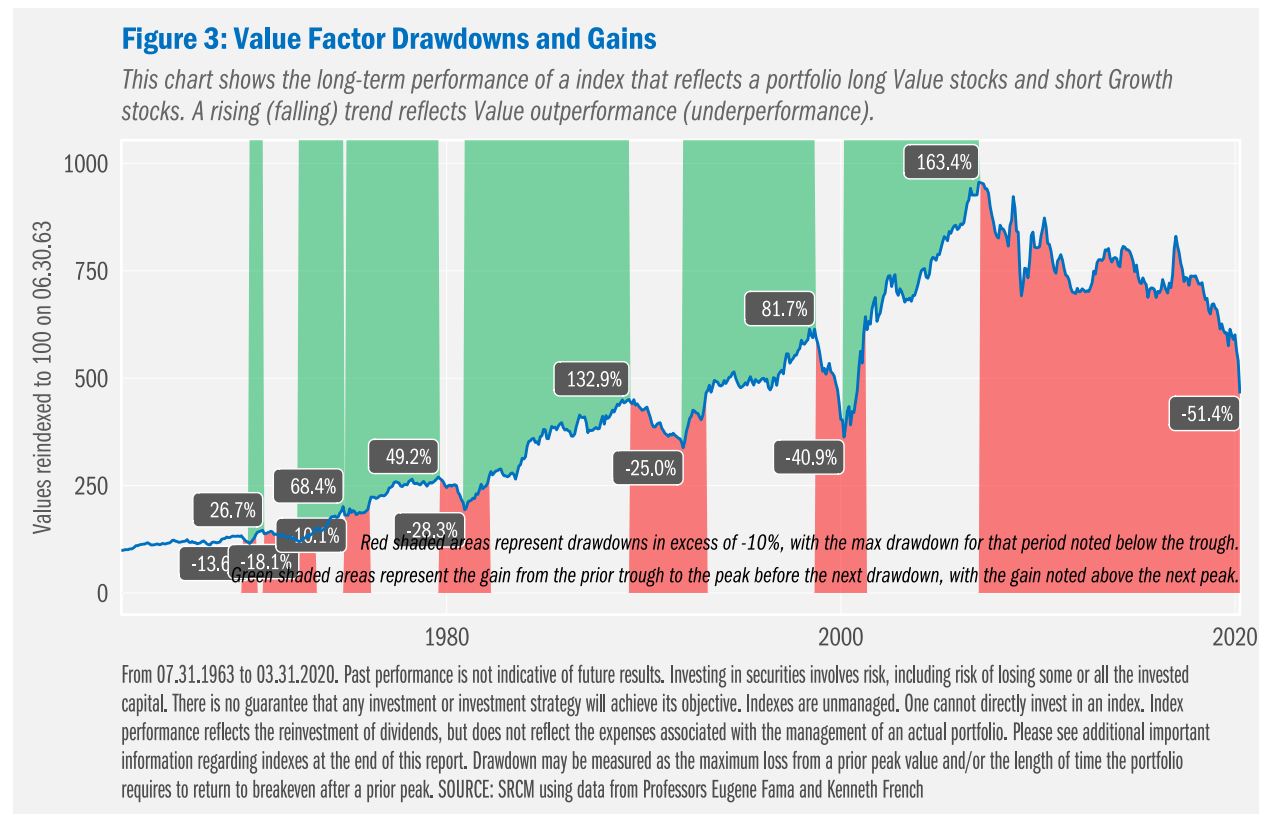
Of course, we've just described a feature of investor behavior / realization of a risk premium that is cyclical in nature. And that cycle is not bound in time or extreme. We just so happen to be in a cycle that so far is both very long and very extreme, but we've found no evidence that we were incorrect in our having tilted our portfolios toward Value stocks in the first place. And we neither have found any evidence that we should not continue to do so. Importantly, neither have our many colleagues that provide investment solutions fueling multi-factor investment approaches such as ours (readers can reach out to us for a summation of additional research and commentary for deeper context). Neither are we alone in our belief in the Value factor, nor are we alone in scratching our heads in contemplation of Value's underperformance.

Figure 2: Rolling 10-Year Cumulative Total Return: Value and Growth Stocks



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We can reach back into market history for additional perspective. While we never have seen this dramatic of an underperformance, there have been times when, for seemingly similar reasons and otherwise, Value has strongly underperformed Growth. In Figure 3 we show a long-term chart of the Value factor, represented by an index that is long the most inexpensive 30% of stocks in the index’s universe and short the most expensive 30%. Evident is the longevity and severity of the present drawdown (drawdowns are shown in red). Notable, too, are the historical gains (shown in green) that have come subsequent to past drawdowns.



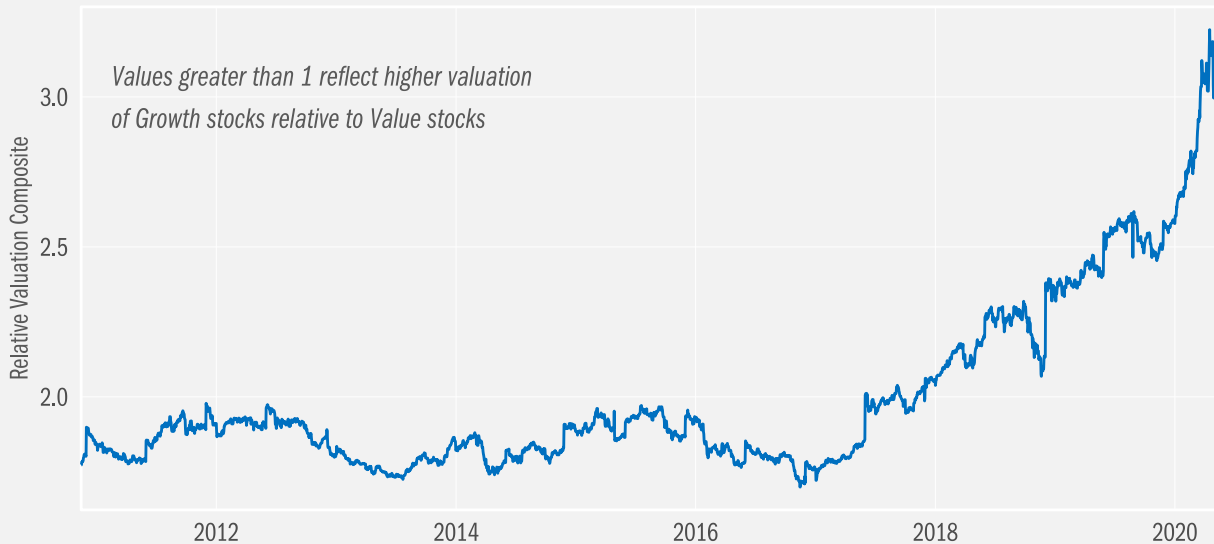
Valuations Supportive

Again, we’d understand folks being skeptical that any such resurgence might be in order. Outside of the expression of disbelief, however, we’ve yet to read broadly defensible basis for thinking that the Value factor is dead. And among the more powerful data that we believe support the opposite is a trend we presented last year when we offered a commentary with a similar title. We know that the gap between the total returns of Growth stocks widened over those for Value stocks. But those outpaced returns have not come solely as a result of actual improvement in corporate fundamentals (i.e., actual growth in earnings). We also have seen a steady expectation in Growth-stock investor expectations for future growth. We see this in the gapping out of valuations (again, the price of a stock, versus a fundamental metric) for Growth stocks, versus Value stocks, which we chart in Figure 4. The series in that chart is a simple daily average of the ratio of Growth-stock valuation metrics to Value-stock metrics. The metrics we used are price-to-book value, price-to-earnings, price-to-sales and dividend yield, computed by Bloomberg, for the MSCI U.S. Value and Growth Indexes. Readers can find a definition of those metrics at the end of this commentary.

While the relative valuations saw Growth stocks range a bit below twice-as-expensive through late 2017, Growth stocks thereafter saw their relative valuations soar. While Value stocks have become a bit more expensive relative to their own historical levels (at least by these metrics over this relatively short time frame), Growth stocks have become much more expensive.

Figure 4: Relative Valuations Value and Growth Stocks

A composite of several valuation metrics (listed below chart) shows Growth stocks have become increasingly expensive relative to Value stocks



From 11.15.10 through 05.08.20. Values represent average of price-to-book (PB), price-to-earnings (PE), price-to-sales (PS) ratios and dividend yields (DY) for each market relative to the U.S. PB is a ratio that compares market capitalization to the value of corporate assets. PE is a ratio that compares market capitalization to corporate earnings. PS is a ratio that compares market capitalization to corporate revenue. DY is a ratio that divides annual dividends by market price. SOURCE: SRCM using data from MSCI via Bloomberg

Reversal Not Determinable, but Presumable

As with most trends in investing, we cannot be sure when either the relative expansion in Growth-stock valuations or their relative outperformance will end. But, we remain convinced that our approach, grounded upon a long history of empirical evidence, remains far more defensible than the estimations often utilized to support Growth investment strategies. We, in fact, believe that the justifications for our preference for Value as a component of our multifactor approach in our portfolios are as applicable and as rational as ever. As always, we are here to provide more detail where desired.

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Domestic (U.S.) equity: The MSCI U.S. Investable Market 2500 Index is designed to measure the performance of the large-, mid- and small-cap segment of the U.S. equity market. The index represents approximately 99% of the free float-adjusted market capitalization in the U.S. equity market. "Value" and "Growth" versions of this index are constructed as described in the "MSCI Value and Growth Indexes" note below. May be referred to as "All Stocks" in a section specifically describing only U.S. stocks.

MSCI Value and Growth Indexes: The value investment style characteristics for MSCI index construction are defined using the following variables: book value to price, 12-month forward earnings to price and dividend yield. The growth investment style characteristics are defined using the following variables: long-term forward earnings per share (EPS) growth rate, short-term forward EPS growth rate, current internal growth rate, long-term historical EPS growth trend and long-term historical sales per share growth trend. The objective of the MSCI Value and Growth Indexes design is to divide constituents of an underlying market capitalization index into a value index and a growth index, each targeting 50% of the free float-adjusted market capitalization of the underlying index. The market capitalization of each constituent should be fully represented in the combination of the value index and the growth index, and, at the same time, should not be double-counted. One security may, however, be represented in both the value index and the growth index at a partial weight.

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Fama/French U.S. Book-to-Market Research Indexes: Provided by Professors Eugene Fama and Kenneth French. Index constituents are formed on book equity (BE) / market equity (ME) at the end of each June using NYSE breakpoints. The BE used in June of year t is the book equity for the last fiscal year end in t-1. ME is price times shares outstanding at the end of December of t-1. The reconstitution considers all NYSE, AMEX, and NASDAQ stocks for which we have ME for December of t-1 and June of t, and BE for t-1. The Fama/French U.S. Value Research Index includes the lower 30% in price-to-book. The Fama/French U.S. Growth Research Index includes the higher 30% in price-to-book.

Fama/French U.S. Size Research Indexes: Provided by Professors Eugene Fama and Kenneth French. Index constituents are formed at the end of each June using June market equity and NYSE breakpoints. The reconstitution considers for July of year t to June of $t+1$ include all NYSE, AMEX, and NASDAQ stocks for which are available market equity data for June of t . The Fama/French U.S. Small Research Index includes the lower 30% in market capitalization. The Fama/French U.S. Large Research Index includes the higher 30% in market capitalization.

Fama/French U.S. Profitability Research Indexes: Provided by Professors Eugene Fama and Kenneth French. Index constituents are formed on profitability (OP) at the end of each June using NYSE breakpoints. OP for June of year t is annual revenue minus cost of goods sold, interest expense, and selling, general and administrative expenses divided by book equity for the last fiscal year end in $t-1$. The reconstitution considers all NYSE, AMEX and NASDAQ stocks for which are available market equity data for June of t , (positive) book equity data for $t-1$, non-missing revenues data for $t-1$, and non-missing data for at least one of the following: cost of goods sold, selling, general and administrative expenses, or interest expense for $t-1$. The Fama/French U.S. Robust Profitability Research Index includes the higher 30% of stocks by profitability. The Fama/French U.S. Weak Profitability Research Index includes the lower 30% of stocks by profitability.

Fama/French U.S. Investment Research Indexes: Provided by Professors Eugene Fama and Kenneth French. Index constituents are formed on the change in total assets from the fiscal year ending in year $t-2$ to the fiscal year ending in $t-1$, divided by $t-2$ total assets at the end of each June using NYSE breakpoints. The reconstitution considers all NYSE, AMEX and NASDAQ stocks for which we have market equity data for June of t and total assets data for $t-2$ and $t-1$. The Fama/French U.S. Conservative Investment Research Index includes the lower 30% of stocks by profitability. The Fama/French U.S. Aggressive Investment Research Index includes the higher 30% of stocks by profitability.

Price-to-book (PB) is a ratio that compares market capitalization to the value of corporate assets. Price-to-earnings (PE) is a ratio that compares market capitalization to corporate earnings. Price-to-sales (PS) is a ratio that compares market capitalization to corporate revenue. Dividend yields (DY) is a ratio that divides annual dividends by market price.

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

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