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**HIGH CONVICTION:** THE LATEST IN GLOBAL ACTIVE EQUITY WITH OLIVIA ENGEL

# IS VALUE READY TO TURN?

**Olivia Engel**, CFA
CIO, Active Quantitative Equity
State Street Global Advisors

## Long period of underperformance may be coming to an end

Value investing, famously born in the 1920s by Graham and Dodd, has been bruised and battered over a number of market cycles, no more so, perhaps, than over the last eight years when the strategy has underperformed its growth investing counterpart. Still, there are good reasons why it's become one of the most popular approaches to active equity investing: Who doesn't want to buy something for less than the market price? Bargains are good.

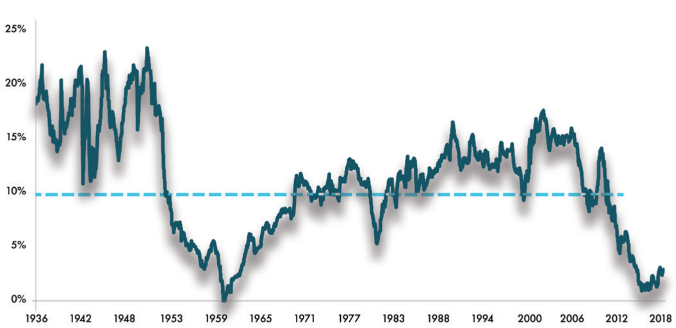
Indeed, the long history of equity return data confirms the value premium over the long term.

But these last eight years — since the global financial crisis led central banks around the world to pump their monetary systems up with cash — have not been good for value investors. So much so that some might even begin to think value as a strategy is dead altogether.

That, however, would be wrong.

"When there's a theme that has been underperforming in the marketplace for a relatively long period of time, I think it's very tempting to want to say this theme is dead and not invest in it," Olivia Engel, senior managing director and CIO of active quantitative equity at State Street Global Advisors, told *Pensions & Investments* recently. "There is performance variability, but that's not a reason to give up on something that's as fundamental and essential to equity markets as value."

### The cyclicality of value investing




Ten-year rolling annualized quintile spread returns for U.S. equities listed on NYSE, AMEX and NASDAQ.

Eight years may seem like a long time but Engel pointed out that after World War II, when the broad market was returning about 20% a year, value investing underperformed for almost 17 years, from 1953 to 1970.

So what's an institutional investor to do?

To begin, expand the definition of value beyond the three most common metrics: book value to market, cash flow to price and earnings to price. That means using metrics such as dividend yield, price to sales and price to forward earnings.

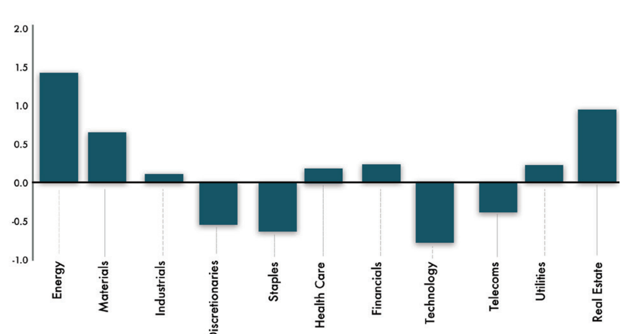
"Using a robust definition of value rather than relying on one or two individual measures can help investors fully capture the value premium," Engel said.

What's more, a broader definition of value can help uncover opportunities in general and, for example, by sector.

"You may think value just hasn't been working at all but it has been working in some pockets of the market," Engel said. "It's not working in the technology sector, but in some other parts of the market, it's very strong."

Finally, remember that the long period of underperformance began when central banks pursued aggressive monetary easing to provide liquidity. Led by the U.S. Federal Reserve, they are now beginning to reverse those policies.

### Where value investing is working in the market today




Average monthly, quintile-spread returns by GICS sector for a composite value factor, December 2016 to May 2018.

*Source: Factset, State Street Global Advisors as of May 31, 2018*

"I think the macro environment we're in could be a good turning point for value to be rewarded as we head into an environment where monetary easing is not propping up economies and interest rates are starting to rise," Engel said.

She explained that rising interest rates — in June, the Fed raised rates for the second time this year and indicated it would do so twice more before the end of the year — have a positive effect on the value premium. A large component of growth stocks' valuation depends on the present value of future cash flows, so steadily rising rates lead to progressively lower growth-stock valuations. Value stocks, on the other hand, are less susceptible to increasing rates, so a rising interest-rate environment would help to bring the value premium back to long-term averages.

She added that over the last 18 months or so, the outperformance of growth investing has been largely momentum-driven.

"The underperformance of value in last 18 months, I think, has been driven more by the outperformance of growth than the underperformance of value," Engel said. "The outperformance of a very expensive and high growth part of the market."

As the trend begins to turn, Engel said investors should look for the sectors that are the most recent underperformers, such as financials and consumer staples, to lead the way.

"Investors should look to segments where value has not been working for any significant period to reverse," she said. "Financials are definitely an area where you see some value and some improvements to earnings because of the rising rate environment."

So while value investing has taken its share of hits over the last eight years, it remains a viable strategy that investors should not abandon. Rather, they should look beyond the traditional value metrics and keep a close eye on the macro economic environment, which is shifting to one that will benefit value.

"We believe that a robust and multi-dimensional approach to value is essential for investors who seek to reap the benefits of value investing over the long term," Engel said. •

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