Growth vs Value – Is this the turning point?

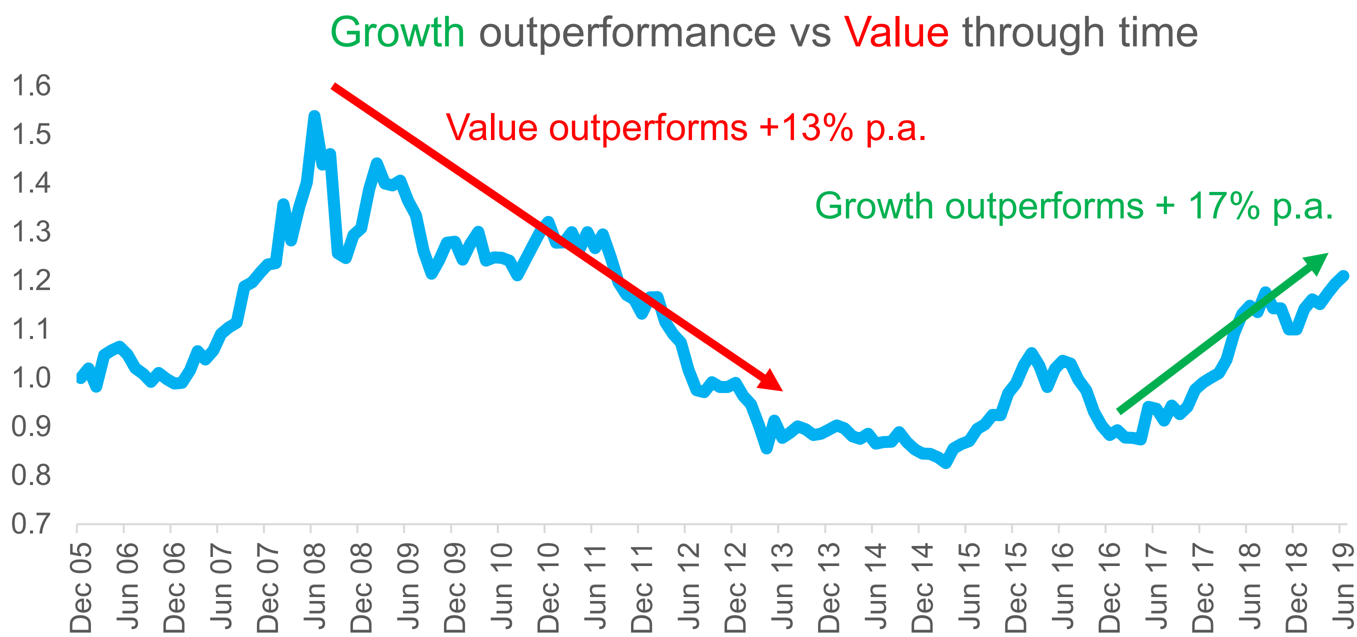
September 2019 – James Miller, Portfolio Manager

At the start of September 2019, we saw some of the strongest signs of life from value stocks since 2016. Whilst the equity market moves themselves were small, the rotation from growth to value stocks within the market was fierce and rapid. A big question in the market is currently whether this is the beginning of a value phase, or simply a blip in the road for growth stock performance.

We don't proffer to have a definitive answer to the question – picking turning points is as difficult as timing the market (covered in detail in our market timing article here). However, decades of experience (and history) has taught us that markets move in cycles. Changes in the cycle are not a matter of if, but when. In this insight piece we explore recent market performance, future conditions which are conducive to growth or value stocks, and how we think about navigating changing market cycles.

Growth companies have been outperforming materially since 2016

Since the end of 2016, the market has been in a strong growth cycle. Global economic growth has slowed and uncertainty has increased – impacting end markets for many value stocks (defined as companies trading at low price or earnings multiples). Many earnings forecasts have been downgraded and price to earnings ratios have been compressed. In contrast, sectors with long-term growth profiles such as technology and healthcare have outperformed with valuations expanding over the past 3 years. The extent of the latest growth cycle can be seen graphically in the chart below.



Source: MSCI Australia

However, what is also worth noting is that whilst growth might be in vogue now, value had a great run between 2008 and 2014. We also saw a material swing when value outperformed in 2016. The key question is, where to from here?

Below, we argue the case for both growth and value outperforming in the coming years and how we think about positioning the Firetrail portfolios to navigate changing market cycles.

Why growth stocks could continue to outperform

1. **Are low interest rates here to stay?** The Australian 10-year government bond yield has fallen from 2.8% to ~1.0% within a year – a rapid decline. As a proxy for the risk-free rate used in a discounted cash flow (DCF) valuation, it doesn't get much better than the long-term government bond yield. Yet when we look at sell-side broker forecasts, the risk-free rates for many valuations are still 3% or higher.

   The biggest beneficiaries of lower rates in a DCF valuation are growth stocks – they have long dated cashflows which are worth increasingly more as interest rates (and the cost of capital) falls. If this normality of lower rates continues, it is possible to see valuation uplifts for growth stocks continuing. The key risk is that investors are already ahead of the sell-side brokers in reducing the risk-free rate in their equity valuations.

2. **Do we have a period of economic stagnation?** Slower economic growth typically hits the earnings of value stocks harder than growth stocks. This is because many value stocks can be linked to the economic cycle. Think about a construction company with a business model set up for 180,000 housing starts in Australia, however, housing starts come in at 160,000. Higher costs and lower revenue (the operational leverage) for the company will result in a material earnings hit. Similarly, across the retail sector, when times are tough and unemployment is rising, consumers spend less and save more, impacting the sales lines of retailers. In contrast, technological innovation will continue, as will our demand for better healthcare.

3. **Does the hunt for income intensify?** The going rate on a 1-year term deposit in Australia is ~1.60%, compared with the dividend yield on the ASX 200 index of 4.2%. Could we see further rotation into defensive equities as savers require a higher income to fund their retirement? Whilst not strictly limited to growth stocks, likely beneficiaries of this would be companies with stable, predictable long-term earnings with long dated cashflows like Transurban (with a current dividend yield 4% and growing).

Why value stocks could make a comeback

1. **Have interest rates nearly bottomed?** In the context of the Australian market, the cash rate at the time of writing sits at 1.00%, and market consensus forecasts have this lowering to 0.50% within the next 12 months. The effectiveness of the RBA dropping rates lower than this rapidly diminishes, as banks would find it hard to pass on the full impact to borrowers. Thus, at that point we would likely see alternative monetary policy, such as quantitative easing (QE) kick in. QE would likely provide a broad-based economic uplift (good for value stocks), rather than the asset price inflation of lowering the cash rate that we have seen so far.

2. **Does Australian fiscal stimulus emerge?** Whilst the political promise of producing a fiscal surplus in May 2020 continues to be the agenda of the current government, beyond this the spending may begin. Whether the spending is on infrastructure, tax reductions/refunds, or other initiatives – government is likely to spend on broad reaching policies that improve the confidence and hip-pockets of the Australian voting public. A good environment for value stocks.

3. **Is the trade war resolved?** The biggest impact we are seeing from the trade war between the US and China is the impact on business confidence. When a company's end markets (and sometimes their cost base) are impacted by tariffs, it has a direct impact on their earnings, and more importantly confidence in future investment. Not to mention the constant headlines drumming up fear and uncertainty in consumers and investors alike. Any resolution may see a pick-up in business and consumer confidence – any subsequent spending could end up on the revenue line of value stocks (think retailers, builders and the like).

How does Firetrail think about navigating value and growth?

Picking the turning point on growth vs value cycles is as difficult as timing the market… which is near impossible! Our efforts remain focussed on finding and investing in companies that we believe are trading at cheap valuations, regardless of whether they are value or growth. The high conviction portfolio currently contains companies which have one-year forward valuations ranging from 4x EV/EBITDA to 24x EV/EBITDA. Providing exposure to both value and growth stocks.

Importantly, over the long term whether value or growth, the key determinant of what drives share prices is earnings, rather than the multiple put on those earnings. By focusing our deep fundamental research on a company's earnings and using sensible and appropriate valuation metrics, we believe we will generate superior investment performance for our clients over the medium to long-term.