Investment Insight

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Share Market Valuations

Is 'growth' or 'value' the winning investment style?

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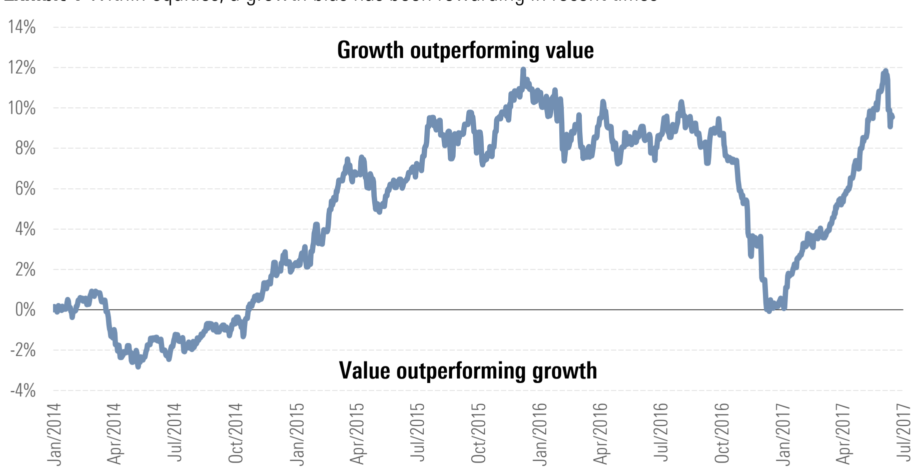
Warren Buffet's business partner, Charlie Munger famously said that "all intelligent investing is value investing, acquiring more than you are paying for"[1]. Yet professional investors are regularly defined by their 'investment style'. When asked who Benjamin Graham was, most investors would describe him as 'the father of value investing' while Peter Lynch was known to focus on investing in companies that he believed would grow faster than average. The labels provide a shorthand to help investors quickly describe the approach of an investor.

In common with other stereotypes, the labels 'growth' and 'value' naturally oversimplify the approach adopted by investors, especially those such as Graham and Lynch who were highly skilled as investors. Nevertheless, the division between value and growth has become embedded in the way people think about investing.

Over the long term, several academics have shown that cheap shares deliver higher returns than expensive shares over the long term[2]. As value investors typically seek cheap shares and growth investors are usually characterised as those prepared to pay premium prices for higher earnings growth, this suggests that 'value investors' should outperform. However, the reality is that over short time periods, the relative performance of the two styles is cyclical. Specifically, growth is said to be dominating against value to the tune of approximately 10% year-to-date, raising many questions about whether it is a contrarian signal or whether growth stocks are better positioned for today's 'low return' world.

Exhibit 1 Within equities, a growth bias has been rewarding in recent times

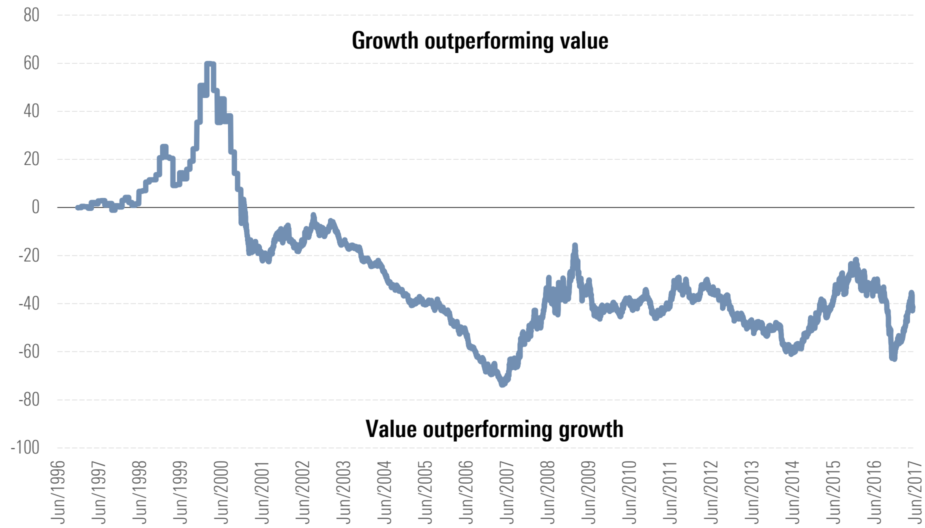


Source: Morningstar Direct, Morningstar Investment Management calculation at 31/05/17

[1] From 'Charlie Munger: The Complete Investor' by Tren Griffin (2015)

[2] See Fama and French 'Value versus Growth, the international evidence' (Journal of Finance, Dec 1998)

Exhibit 2 The longer term shows a value bias winning within share markets



Source: Morningstar Direct, Morningstar Investment Management calculation at 31/05/17

It is interesting to apply a far broader perspective though. Style factors can tell us a lot about what caused a manager's return to be higher or lower than an index and gauge whether outperformance or underperformance is due to that style of investing being in or out of favour. This has two important uses that can improve performance. First, it allows us to better gauge how much of past performance is due to skill and luck rather than style. Furthermore, it can also be used to combine managers with very different investment approaches to generate more consistent outperformance.

What about multi-asset portfolios?

We know that asset allocation is the key driver of the absolute return of a portfolio, so are there styles of investing in terms of what drives asset allocation decisions? For multi-asset portfolios that vary their asset mix, we see three common ways of forming views about the investment outlook and varying the asset allocation:

- **Macroeconomic-driven** – the key driver of asset allocation decision is the managers' economic research and views on the outlook for economic growth, inflation, interest rates and so on. These are used to form a view about the outlook for markets, with the typical timeframe of up to 3 years.
- **Momentum-driven** – the key driver is the short-to-medium term trend in asset prices and in some cases underlying economic and corporate fundamentals such as GDP growth and corporate earnings. Portfolios are biased to assets whose prices have risen and in some cases high or rising growth.
- **Valuation-driven** – the key driver is fair value estimates, which are then used to identify investments offering better value and reward for risk. Portfolios tend to hold more "out of favour" assets and be more contrarian. A fundamental longer-term perspective is required in terms of assessing fair value, implying a discipline to "miss out" on gains when markets become euphoric as well as the patience to wait for prices of out of favour assets to rise back to more sustainable levels.

These multi-asset "styles" can be used to understand how funds might perform in different market conditions. Momentum strategies often perform best when trends are strong. However, they struggle when markets fluctuate sharply within wide ranges. Macroeconomic-driven strategies are less predictable as they are driven by subjective forecasts of economic conditions and their market impacts.

Valuation-driven strategies tend to perform less well when markets are expensive and prices continue to rise but perform much better in market sell-offs.

So, which style does best over the longer term?

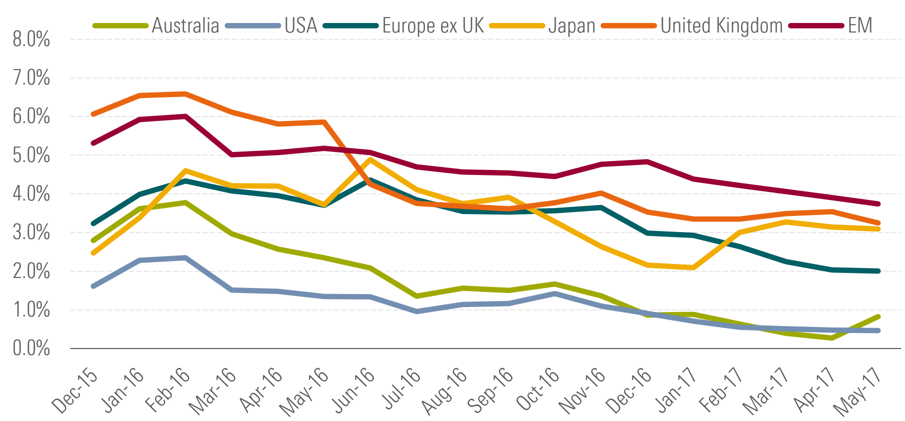
We can draw some useful conclusions from the track record of forecasters, the history of financial markets and behavioural finance.

First, the record of forecasting is very poor. This applies to economic variables like GDP growth, inflation, corporate profits and interest rates as well as asset prices including share prices, bond yields and exchange rates. Once fees and taxes are included, the odds are stacked against you if you base your investment strategy on short-to-medium term forecasts.

Second, share markets are prone to trends in the short-to-medium term but not over longer horizons. In fact, over longer periods returns are more stable, meaning that periods when markets trend up are followed by periods when prices fall. Momentum investing tends to work better over shorter horizons but is exposed to large losses when a reversion in return happens. This makes the approach vulnerable to large losses.

Third, there is a link between the valuation of an asset and future returns and losses. When markets trade at the low end of their historic valuation ranges, future returns are higher than usual and future losses (peak to trough fall in share prices) smaller than usual. Conversely, when they trade at the high end of their valuation range, future returns are lower and losses greater than usual. Behavioural finance has shown that it is hard to apply this approach of being contrarian, in part because our instincts are to extrapolate recent experiences and be part of the crowd rather than be alone. Incentives in funds management are also generally shorter term and do not reward patience.

Exhibit 3 This is an example of our valuation-driven approach, showing that our long-term expectations continue to deteriorate. This acknowledges greater price pressure and helps us to overcome behavioural biases (10-year valuation-implied returns, real % per year).



Source: Morningstar Direct, Morningstar Investment Management calculation at 31/05/17

In summary, which style wins?

While it is not without its challenges, our conclusion is that a multi-asset investor could enhance their chances of success if they support a fundamentally long-term and valuation-driven approach. M

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