Global Equity Edge

Time to take another look at value

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In brief

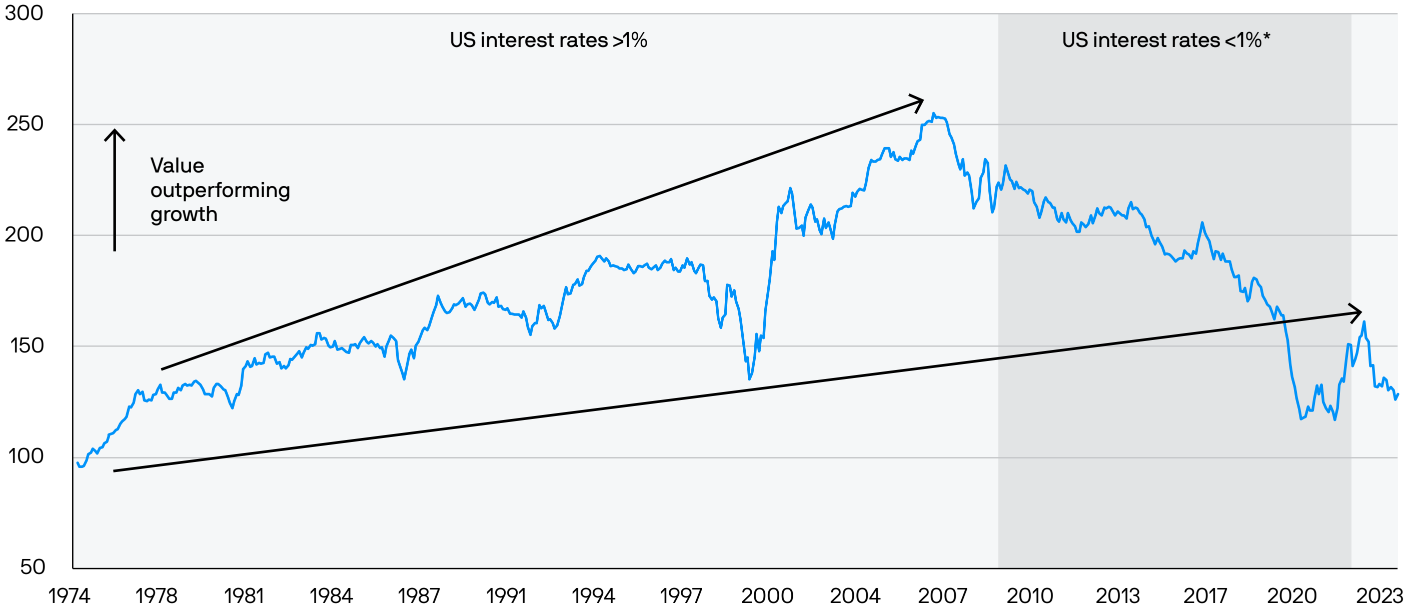
- Historically, value has performed well over the long-term, particularly during periods of 'normal' interest rates.
- The macroeconomic environment has now turned in value's favour, with interest rates back at normal levels.
- Wide valuation spreads and low positioning indicates that the potential for value to outperform is significant.
- Valuation, no matter how magnificent the company, is key.
- As market conditions are turning supportive of value, our process is already finding a number of value companies that we see as excellent investment opportunities.

Over the last decade or so, the classic value versus growth investing debate has been fairly one-sided. Growth, buoyed by a prolonged period of low interest rates, has considerably outperformed value, as investors increasingly looked for companies with strong earnings potential, and overlooked those that appeared cheap today. However, there are some tentative signs that conditions are now changing in value's favour. We believe that it might be time for investors to reconsider this unloved part of the market.

Interest rates are key to value performance

History demonstrates that value investing is a successful investment approach over the long term. Only in extreme, artificially low interest rate environments has growth been able to have a prolonged period of outperformance. Even including this recent period of supernormal growth returns, the MSCI World Value Index has outperformed the MSCI World Growth Index over the last half century.

Cumulative excess return of MSCI world value vs. MSCI world growth



Source: Bloomberg, as of 31 March 2024. *US Fed Fund rate (Upper bound) was 1% or below 80% of the time during this period. Past performance is not a reliable indicator of current and future results.

This relationship between interest rates and returns to investment style exists because of how stocks are valued in discount cash flow models. When interest rates are normal, the discount rate applied to future earnings in equity valuation models is higher than when rates are zero, and hence investors assign a reduced present value for future earnings. Growth stocks are typically characterised by having strong, rising future earnings, therefore much of their valuation is derived from the potential of capturing those future earnings. During a normal interest rate environment, those future earnings are valued lower today.

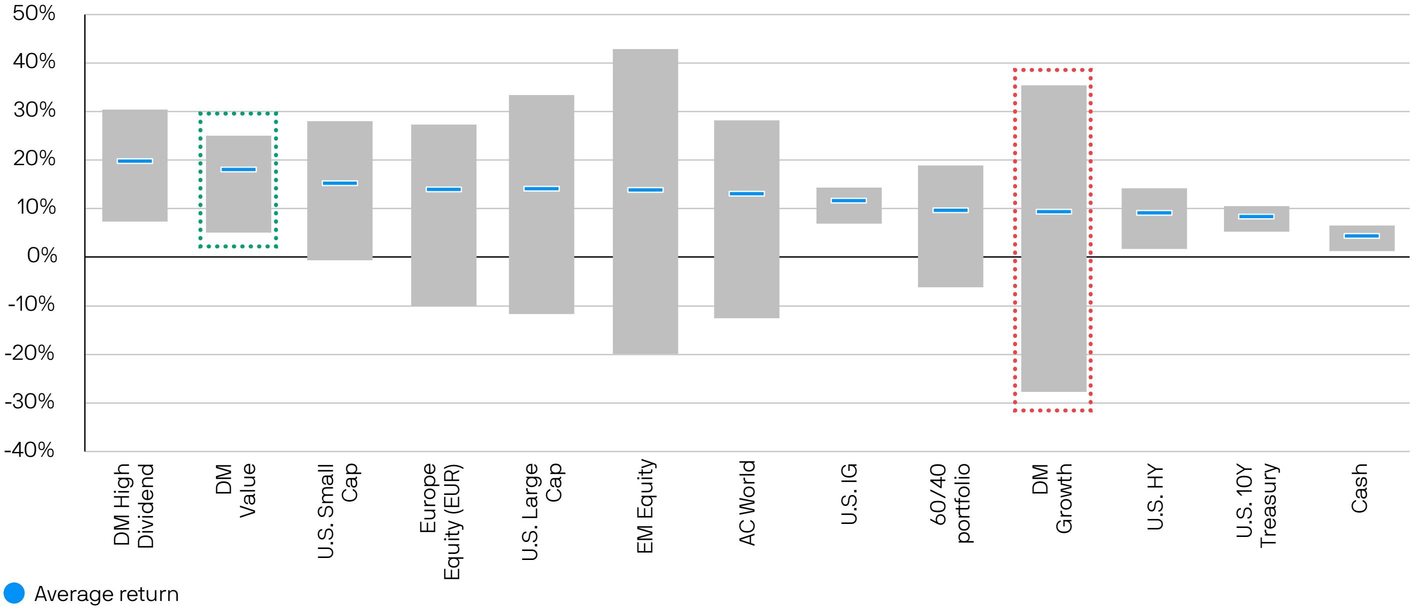
Current macroeconomic backdrop is supportive for value

In a world where the cost of capital was negative, a rising tide lifted all boats, and falling interest rates lifted all growth stocks. Today, the macroeconomic environment has turned in value's favour. Higher inflation and higher interest rates mean investors are once again assigning greater value to cash flow and earnings today, which are plentiful in the value cohort of stocks.

Provided interest rates don't settle back below 1%, a scenario that is unlikely given the resilience in the global economy, value should be well positioned to resume its outperformance.

While history is not necessarily a reliable predictor of the future, it demonstrates that after the last interest rate increase, value tends to perform much better than growth. As the economy receives a boost from monetary easing, growth becomes plentiful rather than scarce and investors become less willing to pay a premium for it. High dividend and value have been the best performing equity categories over the 12 months after the last interest rate increase, while growth is the worst.

Average returns, and range of returns*, 12m after the past four U.S. Federal Reserve rate hiking cycle ended



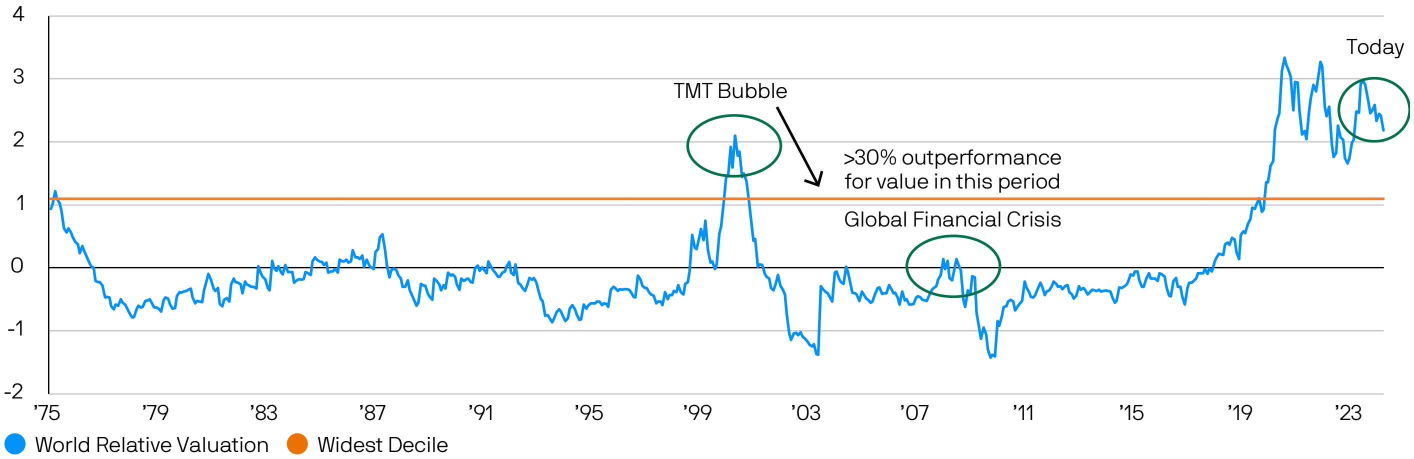
Source: FactSet, U.S. Federal Reserve, J.P. Morgan Asset Management. DM High Dividend refers market cap weighted returns in USD for constituents in the MSCI World Index between the 50th and 90th percentiles of trailing 12-month dividend yield. Also used are the MSCI AC World Index (AC World), MSCI Emerging Markets Index (EM Equity), MSCI World Growth Index (DM Growth), MSCI World Value Index (DM Value), S&P 500 Index (U.S. Large Cap), Russell 2000 Index (U.S. Small Cap), MSCI Europe Index (Europe Equity), Bloomberg U.S. Treasury Bellwethers 10Y (U.S. 10Y Treasury), Bloomberg U.S. Corporate Investment Grade Index (U.S. IG), Bloomberg U.S. Credit Corporate High Yield (U.S. HY), Bloomberg U.S. Treasury Bills 1-3M (Cash), 60% AC World and 40% Global Bonds (60/40 portfolio). *Total returns in USD are used, unless otherwise specified. Bars refer to the historic spectrum of returns, lowest to highest. Data reflect most recently available as of September 30, 2023. Starting periods for returns analysis are: 02/01/95, 05/16/00, 06/20/06, 12/22/18. Past performance is not a reliable indicator of current and future results.

Valuation spreads have reached extreme levels

The performance deviation between growth and value stocks over the last few years has driven the valuation spread between the two to extreme levels, even wider than the peak of the technology-media-telecoms (TMT) bubble, during which the euphoria over telecommunications companies caused valuations for these stocks to balloon.

The current valuation spreads are stretched on both an intra-region and intra-sector view. Take the autos sector as an example, where you have Tesla trading on 70x historic price-earnings ratio (P/E) with a market cap over 10x larger than General Motors on 5x P/E.

Relative valuation: MSCI World Value Index vs. MSCI World Growth Index (Z-score)



Source: J.P. Morgan Asset Management's chart based on data from MSCI between 31 December 1974 and 31 March 2024. The relative valuation is based on the P/B, P/E and the dividend yield of the Value relative to the Growth index normalized for comparison. Past performance is not a reliable indicator of current and future results.

Concentration risk in growth is concerning

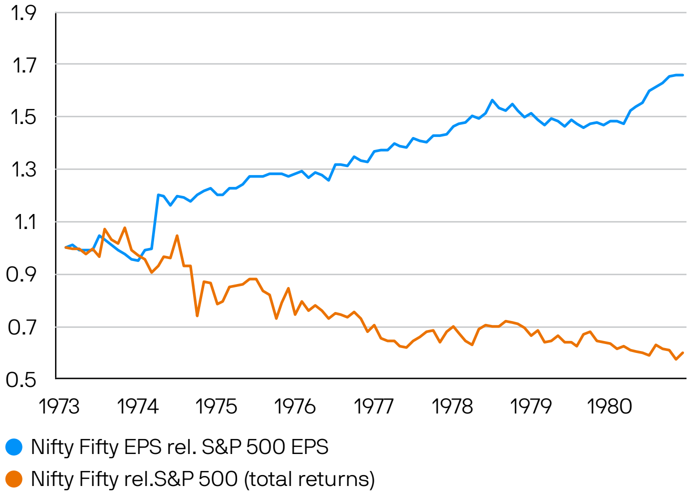
Value investing remains a lonely place. Around the world, the proportion of equity assets invested with value managers has fallen to 5%-10%. Returning to the level of 2006-2007 would require a roughly three-fold increase in the current proportion of equity assets held in value funds.

Today's extreme concentration in the US market also stands out. Such high expectations have already been baked into these few high growth companies, that even if they were to deliver on their astonishing guidance, returns may not follow. A good historical example of this is the "Nifty 50", which were a group of 50 high quality US companies that were never supposed to disappoint on earnings because they traded at high valuations versus the market. But, once inflation and higher rates became more structural, and valuations compressed, the "Nifty 50" underperformed for a decade.

As it turned out, the market was right. They didn't disappoint on earnings, outgrowing the S&P by 70% in the next seven years, but owing to high valuations, they still underperformed by c.40%!

Valuation, no matter how magnificent the company, is key. We feel that the combination of the current extreme valuation spreads, low positioning and favourable macro backdrop indicates that the potential for value to outperform could be significant.

You can be right about the fundamentals and wrong about the outcome



Source: Exane BNP Paribas estimates, DataStream. Past performance is not a reliable indicator of current and future results.

Finding the value gems

We have explained why we think market conditions are turning in favour of value, but already today there are a number of examples of excellent value companies. Our core global equities strategies are focused on finding the most compelling opportunities across the investment universe in both value and growth environments. One compelling value stock our process uncovered is AbbVie.

AbbVie

AbbVie is a large US biopharmaceutical company with market leading positions in immunology, oncology, medical aesthetics, neuroscience, and eye care. The company is best known for its arthritis treatment Humira, which was approved by the FDA in 2002.

However, this blockbuster product lost patent protection in 2023 and for years the market has been concerned over the future growth profile, as cheaper biosimilars can now enter the market. The stock traded down to a single digit P/E multiple in recent history and continues to trade at a substantial discount to the broader sector, as the market remains overly pessimistic about the remainder of the business.

On further analysis, we observe that AbbVie has successfully broadened out the revenue concentration, with several new launches from the pipeline which are now best-in-class across large patient populations. Furthermore, the balance sheet is robust, the company continues to generate attractive cash flows, and has committed to growing the dividend which is already one of the highest in the sector. New blockbuster products Skyrizi and Rinvoq are exceeding growth expectations, while the aesthetics division remains well placed to capture share in an expanding market.

Despite not making the same headlines as market favourite Eli Lilly, which today trades on a P/E ratio >50x, AbbVie continues to execute strongly on a compelling portfolio which remains overlooked by the market.

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