Nordea

Growth vs. value

The price you pay matters...

MARKETING MATERIAL

Introduction

Value investing and growth investing are two different investment philosophies, which utilise the fact that markets may not be fully efficient in the sense that stock prices may not reflect all available information. Investors who include value or growth investing in their equity portfolio can potentially increase returns, and the debate between the two is among the most popular investment themes.

Value stocks present an opportunity to invest in companies that are trading at a price that is believed to be below their fundamental value. Growth stocks, on the other hand, are trading at higher prices compared to current fundamentals, but this can be justified by above-average revenue and earnings growth potential. In a famous study, Eugene Fama and Kenneth French found that investors that systematically expose themselves to value relative to growth can earn a value premium and through this obtain a positive excess return to the market. The study suggests that the market tends to overestimate the value of companies with higher expected future growth rates and underestimate the value of companies, which are trading at a low price relative to their fundamentals.

However, the reality is far more complex and identifying which companies are trading below the fundamental value or which growth rates that are most appropriate for the future are not straightforward. Moreover, even if value tends to outperform growth over long periods, growth can outperform value for prolonged periods of time. This makes value versus growth investing risky (i.e. not trivial) and it also introduces the need to consider the timing for when either one will outperform the other. In this publication, we provide you with perspectives that will help you as an investor to navigate. We take a deep dive into what growth and value stocks really are, the relationship with interest rates, the pitfalls and the current valuations in a historical context.

Down the history lane...

Factor investing has its roots in the book "The Intelligent Investor"(1949) by Benjamin Graham and the three-factor model developed by Eugene Fama and Kenneth French (1992). The three-factor model was an improvement to the capital-asset-pricing-model (CAPM); a one-factor model, which tries to explain stock returns through their co-movement with the general market, measured by "beta" or market risk.

A stock with a high beta is very sensitive to general market movements, while a stock with low beta is less sensitive. As the equity market is expected to go up over time, stocks with high beta are expected to have higher return (and risk), while stocks with low beta are expected to have lower return (and risk). CAPM suggests that the parts of stock returns that are not explainable by beta are random. Moreover, the CAPM was unable to fully account for the fact that some companies have higher returns than other companies.

This was the part Fama and French investigated, and in their first model, they argued that in fact, the return for a stock could be explained by its exposure to three factors: The market factor, size and valuation. The latter is what this publication is about.

Defining growth and value

A common way to exemplify value and growth is through sectors. Growth is often associated with the technology sector, because this is where we typically find the fastest growing companies. Value stocks are often associated with sectors like utilities or financials. These companies have more stable and mature businesses with a moderate expected growth rate. However, this is too simplified, and we need to take a step deeper to fully understand the core of this. In essence, the question of value and growth is really about valuation of the specific companies, and while technology companies on average tend to be more expensive than financial companies, we often see big differences in the price of stocks within the same industry, and thus, value and growth companies can be found within all sectors.

Valuation is about how much an investor must pay to become a shareholder of a company in order to get a portion of the company's earnings. The natural question here is why are investors sometimes willing to pay a high price for a company with low earnings? To answer this, one must remember that a company's intrinsic value is the discounted value of all future profits. In other words, growth companies are companies which are believed to be able to grow their earnings at a rate significantly above the market. Therefore, growth companies *seem* expensive when measured by traditional key ratios, but may still be cheap if the company manages to live up to the high expectations. Growth stocks can often be found within booming industries and involve innovative technologies. Value companies, on the other hand, are companies, where investors are only willing to pay a relatively low price for the company relative to its earnings, because investors do not expect a significant growth in the future. Often this can be explained by the companies being relatively mature or being part of an industry where growth opportunities are limited. In other words, the investment in a value company is to a large extent based on what the company is today – what you see is what you get. It is important to understand that both value- and growth investing is exploiting potential mispricing of company values. The value investor believes the value company is worth more than the price reflect, and the growth investor believes the price does not fully reflect the potential of the (growth) company.

EPS = Earnings Per Share

Earnings per share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock. The resulting number serves as an indicator of a company's profitability.

P/E = Price-to-Earnings ratio

The price-to-earnings ratio (P/E) is the ratio for valuing a company that measures its current share price relative to its earnings per share (EPS). The price-to-earnings ratio is also sometimes known as the price multiple or the earnings multiple.

P/B = Price-to-Book ratio

The P/B ratio reflects the value that market participants attach to a company's equity relative to the book value of its equity.

P/S = Price-to-Sales ratio

The price-to-sales ratio (P/S) measures the ratio between a company's market value and revenue. An investor should be mindful that profit margins can vary a lot between industries and thus make the P/S ratio inadequate when comparing companies from different industries. On the other hand, it can help comparing similar companies, especially if they are not yet turning any profits, and therefore render the earnings based ratios insufficient.

The pitfalls: growth bubbles & value traps

To successfully pursue the value versus growth opportunities, the investors must carefully analyse company earnings, growth rates and valuation. This is not trivial, and value- and growth investing both come with problematic pitfalls. For growth, the most important pitfall is when the hype of a certain stock reaches levels beyond what the company can possibly live up to. The most well-known case of this is the IT bubble that popped in 2000. Anything even remotely related to the internet got bid up to obscure price levels, leading to the inevitable demise of the majority of the companies that were priced to take over the world, often without having ever earned a profit. Valuation of growth stocks to a large extent depends on the view of future growth rates. These are uncertain and even small misspecifications can heavily influence the valuation. That can make growth companies a victim of speculation and momentum, often exacerbated in times of low rates and excess liquidity. Misjudging future growth rates of high-multiple growth stocks can be painful as sentiment can turn fast as witnessed both in the wake of the dot-com bubble and the corona pandemic.

Identifying companies that trade close to or below the intrinsic value is not trivial either and the investor must be careful not to mistake a truly valuable company for a so-called “value trap”. A value trap is a stock or investment that appears to be undervalued, but in reality is not a good investment opportunity – or in other words: cheap for a reason. Value traps can occur when a company's financial performance is declining and is unlikely to recover, or when a company has serious underlying problems such as high debt levels, competitive pressures, or declining market share. Investors may be drawn to value traps because they appear to offer a good buying opportunity at a low price. However, if the underlying problems cannot be addressed, the company's financial performance may continue to decline, and the stock price may remain low or even fall further. To avoid value traps, it's important for investors to carefully research and analyse a company's financial performance and future prospects. Factors to consider include the company's earnings and revenue trends, competitive landscape, debt levels, management quality, and other risks.

Behavioural finance

Behavioural finance is a field of study that combines insights from psychology, economics, and finance to understand how people make financial decisions. The discipline seeks to explain why people often behave irrationally when it comes to managing their money, and how these behaviours can impact financial markets. The explanation is that people are subject to biases, emotions and other psychological factors, which affect their decision making. Some of the key concepts in behavioural finance include:

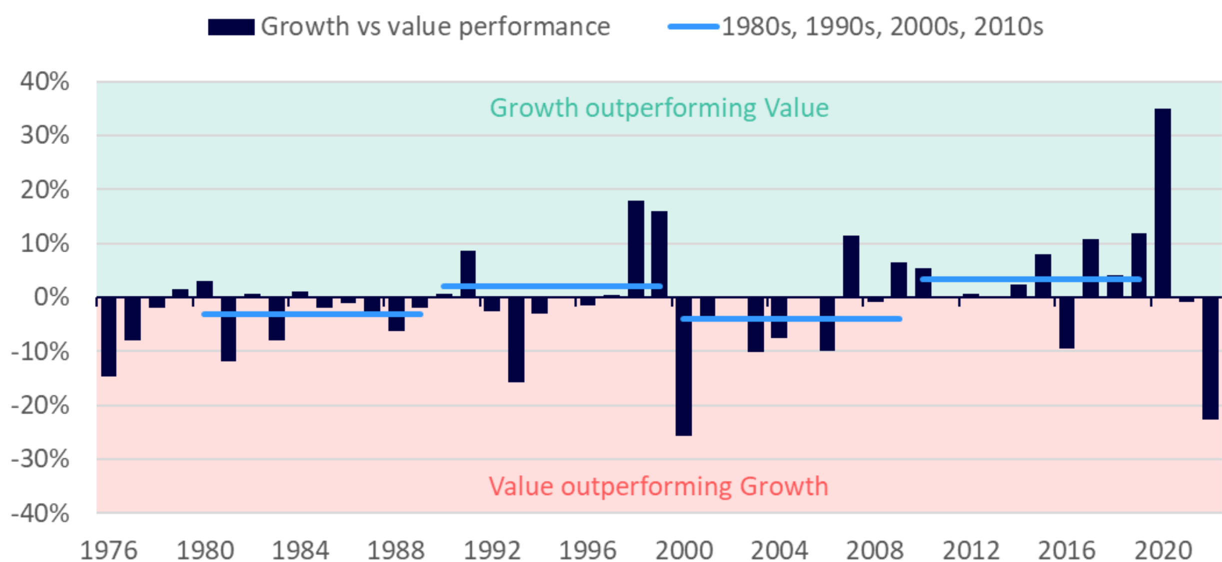
- Herd mentality which describes how people can be influenced by what other people do
- Confirmation bias which describes our tendency to cherry-pick information that confirms our existing beliefs
- Endowment effect which describes how people place a higher value on something they already own compared to something they don’t own.
- Anchoring bias which describes people’s tendency to rely too heavily on the first piece of information they receive on a topic.

In a growth versus value context several explanations have been suggested to explain the findings by Fama and French. As an example, “Fear of Missing out” (FOMO) is a case of herd mentality and may be one of the explanations as to why investor are willing to overpay for certain (growth) stocks, while the more “boring” (value) stocks tend to be overlooked by investors and therefore trade at a price lower than the fundamentals justify.

Historical performance of value and growth

Since the mid-1970s, which is the start of our preferred indices, value stocks have outperformed growth stocks somewhat. As we can see, the relative performance has differed across decades, whereas particularly the last decade has been strong for growth stocks. The relative outperformance of growth vs. value clearly depends on the time period. However, since the mid-1970s, value stocks have outperformed with annualized return at 10.4% vs. 9.4% for growth stocks. This is mirroring the findings in the Fama and French study and explains why some investors have subsequently tilted their portfolios towards value in their pursuit of an excess return over the market.

Figure 1: Growth vs. Value historical performance



Source: Nordea, Refinitiv and Bloomberg

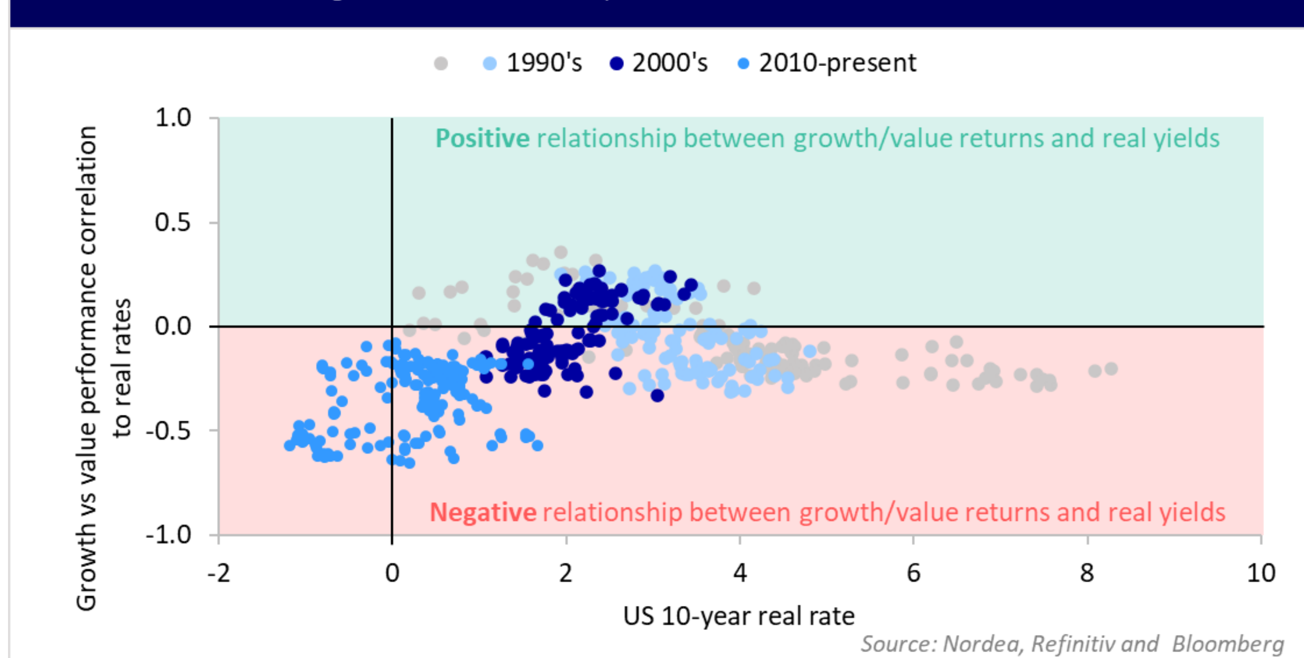
While value in the long run has outperformed growth, it is remarkable how growth has dominated the markets from 2007-2021. The picture changed dramatically in 2022, and naturally investors ask themselves if that was a start of a more prolonged period of outperformance for value. It is probably too early to draw that conclusion, although the relative pricing between growth and value, which we describe in detail further down, might suggest that growth performance will not be as dominant going forward.

Moreover, it introduces the question of timing. Even if investors are able to predict which will outperform the other over the next decade, the exact time of the rotation is equally important. As it is always the case in economics, timing the market is difficult and should not be underestimated.

The effect of interest rates

Among the perceived usual underlying drivers of growth and value performance is (real) interest rates and changes in them. Evaluating the effect involves two effects. The first effect is the discount rate effect: When interest rates fall, both value and growth stocks benefit as their cash flows are discounted at lower rates resulting in a higher net present value. However, growth companies should be more sensitive to changes in discount rates as a larger part of their earnings are expected to come later in the future. At least that is the theory. The second effect is how the interest rates effect future earnings. For some companies, higher interest rates lead to higher earnings, while it has the adverse effect for other companies. The two effects may not necessarily work in the same direction and impact value and growth companies in the same way. This is important to keep in mind when analysing the effect on interest rates on value and growth companies. A simple correlation, which shows how the two metrics move in relation to each other, does support that growth vs. value returns, at times, are negatively correlated to changes in (real) interest rates. Negative correlation in this case means that growth performs better than value when interest rates fall. However, the relationship is not constant over time. In longer periods, the correlation is opposite of what one should expect, meaning that value has performed while rates have dropped and vice versa.

Figure 2: Growth vs. Value performance correlation to real rates



Source: Nordea, Refinitiv and Bloomberg

Correlation has been particularly strong over the past decade. However, throughout our sample, correlation is weak. That suggests that other factors than rates also have been in play over the past decade. For example, changes in rates are often associated with changes in growth and inflation expectations which can affect future cash flows. Following the great financial crisis global GDP growth has averaged 3.1%. In the decade prior to the GFC, global growth averaged 4.2%. The somewhat weaker growth outlook and low inflation environment may have increased appetite for growth stocks, thus exaggerating the effect of interest rates in a simple correlation analysis. Further, growth stocks are often found within booming and innovative industries, and the performance of growth over the past decade may be more about an expanding tech industry than lower rates.

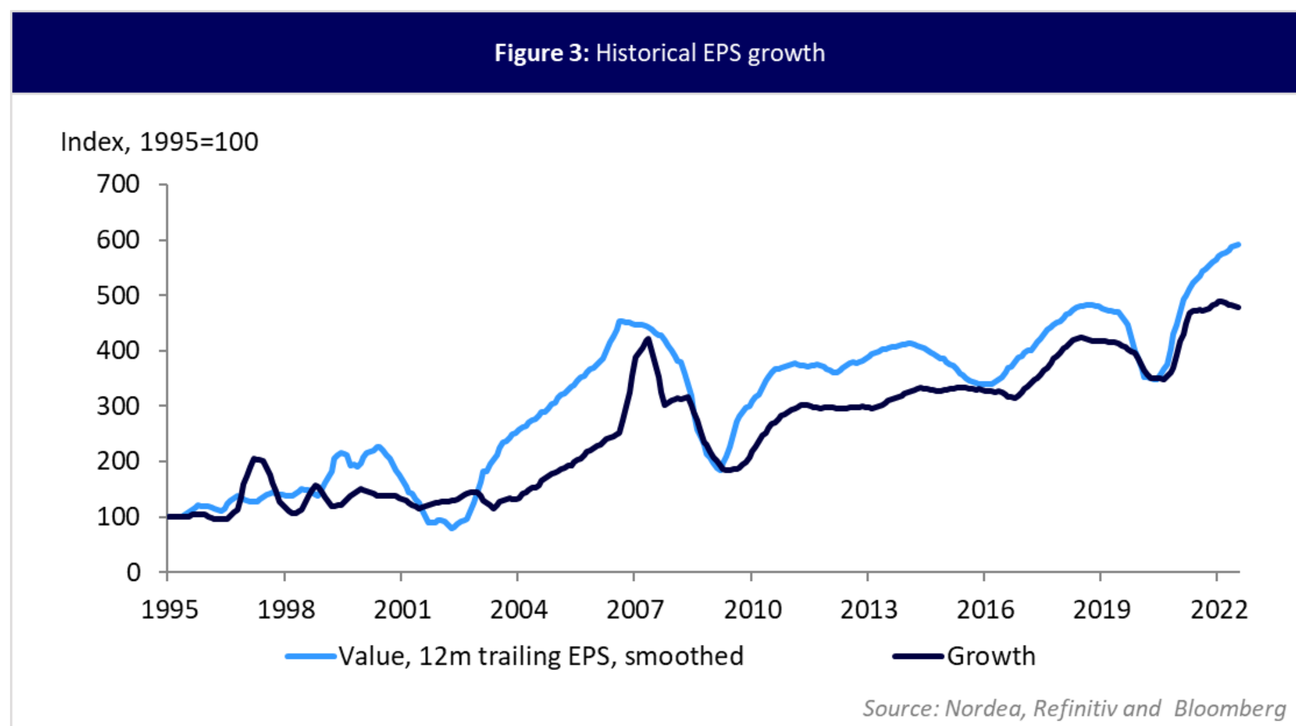
The fact that growth has outperformed in tandem with lower rates has nonetheless made many believe that rates are a key driver of growth vs. value performance. The arguments for this are weak, but at the same time we have to acknowledge that this to some extent has become a self-fulfilling prophecy.

How "growthy" are growth stocks in reality?

Everything else equal, investors should be willing to pay more for a stock that grows its earnings faster. This is also why growth stocks typically trade at a P/E premium over value stocks. But how much faster are growth stocks actually growing their earnings?

Looking back at our dataset to 1995 provides no clear answer, unfortunately. Since 2005 the annualized EPS growth rates are 3.5% and 5.6% for value and growth respectively. A mere 2.1% may not sound like all that much, but is significant and the compounding effect adds up over time.

Figure 3: Historical EPS growth



Source: Nordea, Refinitiv and Bloomberg

If we expand the time period to 1995, value stocks have actually grown their EPS by more. One explanation is that some stocks got labelled as growth because of their high price, and not because of their high earnings growth, as we saw in with the IT-bubble. Further, the pain from the bursting of the IT-bubble in 2000 was felt for some time in growth. It took until 2005 for earnings to recover properly and face a meaningful upward trajectory. As previously discussed, this highlights the importance of carefully reflecting on the period studied and if it includes event that is materially affecting the EPS growth rates for value and growth companies.

It is therefore also important to be aware of how the different index providers define value and growth. It is unfortunately quite common that a stock finds itself in both the value and growth index (although with different weights), because some cheap companies also have high earnings growth, and some expensive companies have low earnings growth. As a result, investors need to be careful when choosing an investment vehicle. You do not always get exactly what you think.

How expensive are growth stocks in 2023?

Growth stocks have managed to grow their earnings at a faster pace than value stocks over the past two decades. However, the lion's share of growth outperformance stems from investors being willing to pay an increasingly higher price for growth stocks, i.e. the P (price) has increased more than the E (earnings), and thus the P/E multiples have increased. This is illustrated in the chart below. Relative Price/Earnings ratio stands at very high levels, thus indicating that growth is priced at a high premium to value.

The high premium of growth stocks over the past years is to a large extent a result of high valuation of tech companies and the belief that these big companies will dominate the future. Whether or not the valuations can be justified remains to be seen. That being said, the Fama and French study found evidence for valuation levels between companies which can explain why some companies have higher average return. The counterpart is to study if current valuation is an explanatory factor for the return over the next decade. Interestingly, it turns out that P/E contains a predictability for future returns.

Currently, we are seeing extreme valuations across sectors and industries, and in a historical context, the current growth premium is associated with underperformance of growth stocks vs. value stocks over the following ten-year period. This is visible in figure 4. The horizontal axis shows the difference in valuation between growth and value. The vertical axis shows the subsequent ten-year annualised return. So a high growth premium typically leads to weak growth vs. value performance over the next decade, on average. In other words – the price you pay matters. The chart is based on 10-year return data from June 2000-February 2013. March 2023 is forecasted based on historical relationship, so we'll have to wait 10 years to see if history repeats itself.

Figure 4: Relative valuation growth vs. value and subsequent 10-year annualized returns

Source: Nordea, Refinitiv and Bloomberg

We should of course be careful of jumping to any strong conclusions. Growth was already overvalued in 2017 based on historical standards, but outperformed vs. value over the next four years. At the same time, markets are in constant change. This emphasizes (again) the importance and caution that investors should have in trying to time these investments. Maybe current valuations of some growth companies will look low in the future as we embrace the technologies of tomorrow.

Conclusion

Over the course of the past decades, there have been pockets of outperformance for both growth and value. That is likely to be the case also going forward. We do not know what the future brings, but we do know that:

- The relative performance between value and growth has shifted in cycles of 10-15 years historically
- The last 15 years have been dominated by growth
- Value has outperformed in periods with higher yields but one has to be careful about making a direct link to interest rates as there are multiple effects at play that can impact in different ways
- In 2023 growth stocks are historically expensive relative to value stocks

We believe the latter is a strong argument for a period of outperformance by value stocks, while the technological revolution is the main argument for continued growth dominance. But watch out and do not forget the importance of diversification, we have not seen the last growth bubble or value trap.

How to invest

To get exposure to the value or growth factor a large number of value or growth stocks are needed to avoid or reduce the company specific risks. Therefore, many investors take the exposure through a fund, where a portfolio manager selects the most attractive value or growth stocks.

Value oriented funds often have names such as "Value", "Stability" or "Dividend", while growth oriented funds often have names such as "Growth", "Opportunity" or "Disruption".

However, fund names are not always informative, so we always encourage investors to seek professional advice, not least to ensure that the allocation is right in a portfolio context. In addition, an investment advice provided by a professional advisor entails a suitability assessment of the investor's financial objectives and situation and ensures that the recommended product is suitable.

For self-directed investors, an indicator of a funds value/growth tilt can be found in Morningstar's so-called "style box".

IMPORTANT INFORMATION

Past performance is no guarantee of future return. Investments imply risk.

Nordea gives advice to private customers and small and medium-sized companies regarding investment strategy and concrete generic investment proposals. The advice includes allocation of the customers' assets as well as concrete investments in national, Nordic and international equities and bonds and in similar securities. To provide the best possible advice we have gathered all our competences within analysis and strategy in one unit - Nordea Investment Center (hereafter "IC").

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