Drums are beating for value investing after growth's off-key turn

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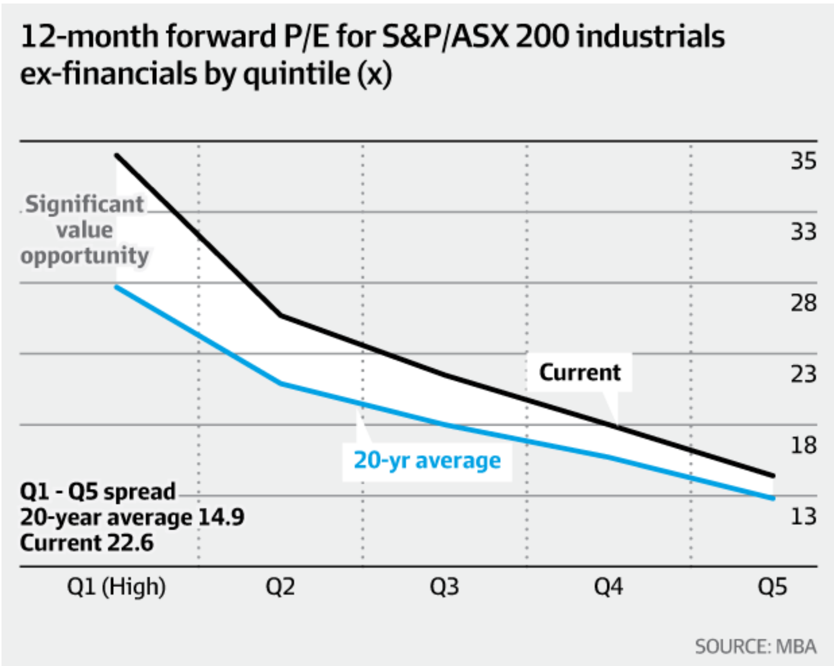
The drums are beating for value investing after a long period in the wilderness.

It will take more than one quarter's relative performance to be more definitive about the prospects for value, the style of investing popularised by Warren Buffett and Benjamin Graham, but this time the chorus is sounding more than just a hopeful note that value is in, and growth is on the way out.

In the annals of investment history, value has found itself constantly redefined. Lately, there is a view that the instinct for value need to be married with quality, because businesses trading at low multiples are often cheap because the earnings are at risk or already in decline for structural reasons.

That invites more selectivity than previous cycles, but fund managers are not struggling for ideas.



The distance between the most expensive and least expensive stocks has almost never been wider.

The origins of what may come to be seen as a flashpoint lie with savage moves in the bond market that have raised the stakes for growth. When the yield on US 10-year Treasuries hit 3.23 per cent it sent a message to the equity market that the lower-for-longer mentality fuelling growth is seriously in doubt. Under that scenario, the future cashflows embedded in growth stocks are ascribed a lower valuation.

"Your starting point is that the market looks reasonable value, but within that there's been this massive dispersion between growth and value," says Stephen Bruce, Perennial Value Management's director of portfolio management. "We're definitely at an inflection point in the rate cycle where money is no longer free, or as cheap as it was."

The S&P/ASX 200 Index is trading at 15 times earnings, just above its historical average of 14.5, masking the fact that stocks such as CSL – which usually trades at a 15 per cent premium to the market – has traded at 33 times earnings, and Brambles is on 16 times.

"I don't think the curtain's closing on the earnings outlook for the growth companies, but the curtain is closing on the valuations people are prepared to pay," Bruce concludes.

Value and growth investors don't dispute that CSL has outstanding growth, they just can't arrive at a consensus on what's a fair price to pay for that growth. And when stocks de-rate, or adjust to a lower multiple, investors can incur a capital loss with no change to the earnings profile.

Value's run out outs

Since 2007, value has underperformed in nine out of 11 years versus the market. And since the end of August, when the Australian market peaked, a proxy basket of growth stocks would have fallen 13 per cent versus a 5 per cent fall for broader equities. Value stocks have matched the market.

Leading those falls have been stocks such as Afterpay Touch, down 31 per cent, and Appen, down 25 per cent. CSL has retraced 17 per cent and Macquarie Group 10 per cent over the same period.

"Growth has been focused on a smaller and smaller group of stocks, which have become more and more expensive," says Garth Rossler, chief investment officer of Maple-Brown Abbott who believes the risk remains in the growth camp following a "once in a generation" move in rates.

"The value philosophy is buying something for 70 cents that's worth a dollar. That doesn't change, it's just what the cheapest stocks are in any point in time. Brambles was an expensive stock, but Brambles at 16 times earnings is a value stock."

Historically the market has been able to rely on self-correcting mechanisms to readjust but the unique aspects of this cycle make that difficult.

"The process of equitisation often kills bubbly parts of the equity universe. That's the thing that's missing now," says MST Marquee senior research analyst Hasan Tevfik, referring to the need to raise equity.

"This time around the growth companies don't actually need much capital," he says, speaking with the digital giants in mind.

But initial public offerings, such as the speculation linked to Uber's, could have the effect of redistributing capital from other FAANG stocks and high-growth names.

The moves unleashed on Wall Street in the past fortnight have been acute by any measure. Goldman Sachs' "strong momentum" stocks strategy fell 8.4 per cent in the worst week, a 4.4 standard deviation move and the third largest drawdown in 18 years.

Goldman equity strategist Matthew Ross said such sharp moves in market momentum historically signify a meaningful turning point.

"While we would expect the high-growth stocks to continue to de-rate as interest rate expectations rise, I wouldn't be so optimistic about the outlook for value stocks," Ross says. "The clearest precedent we can see is the period of 1994-95 when there was quite a large inflation shock and interest rates rose quite quickly. In that period, growth stocks fell by nearly 30 per cent, and while value performed better, it still slightly underperformed the 17 per cent correction in the ASX 200."

For all the difficulty endured by value, fund managers have in fact done better than the style suggests.

"There has been a fair amount of style drift where people that were deep contrarian value investors have changed their style in the post-crisis period to focus more on owning good quality businesses trading at a small discount, as opposed to very distressed, out-of-favour sectors," Ross observes.

"A number of value managers have performed better than the textbook value basket."

In terms of opportunity, Perennial Value identifies Woodside Petroleum, Star Entertainment, Stockland and Macquarie as on attractive multiples with enticing yields.

"We see quite fertile ground at the moment, if you're positive – which we are – about the medium-term outlook for the Australian economy, then value investing in the Australian market makes sense," says John Murray, managing director and Bruce's colleague at Perennial Value. Dividends, he argued, offset the uncertainty around timing for value stocks to re-rate.

"If you're the management of a company trading on a very, very lofty valuation it's not always a pleasant place to be, the sharemarket's built expectations so high. That can be difficult, and nothing's perfect in this world. Even high-growth companies can't always maintain growth."