Is it time for value investing?

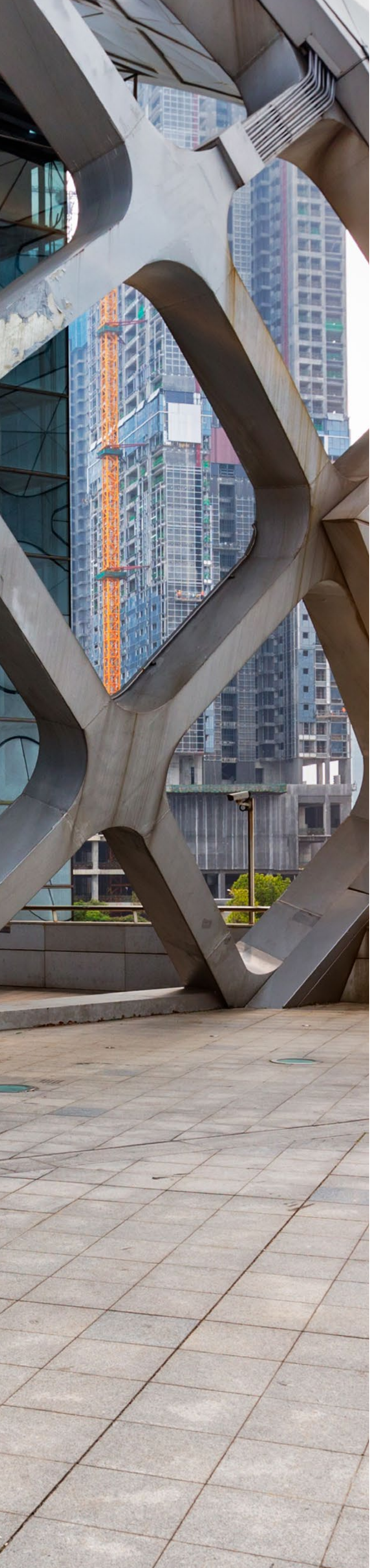
While the steady increase in market valuations over the past decade has been largely driven by growth stocks, analysts are advising the time may have come for value investing. With today's rising interest rates, increased inflation and market volatility, the strategy may provide investors with some downside protection.

The value investing approach

The value investing approach involves picking stocks, bonds, real estate or other assets that appear to be trading below their intrinsic value considering their "financial fundamentals," such as the underlying revenue and earnings from their businesses. This differs from growth investing that invests in growth-oriented stocks that typically invest their revenue in expansion and are projected to outperform the overall market.

Investors who use the value investing strategy are aiming to get a "good deal" on stocks selling at a discount to their intrinsic value. Their hope is that the stock price will rise as more people come to appreciate the true value of the company's fundamental business.

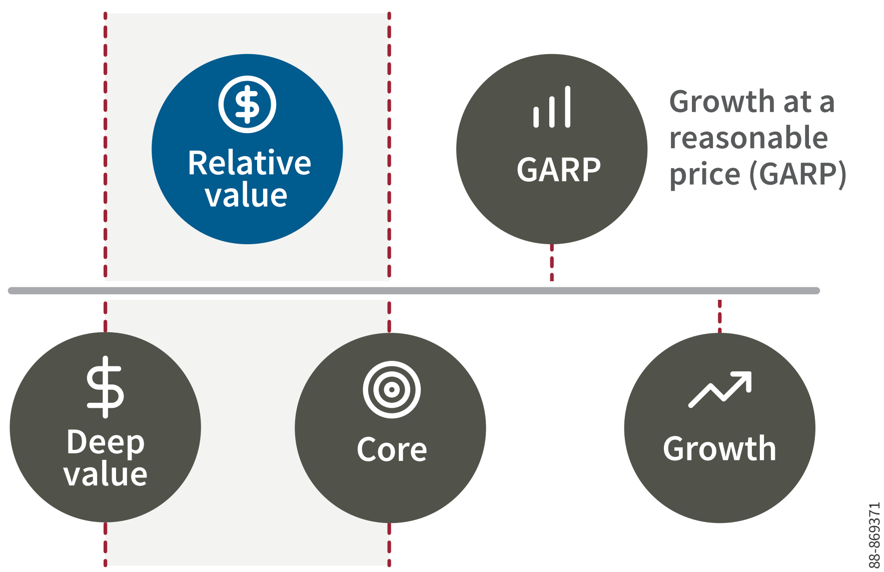
Legendary investor Benjamin Graham, considered by many to be the "father of value investing," described it as buying when most people are pessimistic. In his book, The Intelligent Investor, he notes, "A great company is not a great investment if you pay too much for the stock."[1]



Why value stocks may outperform in today's economy

During periods of high interest rates, when corporate earnings may be negatively impacted, stocks can feel the pressure. This can make it a good time for value investing, which looks at the health of companies, not just how they are currently performing. There are many approaches to value investing. It's a spectrum that can range from "deep value" to "growth at a reasonable price," which combines attributes of growth and value investing.

While value investing outperformed growth investing at the end of 2022,[2] the question of which investing style is dominant at any particular time depends on many factors. Over the past decade, value trailed behind growth. However, with today's rising interest rates and economic headwinds making it more expensive for companies to borrow money to grow, value investing is making a comeback.



Why value stocks may outperform in today's economy

> That said, there are some similar factors many value investors agree are features of a good value stock. These include an established business with history of success, a business model that leads to consistent future profitability/stable growth and the potential for dividend payments.

Chris Koltek, Institutional Client Portfolio Strategist at Portfolio Solutions Group, a division of Canada Life Investment Management Ltd, says during volatile market conditions when investors tend to be more risk averse, they can become attracted to companies that exhibit a strong valuation (e.g., strong existing earnings and cash flows). "Instead of being drawn to companies that focus on the potential for future growth," he says, "value companies are those that have stronger near-term earnings and cash flows."

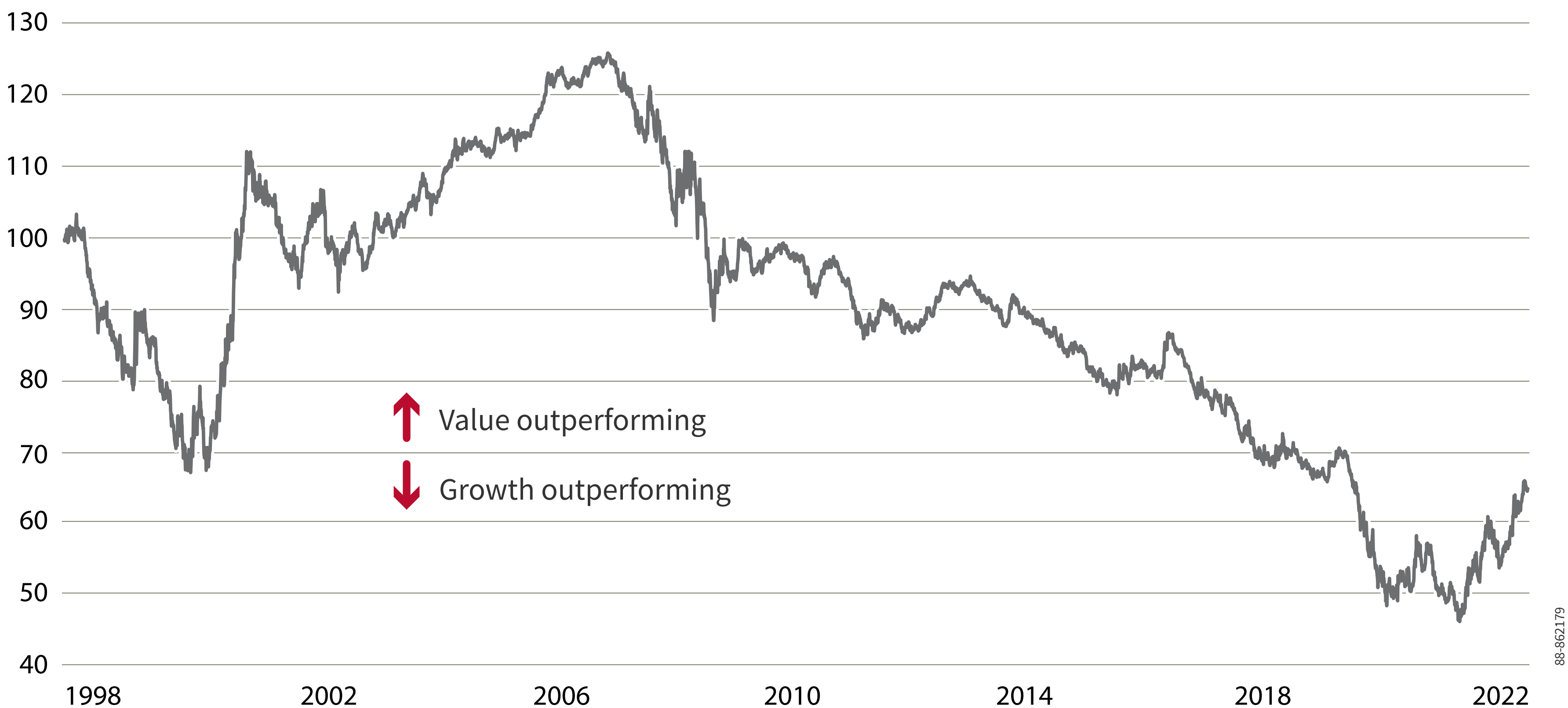
Value companies are also more likely to be the ones that provide dividends, something Koltek points out can provide a bit more of a margin of safety for investors during uncertain times.

"By providing an income component, an investor is not just waiting for the stock price to jump up, they are also being rewarded by the dividends."

Chris Koltek, Institutional Client Portfolio Strategist at Portfolio Solutions Group, a division of Canada Life Investment Management Ltd

A comparison of value vs. growth investing from 1998 to 2022, indicates that each approach may outperform the other at different points during the market cycle.

S&P 500 value index / S&P 500 growth index



Source : Bloomberg

S&P Value / S&P Growth updated as of January 31, 2023

What does this chart mean?

By dividing the S&P 500 Value Index by the S&P 500 Growth Index, the following chart demonstrates which style is performing best at various points in time. When the value style is outperforming, the line moves up. When the growth style is outperforming, the line moves down.

How to calculate intrinsic value

One of the ways to calculate a company's intrinsic value is by analyzing some key stock metrics. Using some of these basic "yardsticks" of value, can help an investor determine whether the market may have failed to price in the true value of a stock based on its long-term fundamentals.

Some of the key metrics analyzed by value investors are:

- ✓ **Price-to-book ratio** – calculated by dividing a company's current stock price per share by its book value per share.[3]
- ✓ **Price-to-earnings ratio** – calculated by dividing a company's market value price per share by its earnings per share.[4]
- ✓ **Price-to-cash-flow ratio** – calculated by dividing a company's share price by its operating cash flow per share.[5]

The lower a company's price-to-book, price-to-earnings and price-to-cash-flow ratios, the more likely it may be considered a value stock. However, checking the box on those valuation metrics alone don't mean that a company is a good investment. In fact, an investor needs to be wary of "value traps," which might make a company appear to be a good value but is in fact the opposite. For example, examined in isolation, a company may appear cheap based on its price-to-book ratio, when in fact it may have a lot of debt on its books, which is inflating the measure of its assets.

Koltek stresses that while examining valuation multiples like price-to-book, price-to-earnings and price-to-cash-flow are an important starting point, it's important to layer on a strategic and qualitative assessment to understand the long-term earnings power of a company. This might include evaluating the strength of a company's competitive advantages and talking to company management teams to assess their vision and strategic direction for the firm.

The long-term view

By its very definition, value investing needs to be a buy and hold approach. "Patience is required," say Koltek, "because you're waiting for the market to realize the company's value in the stock price- the value investor purchased the stock because they believed it was undervalued." If an investor has patience, they can wait for the reprice of a value stock where return potential can be sizable.

Investing for the long term in a company that is valued less then you would expect can provide both protection against losing money and the possibility of being rewarded once the stock market recognizes the stock's true value.

Value stocks support a balanced portfolio

Koltek recommends building a properly diversified portfolio with exposure to both growth and value investing as the two approaches complement one another. While growth investing tends to place more emphasis on growing capital, value investing is often considered to have more defensive characteristics.

There's always the potential risk, however, that the market may continue to punish a stock even if it's fundamentally a fine company. Plus, there's always the possibility that a stock may be cheap for a reason. Koltek says, "value and growth investing work well together – exposure to both can help smooth out returns for a client." That's why he says Portfolio Solutions Group employs both strategies as part of its portfolio construction process. "We take what I call a balanced approach to investment styles and don't have an allegiance to or a belief that there's only one style that's the right way to invest," emphasises Koltek. We know there isn't one style of investing that works best across all time periods, all countries, or all sectors. There could be a growth market in one area and a value market another."

Talking to clients about value investing

Right now, we're in a situation where investors want to know what their advisors are doing to protect their portfolio from market volatility. They're concerned about rising interest rates and persistently high inflation and want to know if they should consider different investment options given today's economy.

This provides the opportunity to explain to your clients how allocating a portion of their portfolio to value investments can help provide them with both downside protection and the potential for long-term gains. However, while value investing is classified as a "low-to-medium-risk strategy,"[6] it's always essential to consider your clients overall risk tolerance and investment timeline when making any investment recommendation.

Value investing – Why now?

Here are five key things to know before having a conversation about value investing with your clients:

1

Value is making a comeback: Current economic conditions – including rising interest rates and other economic headwinds – are resulting in value investing coming back in favour. This is due, in part, to the fact that investor pessimism and market and economic drivers may cause some stocks to become undervalued.

Takeaway: It's a good time to understand and assess the value allocation in your portfolio.

2

Higher interest rates make value more attractive: During periods of high interest rates when companies' growth may be negatively impacted by higher capital costs, value stocks may tend to outperform growth stocks.

Takeaway: Does your portfolio have a disproportionate weighting to growth with respect to your risk tolerance?

3

Patience is important: You're not going to get instant gratification through value stocks. As it may take many years for a stock's price to match its intrinsic value, value investing should be viewed as a long-term strategy.

Takeaway: Realizing value may take time in your portfolio and avoid making investor behaviour pitfalls.

4

Active management matters: Always look for a manager who is able to layer on strong fundamental analysis, including qualitative inputs such as understanding a management team's strategy, credibility and long-term vision.

Takeaway: Do the homework on your investment managers and understand their particular approach to value investing.

5

Diversification is key: Don't look at value investing in isolation. Value and growth both have a role to play in a well diversified portfolio. It's wise to incorporate a balanced approach as no one investment style can be expected to always be dominant.

Takeaway: Ensure your portfolio is appropriately diversified across investment styles to help you capture upside and mitigate downside risk.

To learn more about Canada Life's fund offerings, including funds that take a value investing based approach, contact your Canada Life wealth wholesaler today.

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Sources:

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