Aditya Birla Sun Life AMC Ltd.
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Value, Growth and Quality – A Global Perspective

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Understanding Value, Growth and Quality

Value investing aims to invest in companies that are trading at a significant discount to their fair value based on traditional valuation metrics (such as price-to-book and price-to-earnings) and hence provide a margin of safety. Companies that are surrounded by pessimism, but which still have strong fundamentals make for attractive investment opportunities. Globally, sectors such as Financials, Commodities, Utilities, and Capital Goods sectors usually fall in the Value category.

Growth investing on the other hand aims to create capital appreciation by identifying companies that can sustain high growth rates for a long period of time. While growth investors also rely on valuation metrics, they are willing to pay a premium for companies that are on an exponential growth path. Globally, sectors such as Technology and Consumer Discretionary fall in the growth category.

The third pillar is investing in quality stocks which share two key characteristics. The first is cash generation. Quality stocks tend to generate high quality earnings, which means that their earnings translate into strong cash flows. These cash flows enable quality companies to reward investors through dividend pay-outs even after investing for growth and protect them from liquidity and insolvency risk during a downturn. The second characteristic is low earnings volatility. Quality companies rarely see large downswings in their earnings as they tend to provide products that their customers can't substitute away from and they also have strong moats which prevent new entrants from taking away market share.

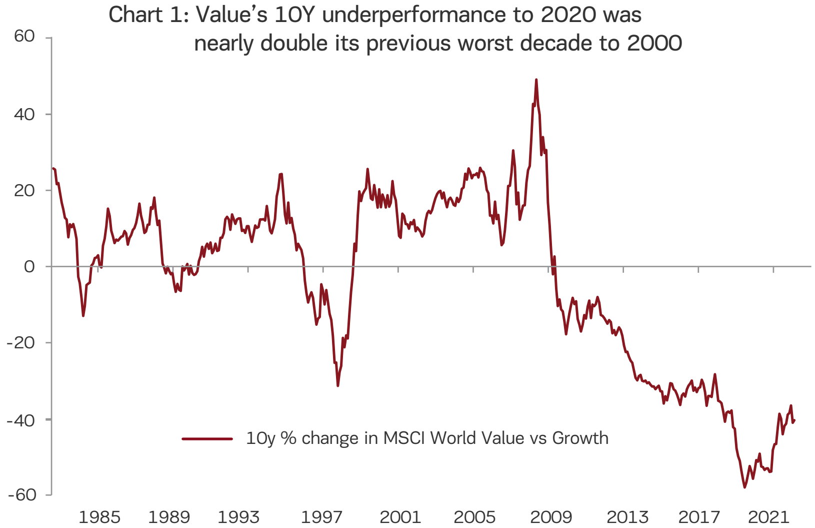
In modern investing most investors combine insights from all three of these styles when they invest. Even well-known value investors such as Warren Buffet have paid a premium for quality companies and have also invested in technology growth companies, while some of the most renowned growth investors such as Peter Lynch have invested in value companies.

Investors rotate in and out of value, growth and quality stocks based on macroeconomic conditions, interest rates, valuations and business fundamentals.

2010-2020: The decade of Value Underperformance

Historically, value stocks have out-performed growth stocks in 8 of the last 10 decades. However, the last decade (2010-2020) was the worst decade for value stocks since the 1920s.

Chart 1: Value's 10Y underperformance to 2020 was nearly double its previous worst decade to 2000



Source: MSCI, Morgan Stanley Research

Note: Relative performance of MSCI Growth and Value Index Since 1985

Growth stocks, most notably, technology growth stocks staged a comeback in the 2010s driven by both macroeconomic factors and strong earnings performance:

Earnings Outperformance by Growth:

With banks struggling to recover from the GFC and depressed commodity prices due to sluggish global growth, earnings of value stocks disappointed through the decade. Meanwhile, growth companies such as technology start-ups delivered strong growth as venture capital financing exploded and as smartphones and the internet became ubiquitous.

Loose monetary policy:

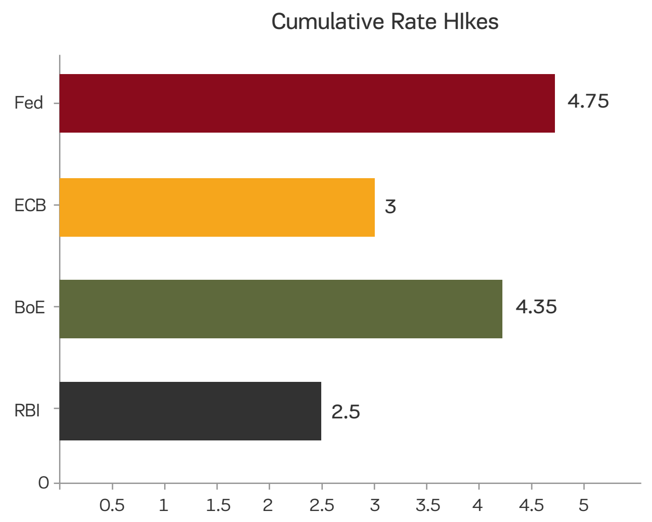
In the aftermath of the GFC, central bankers globally loosened monetary policy to stimulate a stagnating global economy. First by taking interest rates to 0, then by employing unconventional monetary policy tools such as quantitative easing and forward guidance which lower long terms bond yields. Lower bond yields disproportionately help growth stocks, as most of the cashflows for growth stocks are far out in the future so small changes in the discount rate have very large effects on the present value of those cashflows.

Stagnating Global Economy:

Growth stocks tend to outperform during periods of slow economic growth. As most companies struggle to deliver strong earnings growth in a stagnating economy, investors give a larger premium to growth companies which are able to sustain high growth rates. However, in a healthy fast-growing economy, where most companies are delivering satisfactory growth, investors are usually less willing to give large premiums to fast growing companies. In the aftermath of the GFC and Eurozone debt crisis, most economies delivered subdued growth. This led to enormous multiple expansion for growth companies, especially technology growth companies, which continued compounding their earnings (or revenue) at a staggering rate.

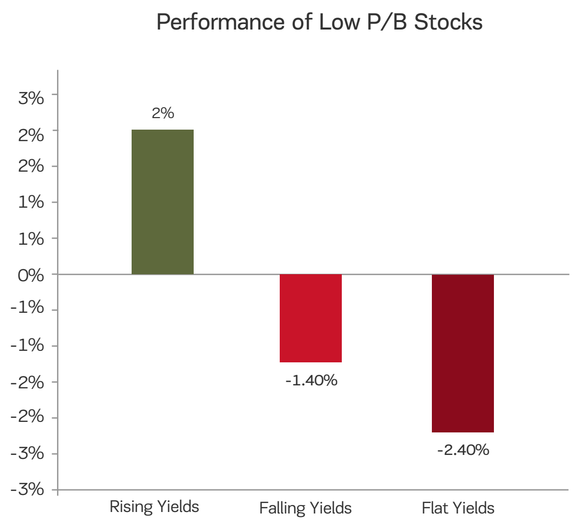
Current Environment - Rate Hikes Hurt All Stocks, but Especially Growth Stocks

2022 was a year defined by tightening of monetary policy by global central banks. The tightening was led by the Federal Reserve which embarked on the most aggressive tightening in over 40 years. The Fed was followed by other major Central banks such as the ECB, Bank of England and RBI. Furthermore, in developed markets, unlike previous tightening cycles, markets priced in these rate hikes across asset prices well before the central banks actually announced the hikes. The result was a significant downturn in global equity markets despite companies delivering decent earnings growth.



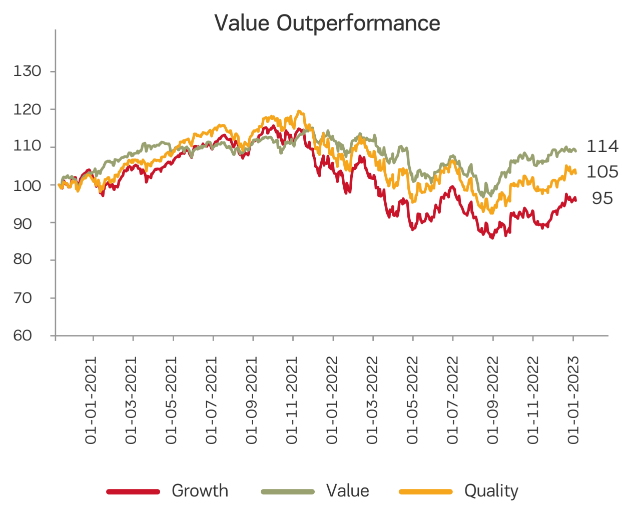
Source: Federal Reserve Economic Data, RBI, Bank of England

These rate hikes came after over a decade of ultra-loose monetary policy which inflated stock valuations. Low rates and high equity multiples increased the duration (interest rate sensitivity) of equities globally which made them especially vulnerable to a large monetary policy tightening like the one we witnessed. Growth stocks, which are generally high duration stocks, had benefitted most from the loosening of monetary policy after the financial crisis and had over a decade of out-performance. In 2022, as interest rates rose, the trend reversed as value stocks delivered significant outperformance. Furthermore, as people returned from lockdowns, many of the technology companies, which saw an earnings boom during the pandemic, struggled to keep up their growth trajectory.



Source: BofA Securities

Note: Performance of low P/B stocks relative to equal weighted S&P 500 in various bond yield environments



Source: MSCI, Citi

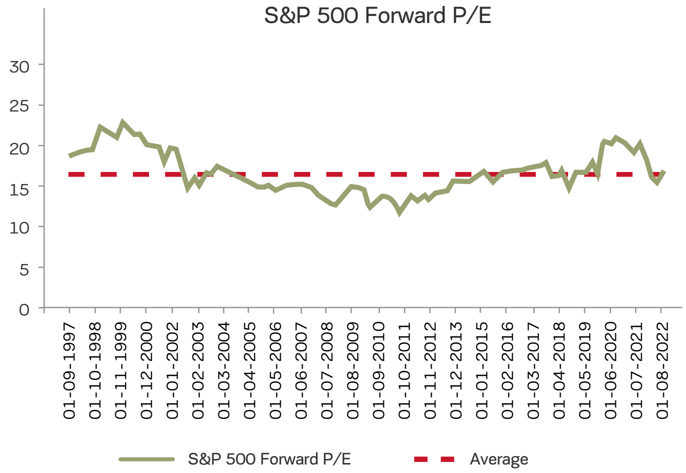
Note: MSCI Growth, Value and Quality Index performance since 2021

Road Ahead: Global Markets

Interest rate hikes are now largely priced in. This has been reflected in equity multiples, with the S&P 500 P/E now at its historical average.

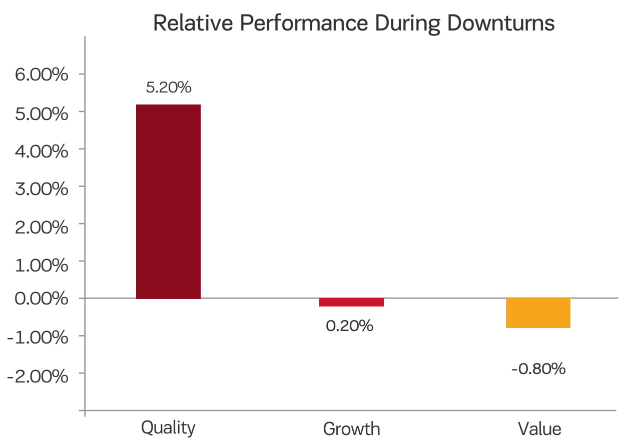
We believe the focus will now shift from multiples to earnings. The slowing effects of the monetary policy are yet to completely flow through the economy. We have already seen a significant slowdown in interest rate sensitive sectors such as housing but as the effects of the tightening get more widespread, delivering strong earnings growth will be the key challenge for companies.

Given central banks are committed to stay the course and bring inflation back down to 2%, we believe it is a little early to jump back into growth. Meanwhile, value companies tend to be more cyclical, and in the current environment of slowing growth, they will likely struggle to keep up with earnings expectations.



Source: Bloomberg

Quality stocks have historically outperformed during slowdowns and recessions. As inflation slows while wage pressures persist, we expect quality companies with strong pricing power to be best placed to maintain earnings trajectory. Quality stocks with low earnings volatility are likely to outperform in the current environment.

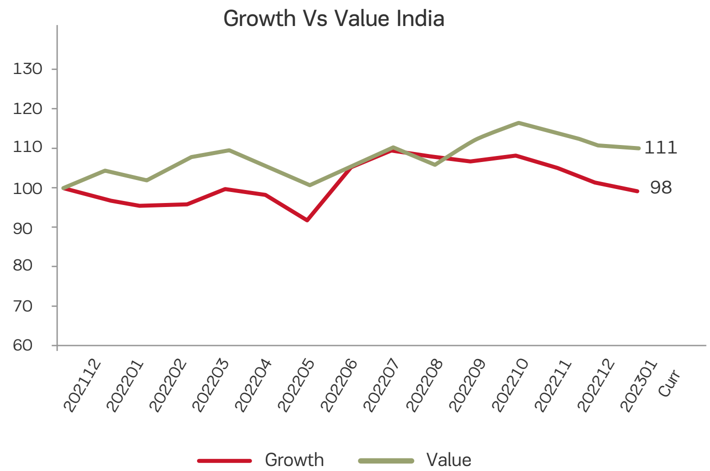


Source: BofA Securities
Note: Equity performance of growth, value, and quality stocks during economic downturns since 1987

We believe as growth, especially nominal growth, slows in 2023, market will reward companies that are able to deliver strong earnings growth in a more challenging environment. Meanwhile, as the global economy takes a downturn, we believe quality stocks, which are least prone to earnings cut, will be best placed to withstand the pressure from global recession fears.

Given this global context, the next question is what can we expect in Indian markets?

The value outperformance theme has played out in India as well in 2022. Like in the case of global markets, rising bond yields were the primary driver of this outperformance. However, Indian value stocks were also helped by the additional tailwind of a robust recovery from Covid in 2022, which helped cyclical value stocks such as banking.



Source: S&P, Axis, ABSLAMC Research