

Has Value's Run Just Begun?

Part 1: The Economic and Fundamental Case

MAY 2021



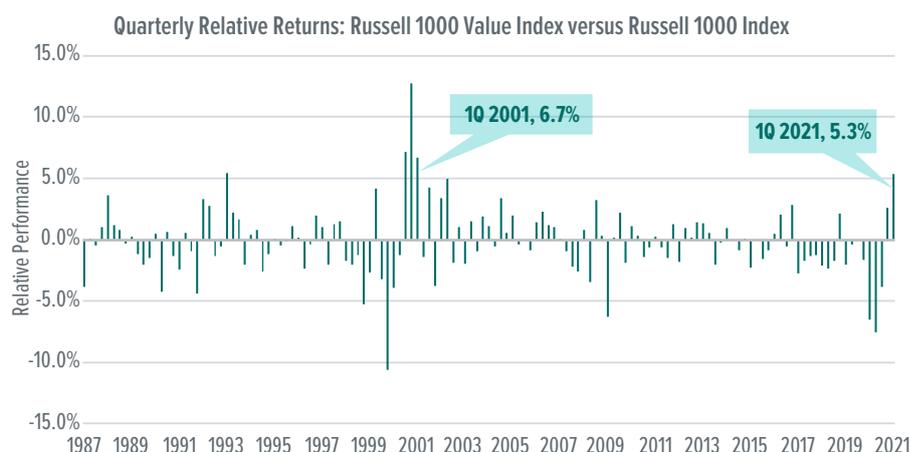
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Snapshot

- Stock-market leadership shifted firmly in favour of value shares last autumn; by the first quarter of 2021, value registered its best performance versus growth in two decades.
- We believe this is just the beginning of value's run; the current economic backdrop favours value, which remains extremely cheap by historical measures as its earnings prospects are seeing unprecedented upgrades.
- Investors who hastily cash in on today's market gains face a good chance, in our view, of missing out on the potential for significantly greater returns as value should continue to ascend.

As equity markets pushed further into record-high territory around the world during the first quarter of 2021, value stocks posted their best performance versus growth shares in two decades (Exhibit 1). Investors may now be wondering how much fuel is left in the proverbial value tank, pressured by a sense of urgency to cash in while their holdings are still hot. We can appreciate the anxiety. However, not only do we view emotionally driven investment decisions as unwise, we have reason to believe that value stocks (cheaply priced companies) have a bright future on the equity-market stage.

Exhibit 1: Best Quarter for Value in 20 years



Source: SEI based on data from FTSE Russell and FactSet. Data as of 3/31/2021. Index returns are for illustrative purposes only, and do not represent actual performance of an SEI Fund. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance is not a reliable indicator of future results.

Has Value's Run Just Begun? is a five-part series dedicated to providing detailed insight into the rationale behind our conviction in value stocks. Each paper will address a specific topic, beginning with the economic and fundamental case for why we believe value leadership is just getting started. The full series will explore:

1. Positive economic drivers and favorable fundamental valuations that support the case for value
2. Historical stock market patterns and reasons to remain patient when growth stocks may temporarily retake the lead
3. Why the timing appears right for value from an opportunistic standpoint
4. The types of strategies that we believe are best suited to capitalize on this potential value rotation
5. How the history of rising interest rates has impacted value and other factors

All references to performance are in U.S. dollar terms unless otherwise noted.

Bargain prices on the frontrunner

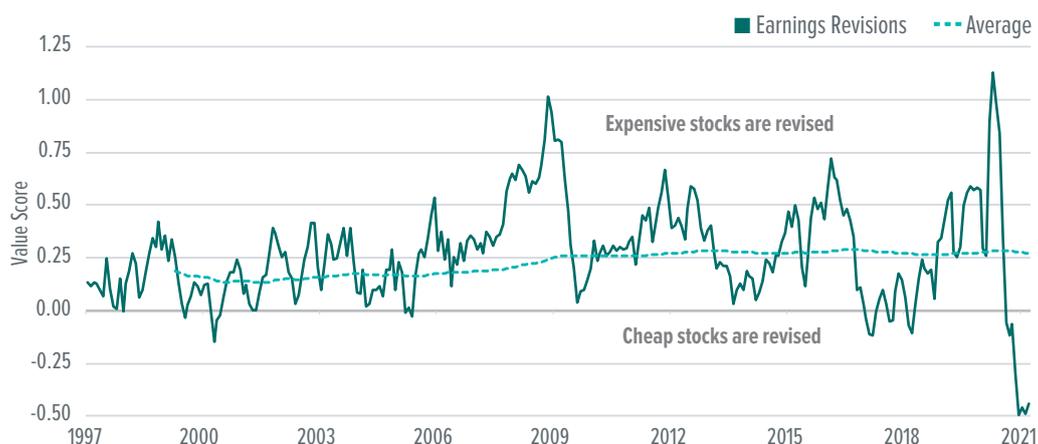
Let's start with the economic drivers and fundamental security analysis that give us good reason to have an optimistic outlook for value. At the macroeconomic level, the global economy has begun to recover from the COVID-19 pandemic—and cyclically oriented stocks (companies that sell discretionary products that consumers historically buy less frequently during economic downturns and more of during recoveries) have been the greatest beneficiaries of this growth. Meanwhile, cyclical stocks are often inexpensive relative to the broad market during slowdowns (think “value” stocks) because, by definition, cyclicals are affected by shifts in the economic cycle. Throughout the economic era of COVID-19, equities have adhered to this pattern. Now, we believe the economic floodgates are just beginning to reopen as vaccine distribution offers the potential to return to normal consumption patterns.

At a more granular economic level, manufacturing activity can serve as a useful proxy for the relative performance of value over time. Strong manufacturing growth, as measured by purchasing managers' indexes (PMIs), implies accelerating economic activity—which, as we said, has an outsized benefit for cyclical companies. And manufacturing PMIs are expected to remain strong for the foreseeable future given the economic opportunity that reopening would provide.

Speaking of consumers...as US government stimulus checks hit consumers' bank accounts, the nation's personal savings rate has reached its highest levels on record (dating back to 1959)¹. This suggests that residents of the world's largest consumer market are well positioned to increase their personal spending.

The improving prospects for value shares are also apparent as companies project future earnings—with estimates being revised upward (Exhibit 2). By plotting earnings upgrades and downgrades according to stock price valuations, we can see that cheap shares are being upgraded relative to expensive shares at the fastest rate we have seen dating back to 1997, the start of our dataset. What does this tell us? Earnings expectations for value shares over the coming year have improved so sharply that their valuations from just a few months ago have become obsolete at this point.

Exhibit 2: Valuation of Earnings Revisions

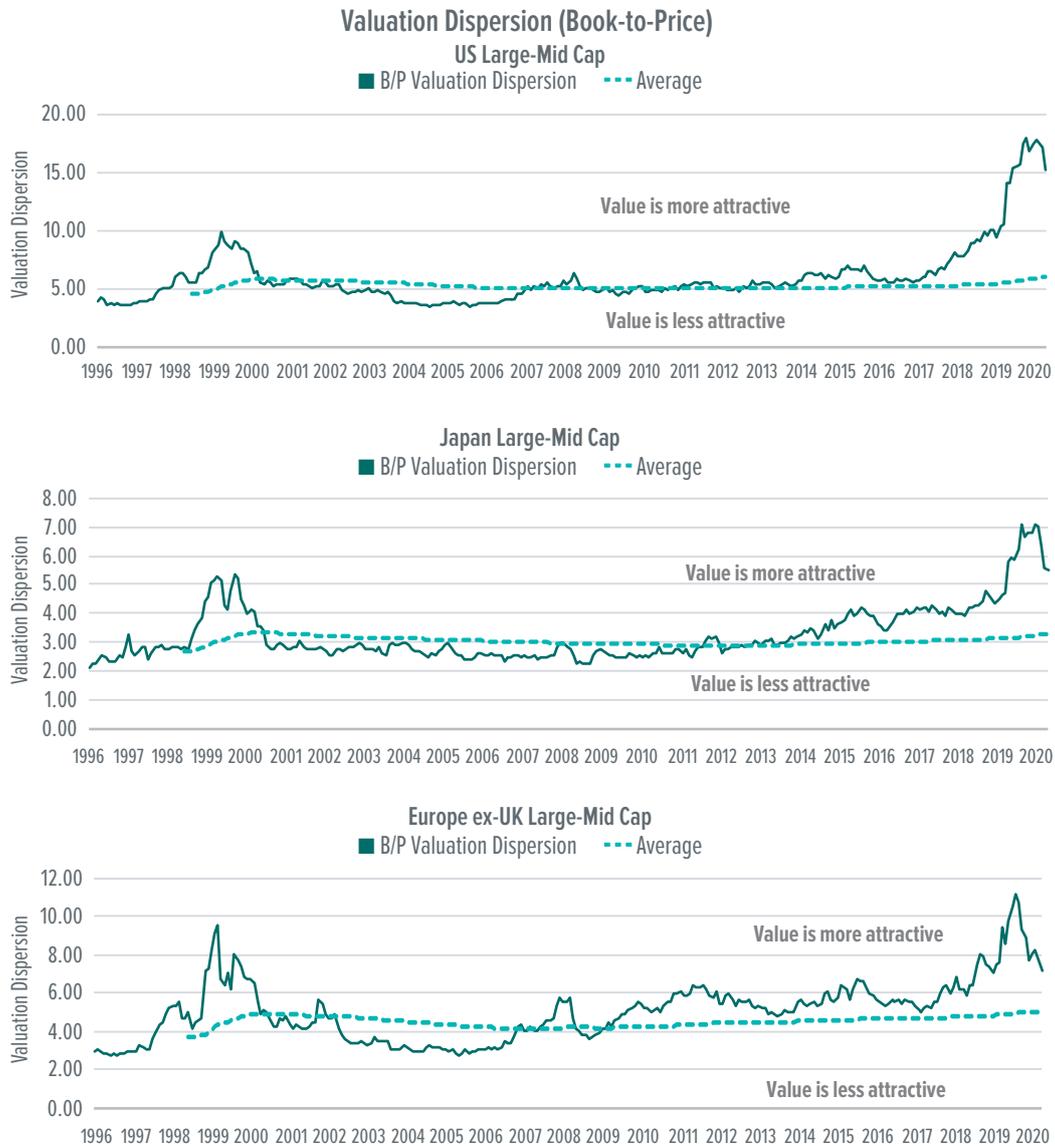


Source: SEI based on data from S&P, FactSet, Axioxa. Index: S&P Developed LargeMidCap Index. The Value Score is measured by the difference in median valuation between the top and bottom quintiles of earnings revisions. The chart also shows Average (dotted teal) line on an expanding basis.

¹ See the U.S. Bureau of Economic Analysis “Personal Saving Rate” release as part of the Personal Income & Outlays report. Relevant reports are dated April 2020, January 2021, and March 2021, coinciding with the distribution of US federal government direct stimulus payments.

This sharply brightening outlook for value has coincided with a steep bargain in its pricing. Value shares began their run of outperformance last fall at historically inexpensive valuations (Exhibit 3). They’ve since grown less cheap, although not by much, and there are regional variations. Generally, the gap between growth and value stocks still has a long way to go before reverting to long-term averages across all regions.

Exhibit 3: Excesses Begin to Correct



Indexes: S&P United States LargeMidCap Index, S&P Europe ex UK LargeMidCap Index, and S&P Japan LargeMidCap Index. Valuation dispersion is measured by a ratio in median values of equally weighted 2nd and 9th deciles. The charts also show Average (dotted teal) lines on an expanding basis. Source: SEI based on data from FactSet, Axioma. Data refers to past performance. Past performance is not a reliable indicator of future results. Index returns are for illustrative purposes only, and do not represent actual performance of an SEI Fund. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index.

SEI's View

With the economic backdrop in favour of value, which remains extremely cheap by historical measures, its earnings prospects are being upgraded to the highest degree in at least several decades (and perhaps longer, as we are limited by the dataset). We therefore believe that value still has a long way to go as the star of this market cycle.

With that noted, we are under no illusions that it will be a smooth ride. The next entry in this series—*Has Value's Run Just Begun? Part 2: A Long and Winding Path*—uses the tech bubble of the 1990s as a case study in exploring how a strong equity-market rotation to value can unfold in a halting and uneven manner that may test investor patience.

Glossary of Financial Terms

Cyclical stock: Cyclical stocks are those whose performance is closely tied to the economic environment and business cycle.

Growth: Growth stocks exhibit steady price or earnings growth above that of the broader market.

Purchasing managers' index (PMI) survey: A PMI survey is compiled from responses to questionnaires sent to a panel of purchasing managers working, for example, in the manufacturing and business services sectors.

Index Definitions

Russell 1000 Index: The Russell 1000 Index includes 1,000 of the largest U.S. equity securities based on market cap and current index membership; it is used to measure the activity of the U.S. large-cap equity market.

Russell 1000 Value Index: The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values.

S&P Developed LargeMidCap Index: The S&P Developed LargeMidCap Index comprises the stocks representing the top 85% of float-adjusted market cap in each developed country.

S&P United States LargeMidCap Index: The S&P United States LargeMidCap Index comprises the stocks representing the top 85% of float-adjusted market capitalization in the U.S.

S&P Europe ex UK LargeMidCap Index: The S&P Europe ex UK LargeMidCap Index comprises the stocks representing the top 85% of float-adjusted market capitalization in Europe excluding the U.K.

S&P Japan Large MidCap Index: The S&P Japan LargeMidCap Index comprises the stocks representing the top 85% of float-adjusted market capitalization in Japan.

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