Is the environment poised for Value-Style Recovery? - A duration perspective

The valuation of almost any asset is principally the discounted cash flows generated by that asset using the appropriate discount rate[1]. Expectations of the timing when cash flows are to flow to asset owners are a crucial component in assessing value. This concept, largely synonymous with bonds, is called duration.

In the world of bonds, understanding the relationship between the time you expect to receive the income (interest) and principal from your bonds and the change in interest rates is essential. When interest rates rise, bonds that have more of their cashflows further into the future or time to maturity (say twenty years) tend to decline more in value than those with a shorter maturity (say two years). The reverse, wherein interest rates decline, benefits the valuation of longer-term bonds more than shorter-term bonds.

The concept of duration can help explain the decade-long Value-Growth equity style performance divergence. The concept can also assist in setting expectations and understanding the recent reversal of the historical growth-style outperformance as the level of interest rates increase, and inflation pressures accelerate. With respect to equities, using the duration framework for valuation and expectations is underappreciated. Still, it works just the same as in bonds, albeit more challenging due to the increased uncertainty on the amount and timing of dividends payments and other equity cash flows.

From the framework above, Growth-style stocks (like technology companies) can be characterized as those whose cash flows and growth are expected further into the future, with a significant part of their present value captured in the future (in the terminal value). On the other hand, Value-style stocks can be characterized as those that have, on average, their cash flows much more near term and depend less on expected future growth. In this framework, one can notice the time factor or duration inherent in those descriptions - Value-style stocks are shorter in duration, while Growth-style stocks have a longer duration. In an inflationary environment such as the one we are in, one can appreciate that money today would have more worth compared to further into the future, making the short duration, value-style attractive at this moment.

The decade after the Global Financial Crisis in 2008/9 was characterized by declining and ultra-low interest rates. This interest rate environment supported Growth-style stocks' outperformance over Value-style, as investors were willing to pay more for stocks with long-term secular growth and with cashflows further into the future, such as technology stocks (Figure 1). However, to the extent that the relative style performance has been interest-rate dependent, it now seems the decade-long Growth-style outperformance is reversing in light of currently higher interest rates.

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[1] The discount rate is the interest rate used to determine the present value of future cashflows from an asset.

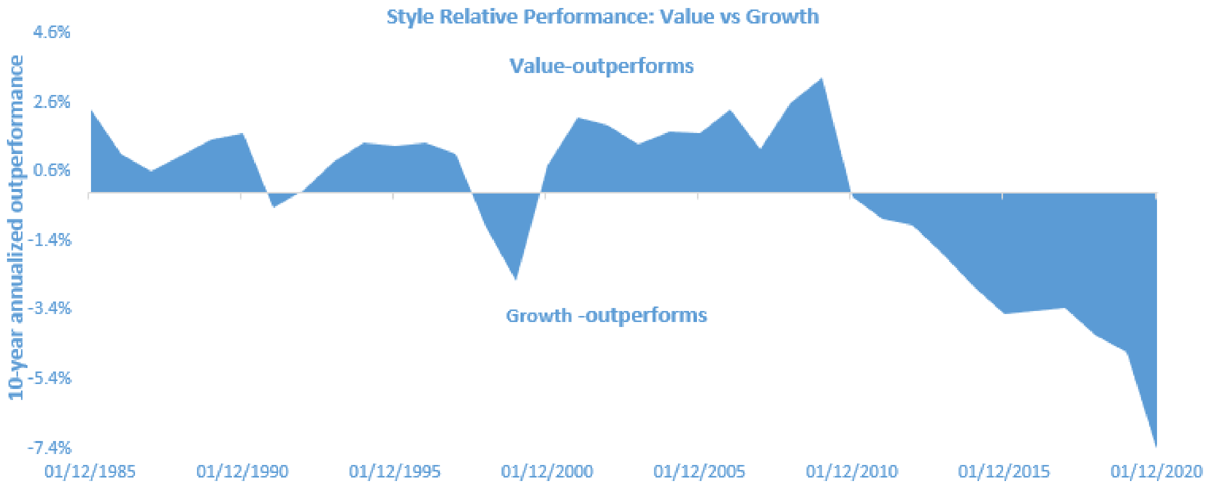

Figure 1

Source: Bloomberg Finance, L.P., Bifm. Value-style is represented by the MSCI World Value Index. Growth-style is represented by the MSCI World Growth Index.

Duration and interest rates consideration in equities should matter for asset allocators like pension funds and their investment managers. This is because equities typically account for the largest allocation in long-term balanced portfolios; therefore, understanding how the rising rates and inflationary environment can change previously observed performance is essential.

The prevailing market environment can help us to understand the change. Measures aimed at controlling the Covid-19 pandemic, like lockdowns, wreaked havoc on economies. Consequently, monetary and fiscal authorities injected significant stimulus into the economy and financial system and maintained ultra low-interest rates. These actions supported the rise of asset prices, especially growth assets in 2020 (Technology and other growth stocks continued to rally in this period, overperforming value stocks and cementing the decade-old trend). However, these actions also brought about inflationary pressures as countries experienced growth from re-opening their economies and the supply side struggling to cope with increasing demand.

Furthermore, the Russia-Ukraine conflict exacerbated already existing inflationary pressures. As a result, expectations for higher rates and yields prevail in the market as central banks continue tightening monetary policy to tame inflation. From the duration framework we described, when interest rates trend up, the market environment challenges the longer duration nature of Growth-style stocks, which had dominated in the past decade.

Even within this volatile period, we can already see that the currently high-interest rate environment impacts equity style performance in different ways - with short-duration style (value) retaining relatively more value than long-duration stocks (growth). Since January

2021, the growth style has lost most of its pandemic gains in this period, while the value style remained resilient as interest rates rose.

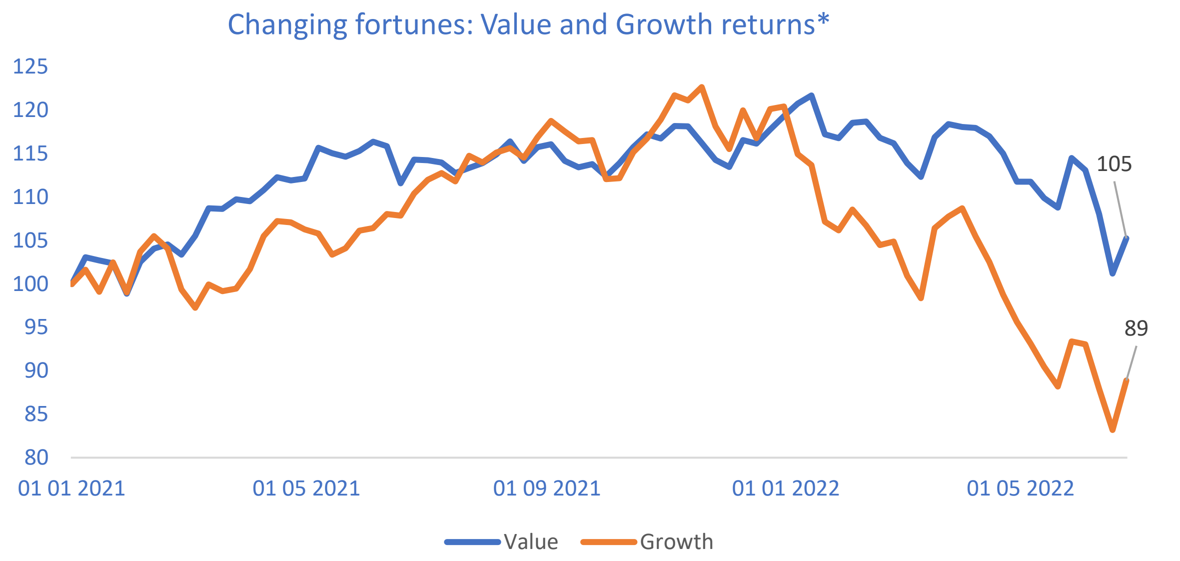

Figure 2

Source: Bloomberg Finance, L.P., Bifm. Value- style is represented by the MSCI World Value Index. Growth-style is represented by the MSCI World Growth Index. *Weekly returns over the past 18 months from 1 January 2021.

Indeed the level of interest rates is not the only explanatory factor for the past and future equity style performance divergence. However, recent market observations demonstrate what might occur going forward in an environment where interest rates rise, which may justify a tilt to value (Figure 2). For those responsible for asset allocation and security selection, long-term company fundamental valuation in the context of the market environment should still remain central. This is especially relevant as significant earnings growth recovery or deterioration can weaken the impact of rate changes on equity style performance. Additionally, inflation can have a pernicious effect on equities, with some sectors and styles being spared more than others; therefore, a thorough fundamental analysis should be used to ascertain opportunities.

In summary, your portfolio should be positioned towards those sectors and styles that are less sensitive to interest rates and can absorb the impact of inflation, which may warrant the addition of high-quality value style stocks in your portfolio.

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