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Marketing material

Value vs. Growth

Strong performance of the "Magnificent Seven" has pushed value stocks into the background - wrongly so?

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IN A NUTSHELL

– Growth stocks are currently enjoying a tailwind, driven mainly by the impressive performance of the Magnificent Seven in the U.S.
– Given that secular trends can generally only be reversed by massive changes in influencing factors, there is still potential for growth stocks, although the risks are also increasing.
– Diversification considerations clearly favor value stocks in a portfolio context, especially over the long term, and valuations currently appear attractive.

Short-term trend or longer-term drifting apart?

Value vs. growth - this decade-old competition between the two equity strategies has recently been given fresh impetus by the impressive performance of the "Magnificent Seven" and other growth stocks, particularly in the U.S., but also in Europe. Since the beginning of 2023 the growth segment has once again decoupled markedly from value stocks. Although the hype around growth seems to be subsiding somewhat at the moment, it remains to be seen whether this heralds the end of the sector's big outperformance of value. We continue to see a good case for both strategies and certainly see the need to find a balance between them in the investment portfolio. Diversification is key.

1 / Value versus growth - the eternal struggle

The definition of growth versus value stocks is simple, at least in theory. Value companies generally have low price-to-book ratios, high dividend yields, and low price-to-earnings ratios; the opposite is true for growth companies. In practice, however, the distinctions are sometimes blurred. Apple, for example, is seen by some strategists as a stock that wanders between the growth and value worlds; it seems to be evolving more and more into a value stock. Value stocks are mainly found in the financial, healthcare, industrial and energy sectors. Growth stocks are mainly found in the technology, consumer discretionary and communication services sectors. Growth stocks typically grow significantly faster than their counterparts in terms of sales and, above all, profits. They are young, innovative and agile companies that differ in many ways from mature, highly cyclical value stocks. The growth segment is riding a wave of success as disruptive ideas and technologies capture the zeitgeist and offer hope for future growth.

1.1 Unusually low interest rates have led to the outperformance of growth stocks over the past 15 years

Since about 2007 economic conditions have created an environment in which, with one notable exception in 2022, growth stocks have flourished while value stocks have lagged (based on the MSCI World Growth and MSCI World Value indices). Historically, value and growth periods have alternated at regular intervals, with growth stocks enjoying somewhat longer periods of outperformance. Value stocks have often been popular in the past when the economy was booming. This was mainly due to the fact that industrials and energy stocks, for example, tend to be cyclical. On the other hand, when the economy was doing poorly, defensive stocks such as utilities were in demand. Growth stocks, by contrast, performed well when growth was only "moderate." This type of environment, with average growth, has tended to persist for much longer periods of time.[1]

Historically, phases of outperformance between value and growth alternate relatively regularly

Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 3/22/24

However, the unusually low interest rates of the past decade and a half have created an imbalance. With interest rates close to zero, it suddenly became attractive for investors to take longer-duration equity risks. Companies whose cash flows were further in the future began to be appealing. Value companies, which tend to generate earnings earlier, became less of a focus. Covid-19 gave growth stocks an extra boost as demand for the products of companies like Apple and Netflix soared during the lockdown.

Things changed drastically in 2022 as central banks around the world began raising interest rates to combat rampant inflation. Technology stocks plummeted and investors fled to the perceived safety of value stocks. As a result, the MSCI World Growth Index was down by nearly 30% in 2022, while its value counterpart fell by "only" about 8.5%.

This mixed picture did not last long, however, as growth stocks rebounded sharply in 2023, gaining nearly 37% and outstripping value stocks by the second-highest margin in 25 years (after 2020). The regional banking crisis in the U.S. in the spring of 2023 hit financials, an important value component, even though rising interest rates should theoretically have favored this segment. The "Magnificent Seven" again rushed ahead, pulling the major growth indices higher and leaving the value segment by the wayside once again.

Many strategists hoped that the comparatively very low valuation of value stocks at the end of 2023 could provide them with a tailwind. "When the cost of capital is no longer zero, what matters is what you pay for things," was just one of the approaches to value.

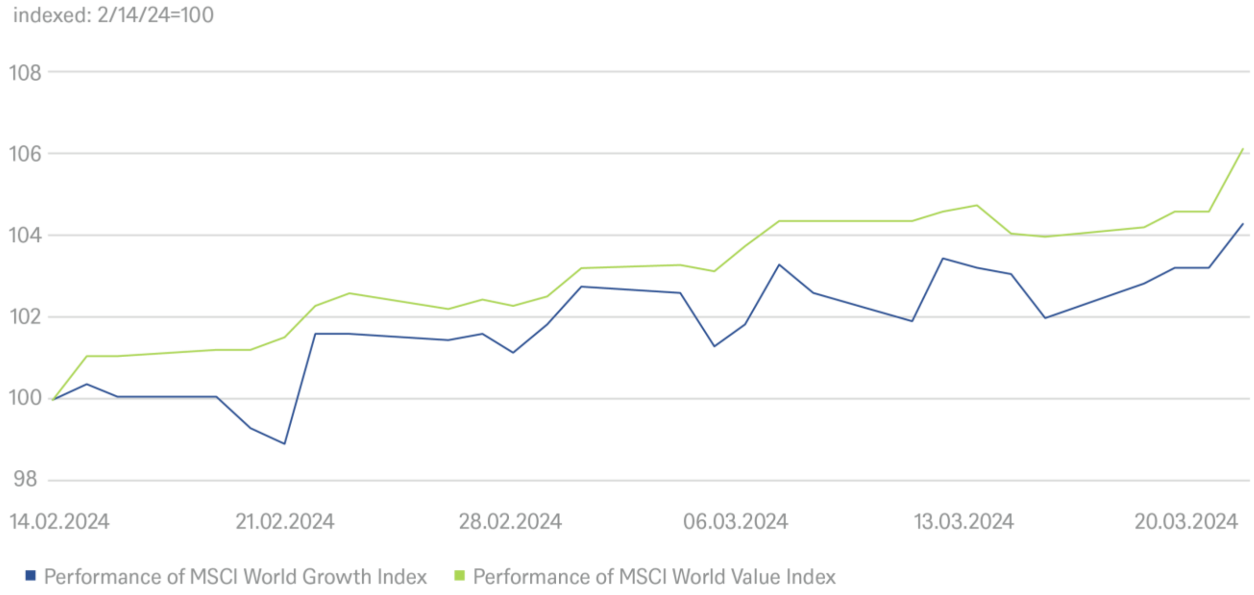
[1] All data and valuation metrics – unless otherwise stated – Bloomberg Finance L.P. as of 3/22/24

1.2 Magnificent Seven and Nvidia in particular continue to drive growth momentum in early 2024

However, the first few weeks of 2024 paint a different picture. For the time being, the dominance of growth stocks has continued or even increased slightly. Value is once again clearly lagging in terms of year-to-date performance. The Magnificent Seven and, within them, Nvidia are again the main drivers. From the beginning of the year to mid-March, Nvidia's share price has risen by no less than 80%; it now has a market capitalization of more than USD 2 trillion. This makes the shares of the developer of graphics processors and chipsets stand out even among the Magnificent Seven.

For about four weeks now, however, since mid-February, the order has been reversed, with value leading the way in terms of performance. There are increasing signs that broad-based support for growth stocks may have peaked. It remains to be seen, however, whether we are entering a more prolonged period in which growth stocks will be overtaken by their value counterparts.

Since mid-February, value has been ahead of growth again



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 3/22/24

How global growth, inflation and, consequently, interest rates on both sides of the Atlantic evolve will be influential. If the economic environment is not solid enough from an equity investor's perspective, value could continue to be challenged. But falling interest rates and moderate inflation and growth could continue to support growth stocks, though expectations of interest rate cuts in the U.S. and Eurozone have retreated significantly since the beginning of the year. And if rate cuts are smaller and perhaps less frequent than the broad market expects, this could create a supportive environment for value stocks. It is also conceivable that a period of slower growth will benefit defensive value stocks such as utilities and consumer staples, while more cyclical stocks are likely to be among the losers.

1.3 Concentration of global equity markets is going to extremes

A few stocks make the market. As simple as this saying may be, it reflects the current reality, especially in the U.S. The market lacks breadth and concentration is high – too high? In 2023, the top five individual stocks contributed around 13% to the performance of the S&P 500 index. In addition to Nvidia and Microsoft, these top performers include Alphabet, Amazon and Apple, the best stocks in the Magnificent Seven. The Magnificent Seven alone now account for 34% of the market capitalization of the S&P 500. Moreover, the market capitalization of the top 10% of U.S. stocks is now back to just under 75% of the entire capitalization of U.S. stocks, a level that in the longer term has typically led to a sharper countermovement. By comparison, the median market concentration since 1926 has been just under 65%. Such valuation metrics could therefore play an important role in a potential rebound in value.

Another interesting observation is the development of factor returns in the S&P 500 over the past year. Those factors that are typical of the growth sector showed a clear positive development; for example, "high WACC" (weighted average cost of capital) and "high beta" stood at 17.2% and 16.8%, respectively. On the other hand, items such as "low earnings growth" and "low beta" were clearly in the red.

Looking at stock market performance over a very long period of time, it is easy to see that the sectors that were most important in each economic phase also played the biggest role in the indices. Today, the technology sector is about the same size as the energy sector at its peak in the mid-1950s. It remains smaller than the transportation sector (which dominated the 20th century) or the financial and real estate sectors that made up most of the stock market in the 19th century.[2]

Concentration in the American stock market at a historic high

Sources: Deutsche Bank Research, DWS Investment GmbH as of January 2024

High concentration in the indices also means high concentration in the corresponding actively managed funds, as active positioning against the general market trend can quickly be punished. Too little diversification, in turn, makes funds vulnerable to rapidly changing market conditions, such as when sentiment turns against value, and many fund managers have to "jump in".

[2] See Visualizing 200 Years of U.S. Stock Market Sectors, Visual Capitalist as of 1/25/19

2 / Growth is currently well ahead in investors' favor

Growth refers to companies that operate in growing markets, gain market share and have pricing power. Growth investing strategies target companies with above-average growth potential. In general, innovation is difficult to predict, especially the exact timing of its arrival. However, when a breakthrough does occur, the company's earnings growth is usually elevated to a new level. In addition, the company is often able to perform largely independently of economic developments for a certain period of time.

A different perspective is also required with regard to the dividend to be paid by growth stocks. Dividend payments are usually much lower than in the value segment. However, when investing in growth stocks, the main objective is to provide the company with capital for research and development over the long term, ideally in order to achieve sustainable earnings growth. In general, growth stocks, by definition, grow earnings faster. Historically, it takes about ten years for earnings to double, while value stocks can gain about 50% over the same period. Over the past ten years the MSCI World Growth index has achieved annual earnings growth of about 10.5%, while its value counterpart has achieved 3.42%. Growth investors expect stock prices to follow earnings; conversely, this means that growth stock price performance should exceed that of value stocks.

Another important consideration when looking at growth stocks is interest rate sensitivity. Growth companies are sensitive to rising interest rates because future earnings are discounted at the current rate. In general, the higher the interest rate, the lower the current value. This rule does not seem to be playing a major role at the moment. However, if expectations of interest rate cuts on both sides of the Atlantic continue to decline, this could have a negative impact. In addition, many growth companies are often heavily indebted due to high levels of investment, and expensive debt repayments put pressure on profit margins.

2.1 Growth strategies may offer great opportunities ...

– High, ideally above-average growth potential is the most obvious advantage of a growth strategy. Companies that are geared towards growth are often associated with innovative products or services that are in demand in expanding markets.
– The return on an investment in growth stocks is primarily characterized by its long-term nature. However, investors also need to be patient. The earlier the entry, the better.
– In the case of growth companies, investors might assume that the innovations presented will also lead to a competitive advantage in the respective industry. This can provide the basis for long-term success.

2.2 ... but also involve risks

– Growth stocks are often more volatile than established value stocks. Higher volatility can therefore lead to increased uncertainty.
– High expectations entail the risk of great disappointment if they cannot be fulfilled.
– The focus of companies in the growth sector is much more on growth than on dividends. Ideally, high share price gains should compensate for the lack of dividend payments.
– Growth stocks are more susceptible to market cycles. They could come under pressure, particularly in times of economic uncertainty or recession, if the chosen business model does not yet deliver what it promises.

3 / Value remains a key component

Value investing – of which Warren Buffet is the most famous exponent – is primarily about identifying companies whose share prices are undervalued relative to their intrinsic value. A company's intrinsic value refers to its assets, liabilities, and cash flows. If a company's share price is below its intrinsic value, it is considered a value company. Value stocks are often referred to as "undervalued" because the market (apparently) has not yet recognized the full value of the company.

As mentioned above, value stocks are characterized by a low price-to-earnings ratio and a high dividend yield. In addition, these companies have stable financial positions, with strong balance sheets and low debt relative to cash flows.

3.1 The advantages of value stocks ...

- They are quality companies that have a low valuation (too low from a market perspective); this valuation gap needs to be closed.
- They are also companies that have already proven themselves on the market thanks to the stability of their business model which could offers solidity and a stable path for the future.
- Investors expect higher dividend yields as well as increased return opportunities in the long term.

3.2 ... are of course also offset by disadvantages

- Value stocks often achieve lower price gains because their medium- to long-term growth potential often turns out to be lower.
- A potential lack of growth may lead to a lower valuation of the stock in the long run, or investors may have to wait longer for the expected price appreciation.
- Value stocks tend to be less innovative than growth stocks, but this is not necessarily a disadvantage.

While they may not be as exciting as their growth counterparts, where (disruptive) innovation is often the main driver of performance, it is important to recognize that value stocks can have as much potential over the long term as growth stocks, if not more. For example, a $1,000 investment in Berkshire Hathaway in early 1965 would be worth more than $28 million today. Identifying companies that are trading below their true value is an investment style that has been tried and tested for decades and is likely to be superior to growth strategies, especially over the very long term. Patience can pay off.

4 / Balance is important!

Growth stocks still seem to be in vogue, even if the hype is starting to fade. Growth at any price is not what investors should be focusing on. It is also important to look at the valuations of growth stocks. The profitability expected by investors should be achievable within a foreseeable time horizon. On the other hand, it should be noted that secular trends are generally only halted by major events. And these "black swans" are, by definition, not easy to foresee.

Looking at the valuation ratio between the MSCI World Growth and its value counterpart, it is clear that value has made a comeback from its 2020 lows. However, from a longer-term historical perspective, growth's valuation premium is still at very high levels. Whether the premium persists depends on whether growth stocks can continue to deliver on high expectations.

Based on consensus earnings in 2024, the MSCI World Growth Index is trading at 27 times its profits, almost twice the price-to-earnings multiple of the 14x for the Value Index. But growth has also grown earnings about three times faster, by 15% versus 5%. Moreover, the latest reporting season has again shown that earnings tend to be revised upwards in the growth sector, while in the rest of the market the opposite tends to happen.

Growth stocks are relatively expensive, even compared to their own history

Sources: FactSet Research Systems Inc., DWS Investment GmbH as of February 2024

Caution is also warranted when comparing the current stunning performance of growth stocks to the 2000s. As mentioned above, a number of growth companies, such as Microsoft and Nvidia (again), have recently reported strong earnings (including estimates.) According to consensus estimates[3], Microsoft is expected to grow its net income from about $72 billion in 2023 to $87 billion and just under $100 billion in the next two fiscal years. Nvidia is expected to grow from a reported $30 billion in 2024 (different fiscal year) to around $60 billion and then to over $70 billion in the next two years.

However, markets also tend to "mean reversion," i.e. that the valuation ratios return to their average or mean value in the long term. Conversely, this means that the valuation advantages of growth stocks should reverse in the longer term, creating a tailwind for the value segment. In addition, historically there have always been phases of exaggeration - and so the fact that the growth profile of growth stocks currently feels like they are simply being extrapolated could cause disappointment. With value, on the other hand, the hurdle that must be overcome to achieve positive surprise potential seems comparatively low.

It should also be noted that much higher interest rates and yields are also separating the wheat from the chaff in the growth segment. There are companies with disruptive ideas and business models that are on a truly promising path. But there are also companies that have simply relied on interest-free capital. Their business models are likely to suffer in the current interest rate environment.

Which investment strategy is preferred is also a matter of attitude and mindset. Our world is changing, and many argue that only innovation can provide solutions to today's most pressing problems. Also, technological advances create positive feedback. Non-technology sectors can also benefit and help create attractive economic conditions.

Ultimately, it is above all diversification that needs to be emphasized again. Arguments can be found for both investment strategies. The goal should be a balanced portfolio.

[3] All consensus earnings estimate are compiled by Bloomberg, as of 3/22/24

Glossary

Beta is a measure of volatility that captures a security's systematic risk according to the capital asset pricing model.

Cyclical is something that moves with the cycle.

Diversification refers to the dispersal of investments across asset types, geographies and so on with the aim of reducing risk or boosting risk-adjusted returns.

A dividend is a distribution of a portion of a company's earnings to its shareholders.

The dividend yield is the dividend that a company pays out each year divided by its share price.

Duration is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Growth stocks are stocks from companies that are expected to grow significantly above market average for a certain period of time.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Key interest rates stated by central banks to determine the most important rates of borrowing.

The Magnificent Seven is a term popularly used for a group of seven high-performing and influential technology companies in the U.S. stock market: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.

The MSCI ACWI Growth Index captures large- and mid-cap securities across 23 developed- and 26 emerging markets, classified as growth stocks.

The MSCI ACWI Value Index captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified as value stocks.

Price-to-book (P/B) ratio or multiple compares a stock's market value with its book value.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

A valuation premium is the excess a buyer is willing to pay for one asset relative to other assets.

Value stocks are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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