

# In Spring, Does an Investor's Fancy Lightly Turn to Value?

Featuring: **Hitendra D Varsani**, Executive Director, MSCI Research, **Saurabh Katiyar**, Executive Director, MSCI Research

Adam Bass ([00:03](#)):

This is MSCI perspectives, your source for insights, for global investors and access to research and expertise from across the investment industry. I'm your host Adam Bass.

Adam Bass ([00:13](#)):

And today is April 1st, 2021, no fool. Today, what's the deal with value? While numbers vary in different parts of the world, the last 10 or 15 years have not been good ones for the value factor. Headlines, like, is value investing dead? Have been common. In fact, that very one ran in Forbes just this January, as we spoke about on the program, the last time Hitendra Varsani joined us, also back in January. Value investing had experienced an upturn during the last quarter of 2020. My first question for him this time out was, has this trend continued?

Hitendra Varsani ([00:56](#)):

Absolutely. So the last time we spoke, we discussed the strong performance in value after the US elections, early vaccine announcements, and also the improvement in economic indicators. And that trend in value out performance has continued throughout the first quarter of this year. So MSCI, ACWI, the all country world index enhanced value index has delivered about headline return around 11.7% versus about 4.6% for the parent index up until 26th of March. And we're seeing similar patterns across regional markets as well.

Adam Bass ([01:32](#)):

The logical followup question of course, is why?

Hitendra Varsani ([01:36](#)):

Sure, to understand the recent performance we tend to look at and reflect on long run patterns in the data sets that we have. And so we've recognized in our research that value typically out performs other factors during economic recoveries and early stage expansion. Value, we've written about has out performed during periods of high inflation and rates. We published a blog last year around this. We've also recognized that factors that have done well continued to do well. So they tend to be trendy. We've also acknowledged that valuations of factors can become scratched and crowded, and that can also be an indicator of future performance. In this case, we're on the opposite side, value has been unloved. It's simply got a lower and lower expectations of future earnings relative to price, and it's just been discounted and finally market volatility in credit spreads have also been useful indicators for what value performance as well. I think the question on investors minds is how long this can continue?

Adam Bass ([02:44](#)):

An important question for now. However, it would appear that investors have taken notice.

Hitendra Varsani ([02:50](#)):

If we look back over the last 12 months, probably about exactly one year ago from today, we were in a deep conversations, where institutional clients about how value has been performing in the recent decade and how it could potentially be a turning point, given the recovery in equity markets. Fast forward six months, we've seen significant inflows into value ETFs and those inflows of outpaced growth ETF inflows have outpaced inflows into other factor ETFs. So investors, particularly retail investors who trade ETFs have shown conviction in value out performance, but it'll be interesting to see if this continues from where we are today. And if values out performance can be maintained.

Adam Bass ([03:46](#)):

Getting back to understanding the performance though.

Hitendra Varsani ([03:49](#)):

So we've seen value outperform at the stock selection level, and that's been fairly uniform across sectors. Have we seen value from sector selection or country selection or region selection? Yes, we have. So sectors that had underperformed last year that were discounted in terms of valuations have been leading the market in this recovery. So, technology has lagged the broader market this year, sectors like energy have out performed. They had much lower valuations to begin with. Clearly, that's been supported by the oil price as well. Now, one misconception could be that value has been concentrated in the sectors like energy and industrials and financials, but that's not the case. Actually, we found that stock selection

based on valuation metrics within the technology sector was actually the most fruitful. Now, does this work in terms of countries as well? I think that's to be seen. US has continued to show strong performance versus other markets and so expensive countries have outperformed, but it's questionable what, how long that's going to be maintained for?

Adam Bass ([05:07](#)):

That's definitely interesting when you talk about something like information technology, right? I know you talked about stock selection being more important, but that may be a surprising sector to hear for some people given, it's usually thought of as a growth sector. No?

Hitendra Varsani ([05:24](#)):

That's right. Technology as a whole is seen as a growth sector. But what's changed in their environment is the macro picture. So, expectations of interest rates and inflation have been rising in the US and that's had an impact, not just on the sectors, but also on stall factors as well. And you could argue the value has been a beneficiary from rising rates and inflation, and that's been pervasive across sectors, including the technology sector.

Adam Bass ([05:58](#)):

Despite more recent performance. As I mentioned at the top of the program and Hitendra also spoke about a bit. Value has been unloved for a long time now, to truly understand what's going on today though, we need to dive down a bit into what being unloved has really meant? To gain some perspective on this. We spoke with...

Saurabh Katiyar ([06:21](#)):

Hi, Adam. So, I'm Saurabh Katiyar, I'm part of the Index Solutions Research team. And here I'm responsible for research to support new and existing indexes, including factor, ESG, climate and thematic indexes, right?

Saurabh Katiyar ([06:37](#)):

So first of all, the value and the performance, which we have seen has been pretty universal, now in a previous research, we looked at the performance characteristics of value funds and found that value funds in aggregate. They have underperformed the broad market. In fact, when we studied the performance of the top core tile of value funds as defined by the intensity of value exclusion, we found that the funds with higher value exposure reported greater under performance.

Saurabh Katiyar ([07:09](#)):

Now, to study the regional disparity of the performance of value factor. What we did is that we use the MSCI enhanced value indexes as a proxy. And we actually do some interesting conclusions. Value did underperform across regions globally, but value in emerging markets fared relatively better as compared to developed markets. So for example, MSCI world enhanced value index underperformed MSCI world by 4.1% on an annualized basis over the last decade. But when we see the same for emerging markets here MSCI EM enhanced value underperformed by a relatively less senior 90 basis points over the last decade.

Adam Bass ([07:53](#)):

Okay. So now we're really starting to get somewhere. It's been a bit of a longer drought in developed markets than in emerging markets, but in either case, we are talking about the last 10 to 15 years. And regardless of where you looked, you did see a sharp distinction between the first and second decades of the century. So, you said decade a couple of times. I know there's definitely a disparity. It sounds like between the first and second decades of, of 21st century, what do you find when you, when you dug in, when you broke down that performance even more?

Saurabh Katiyar ([08:29](#)):

So, so here again, what we did is we used the MSCI world and asset value index as a proxy, to see what change between these two decades of the 21st century. Now MSCI world, and as value under performed MSCI world in the second decade. But this was actually a very sharp contrast with the previous decade, when it had out performed MSCI world by 6.6% annually. So it's been a story of two very contrasting decades for value factor, really, but to get back to the cushion to what changed, it's actually been a combination of factors. The first significant change was the contribution from style factors. So, while in the first decade, the style factors contributed positively and significantly to performance of an asset value. In the second decade between 2011 and 2020, these type factors were significant detractors from the performance. Additionally, what we saw was that stock specific or the asset selection returns had a relatively large negative impact on the performance over the speed yet.

Adam Bass ([09:39](#)):

And... Sorry to go backwards here, but to do so, you mentioned earlier that even though value definitely did not perform well in the emerging markets, its performance was relatively better compared to in the developed markets. What was behind that?

Saurabh Katiyar ([09:57](#)):

Yeah, so that's, that's an interesting question actually, because value factor, what we saw, it had a relatively better performance in emerging markets as compared to the digits. So this was demonstrated by the comparatively better performance profile of value descriptors, like book to price and learning seal. And both of these factors that are actually used in our MSCI enhanced value.

Adam Bass ([10:21](#)):

Coming back to the present, Hitendra mentioned a number of differences in the markets and the economy right now that may be driving values out performance. But as our conversation continued, it became clear that these differences, well, they're not all equally relevant, some were more pronounced than others.

Hitendra Varsani ([10:41](#)):

I think the, by far the biggest has been economic recoveries and early stage expansion. It's that period where there's been a high degree of risk aversion in the market by me, stocks have been the most vulnerable, but during turning points in markets, they're one of the first style factors to bounce back. That wasn't the case last year, because during COVID recovery was a tech sector and the digitalization of the economy that led the market. But now, we're in a different stage where through vaccine role as businesses can get back to doing what they do best. And now we're actually seeing that reflected in, in sectors that have had been a hard hit and also value stocks as well.

Adam Bass ([11:30](#)):

Recently, especially into 2021, in the value factor, performance value, funds, value indexes. So, zeroing in on that period as well as the end of last year. In light of your research, what do you make of the recent better performance for the value factor?

Saurabh Katiyar ([11:53](#)):

I mean, so the scale of the value location has actually been pretty sharp. We saw that the last quarter of 2020, it had actually one of the highest quarterly active return for MSCI ACWI enhanced value index. And that out performance has continued this year as well, the headwinds have been a macroeconomic regime, which is more conducive to the performance of value factor. The economic indicators have been improving. And historically, this kind of recovery has been positive for performance of value factor. Value indexes across regional and international markets have been uplifted as a result of these investors, increasing their expectations for higher growth. Additionally, the early signs of recovery, which we are seeing for the businesses and sectors, which were hit hardest by the pandemic, they are also helping the value rally.

Adam Bass ([12:47](#)):

So, the recovery in the real economy that's... Has that historically been better for value?

Saurabh Katiyar ([12:56](#)):

Yes. I mean, we, again, we have covered this in a previous research paper when we have looked at the various macroeconomic regimes and we have found that the early recovery period for the economy is usually good for the value factor.

Hitendra Varsani ([13:11](#)):

There's still a big dislocation between what's happening in terms of on the ground, how people are living their lives versus what's been happening in the market, which is showing a high degree of optimism. But, one has to keep in mind that the backdrop is more stimulus than we've ever seen in the history of mankind. And that's clearly going to filter through the system into the real economy. That's what's driving market expectations at the moment. And what that has been reinforced is in expectations of rates and inflation. So with the Fed, allowing the economy to heat up effectively, providing more stimulus without raising rates, that's increasing inflation expectations, and that's having repercussions in terms of how equity markets are responding. So like I mentioned earlier, tech sector has been negatively impacted. Whereas, value has been positively impacted energy is positively impacted. It's exposed to inflation.

Adam Bass ([14:18](#)):

Inflation, rising rates, not usually terms that are associated with welcome messages for the market, exactly. But, you're mentioning these as a positive for value stocks. How, how does that work?

Hitendra Varsani ([14:33](#)):

So as lockdowns ease and people get back to spending this concerns that the economy will get too hot and prices rise too fast, and that effectively leads to an upswing and inflation... And I expect it to coincide with higher growth.

Hitendra Varsani ([14:51](#)):

Now, that's negative for bonds, because inflation erodes the value of money in the future for equities. It can be somewhat of a mixed picture. So, inflation and rates are not always tightly coupled, but rising inflation is usually managed through higher rates. But with uncertainty, in

terms of the timing, save rates rise then longer dated cash flows are discounted further relative to shorter dated cash flows. And so growth stocks might be rented relatively more impacted than value stocks. Second, high inflation could be a sign of heating up of the economy or growing economy. And so more leveraged companies may out perform due to outsides outsize earnings growth. So there's a couple of points to consider here, it's not a simple, clear cut exercise.

Adam Bass ([15:48](#)):

Of course, nothing in the markets is guaranteed. We've seen uptakes in value before, even over the last 15 years, Hitendra and I spoke about some of the risks as well.

Hitendra Varsani ([15:58](#)):

So the first, is that economic recovery stalls and the market's expectation doesn't materialize. Second, is inflation and rates could remain subdued. Third, could be some unexpected market shocks, volatility spikes. We experience another sell off and that could potentially be negative for value.

Adam Bass ([16:23](#)):

And if we've learned anything this year, we've learned that anything is possible. You know, we may actually need a new word for shots.

Hitendra Varsani ([16:32](#)):

Another considerations are the value spreads. So I mentioned that, the valuation spreads of value versus the rest of the market has been historically white levels. But if those companies have evaporating earnings and without any pricing movement, they also become less value. And so that's a risk as well. And from a more structural point of view, perhaps our redefine value could have changed as well.

Adam Bass ([17:02](#)):

Oh, well, that's interesting.

Saurabh Katiyar ([17:04](#)):

The macroeconomic regime over the last decade has not been very conducive for the performance of value factor. Now, did that mean that value factor broke down? We don't think so, but in the explanation, which has been provided by academicians and other practitioners has been, that may be the traditional valuation ratios used to measure value. Exposure, could be updated. The tradition value issues. Historically, they have relied on the fundamental accounting measures like book value, but over time, the business models have evolved. We have seen that profits and growth are increasingly being driven by intangible assets, such as R and D expenses.

Saurabh Katiyar ([17:49](#)):

And the importance of these intangible assets is sometimes lost in the existing valuation ratios. So, not only does the value definition need probably needs to be updated. There might be some adjustments to the portfolio construction techniques, which might help control the impact of these non-value factor exposures and the stock specific returns. And these could, again, be helpful for value investors.

Adam Bass ([18:16](#)):

I guess when you think about it, it might actually be more surprising to learn that, his value dead hadn't started to morph into, is value properly defined. We'll follow this research as it develops, and as we continue our quarterly factors in focus series... That's all for this week. A big thank you from co-producer Joe Collevocchio and me, to Hitendra and Saurabh and to all of you for listening for more on factors in focus and the value factor, visit MSCI.com. And for those looking for more ways to access perspectives, we're now available on YouTube. Tell your friends. Next up on perspectives, picture this your refrigerator notices you're out of milk, orders more and pays for it with a currency that exists only online. Now we know this is no longer science fiction, but is a digital life better for the environment? We'll discuss what the answer could mean for investors with analysts, from MSCI and Ark invest until then I'm your host, Adam Bass. And this is MSCI perspectives. Stay safe everyone.

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