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Capturing the recovery in Value stocks

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In 2020, Value fell out of favour in quite a spectacular style with investors addicted to short-term growth and quality. However, we believe the winds are changing. The roll out of a reliable COVID vaccine, a new US Presidency and unprecedented fiscal and monetary support to the global economy suggest the stage is set for Value's resurgence.

In the decade following the Global Financial Crisis Value investing had fallen out of favour as investors persistently shied away from taking an investment decision with a modest time horizon. Over the last 12 months MSCI Asia ex Japan Value has underperformed the MSCI Asia Ex Japan Growth Index by over 38% (to end October) taking relative valuation gap between the two styles to stratospheric levels. This uniquely rare (3++ standard deviation) situation we find ourselves in today has been driven by investor behavior biases.

Equity market investors have become addicted to short-term growth and quality which has turned to momentum investing. What went up continued to go up over the last 10 years. And in the recent COVID-fear-driven economic slowdown investors doubled down on their bet on extremely expensive growth and quality stocks. However, we believe the stage is set for Value's resurgence. Capture this market opportunity by increasing exposure to a disciplined Value manager who is well placed to capture an aggressive correction within equity markets.

VALUE HAS OUTPERFORMED 95% OF THE LAST 20 YEARS

Looking back over the last 20 years Value investing in Asia ex Japan equity markets has had an impressive record. Over that period the MSCI Asia ex Japan Value Index has been ahead of MSCI Asia ex Japan Growth index for 95% of the time. See Fig 1. This relative outperformance has been a strong validation for Value as a long-term investment strategy for Asia ex Japan, however this long-term picture does tell the whole the story.

If we break the period into two decades, what we saw from 2000 to the start of the GFC was a period of very strong Value outperformance. This was predicated on a period in the late 1990s where technology stocks had become very overvalued eastspring investments

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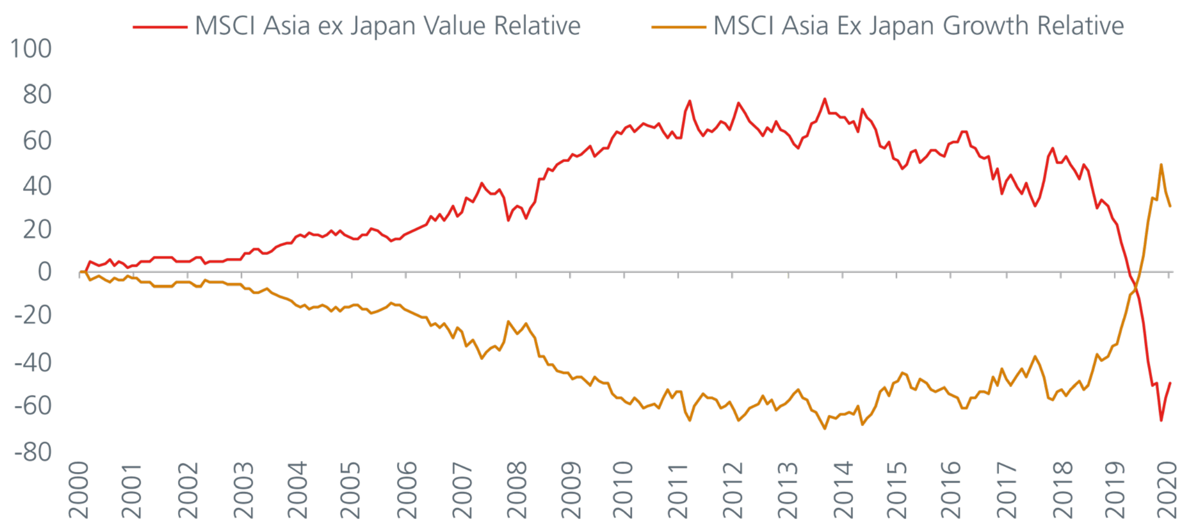
Fig 1: Asia ex Japan Value vs Growth relative performance



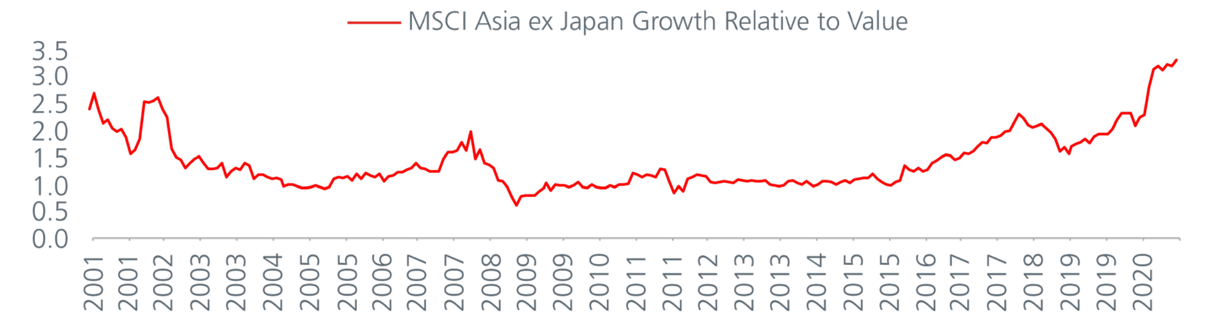
Source: Thomson Reuters Datastream, Eastspring Investments as at 29 December 2020.

(into the tech bubble) as investors had become blindly optimistic over their future potential and had ignored many other parts of the market. As this bubble burst and unwound over the next 10 years, Value investors saw significant outperformance as the past emotional and behavioural biases were unraveled and over-rated expensive growth stocks suffered as their rose-tinted future earnings failed to materialise.

This stellar period of Value outperformance stuttered, and then begun to reverse, as we came out of the GFC into the next decade. Investors across the board were hurt in the crisis as markets collapsed. People lost jobs, livelihoods, pensions, savings and the pain, hurt and emotional baggage has stayed with them for much of the next decade. During this period investors no longer had the desire to take on longer term investments and instead, where they stayed invested in Asia equities, wanted to own well known, well loved, widely researched, high quality, stable companies that let them sleep well at night. At the same time where thematic growth opportunities popped up this was the perfect shot of sugar for investors looking for some growth potential. The price they paid for these investments was of little concern while global banks were offering 'free money' with interest rates hovering either side of zero. So, growth, quality and then momentum stocks outperformed handsomely over this period and Value style lagged. This period began to take relative valuations into unknown territory as quality and growth stocks became extremely expensive and value stocks remained cheap and unloved. See Fig 2.

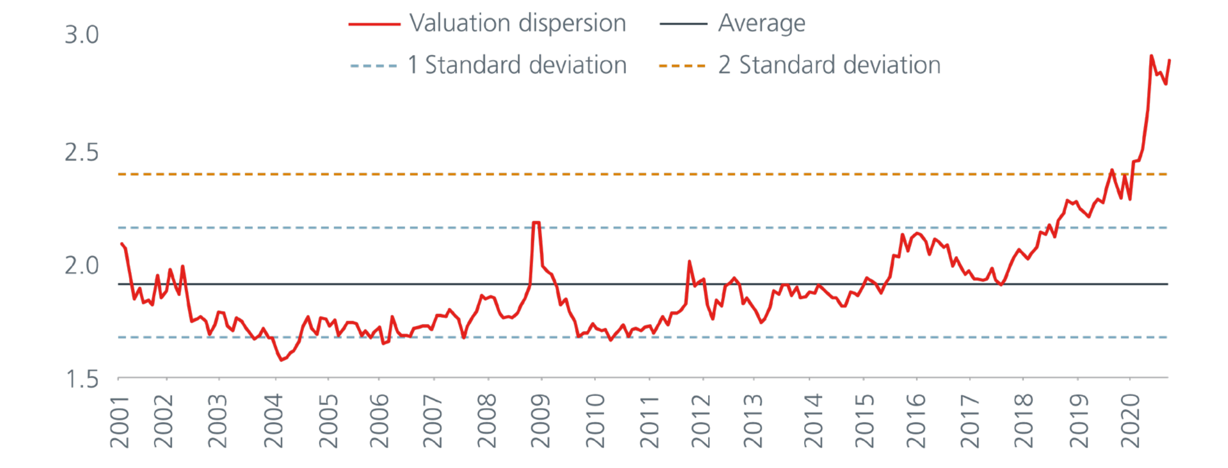
Arriving into early 2020 there were signs that the global economy and many parts of Asia included, were starting to see some signs of recovery and interest in Value stocks, however the unforeseen COVID-19 virus changed everything. In the immediate aftermath of the outbreak and equity market collapse, investors jumped straight back into their pockets of safety and comforting growth stories, taking those stocks into orbit and the relative valuations of cheap versus expensive stocks approached 4 standard deviations. See Fig 3. With an uncertain global geopolitical landscape, second

Fig 2: Asia ex Japan Growth at its most expensive relative to Value



Source: Thomson Reuters Datastream, Eastspring Investments as at 31 December 2020.

Fig 3: Asia Pacific ex Japan valuation dispersion



Source: Eastspring Investments as at 31 October 2020.

and third waves of COVID-19, and concerns over the economic outlook, investors were not being tempted to change their successful growth and quality strategy. Until recently.

WINDS ARE CHANGING

With a backdrop of extreme valuation dispersion within Emerging Market equities, investors are now faced with a different prospect for the next decade.

We have seen recent spikes in volumes flowing into value equities globally and a short-term value outperformance. While we would love to be able to confidently point to specific datapoints or evidence that will confirm the normalization of the valuation dispersion and for Value stocks to outperform from here. But the reality is that style timing has been proven many times to be a futile game. However, we do believe that there are several significant shifts in the global macroeconomic and political environment that put in place very favourable conditions for a shift in investor sentiment and the normalization process to continue.

First and foremost is the successful roll-out of the COVID-19 vaccine. Prior to the effective vaccine news, investor positioning reflected the greatest emotional driver of equity mispricing which is fear. But now investors are starting to believe there is a light at the end of the tunnel and are now being encouraged to shift their focus onto the valuations of assets they own, not just the quality and growth prospects, and to have a more rational investment horizon. This is supportive of Value equities.

Second, having had a very volatile global political environment and much uncertainty over the 2020 US elections, global investors had been holding off from making decisions. But with a new US presidency around the corner, and a Democratic party majority in the Senate and House of Representative, we are likely ushering in a period of lower political volatility, a return to diplomatic norms and fewer headline surprises than the last 5 years. Less geopolitical change and lower policy volatility is also supportive for Asia Value equities.

Finally, we must not forget that the governments across the globe have put in place the largest round of coordinated fiscal and monetary support seen in modern times. With low interest rates in place across the world to finance this spike in funding, an implicitly weaker outlook for the US dollar and a relatively benign inflation outlook, the macroeconomic backdrop looks very supportive for Asian equities from here and particularly supportive for Value.

CAPTURING THE RECOVERY

We believe the best way to capture this investment opportunity is to take an unadulterated position in a pure Value strategy. At Eastspring, our Value philosophy was forged 25 years ago here in Asia, and we continue to observe that human emotions and behavioural biases distort investment decision making, leading to investors overpaying for the promise of growth and perception of quality, focusing on the recent past and extrapolating into the near future. This creates the mispricing we seek to exploit.

Our disciplined Value approach relies on an experienced team of investors debating the best investment opportunities selected from the cheapest basket of stocks in Asia. By design, this means we are discussing, and investing in, stocks others are not looking at, companies with valuation signals created by investors' concern over short-term hurdles, and a lack of desire of other investors to invest over the medium-term.

While we accept that recent experience has played against us, over the long-term we believe a focus on growth and quality at any price is a flawed approach. As the valuation investors are paying for these popular stocks becomes so distorted the search for a 'greater fool' to buy these stocks at ever more elevated prices suddenly becomes illusive. This can lead to a sudden precipitous fall of equity prices and permanent capital destruction -one thing all investors need to avoid.

Investors are starting to look at stocks with medium-term earnings growth potential and realising just how cheap they are which is supporting our Value proposition. We believe there is no time like the present to be invested in Value.

Source: [10]World Bank. 2020.

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