Unprecedented

Have recent market events created a once-in-a-lifetime opportunity for value?

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- The list of unprecedented events seems to grow daily, but one that may have escaped your notice is the historic performance of growth over value.
- Below, we discuss some of the possible causes of this anomaly and highlight some similarities between today's environment and other periods when similar dislocations emerged.
- The proliferation of technology, and its near absence from value-oriented style indices, has been a headwind for value investors; this focus on tech also presents a concentration risk to investors that is only likely to intensify.
- We also see evidence that valuations have become unsustainable in the post-COVID era, and the disconnect is wider for growth firms than for value.
- We believe these and other factors are temporary, and the historical tendency of markets to compensate value investors on a total return basis will reassert itself in the future.

"Unprecedented" is a word frequently used to describe the events of 2020. Somewhat less visible — but just as unprecedented — is the continued dominance of growth over value even as U.S. markets have rotated from bull to bear and back again with dizzying (and yes, unprecedented) speed. Below, we discuss some of the possible causes of this anomaly and ask whether value is primed for a resurgence.

A tale of two sectors

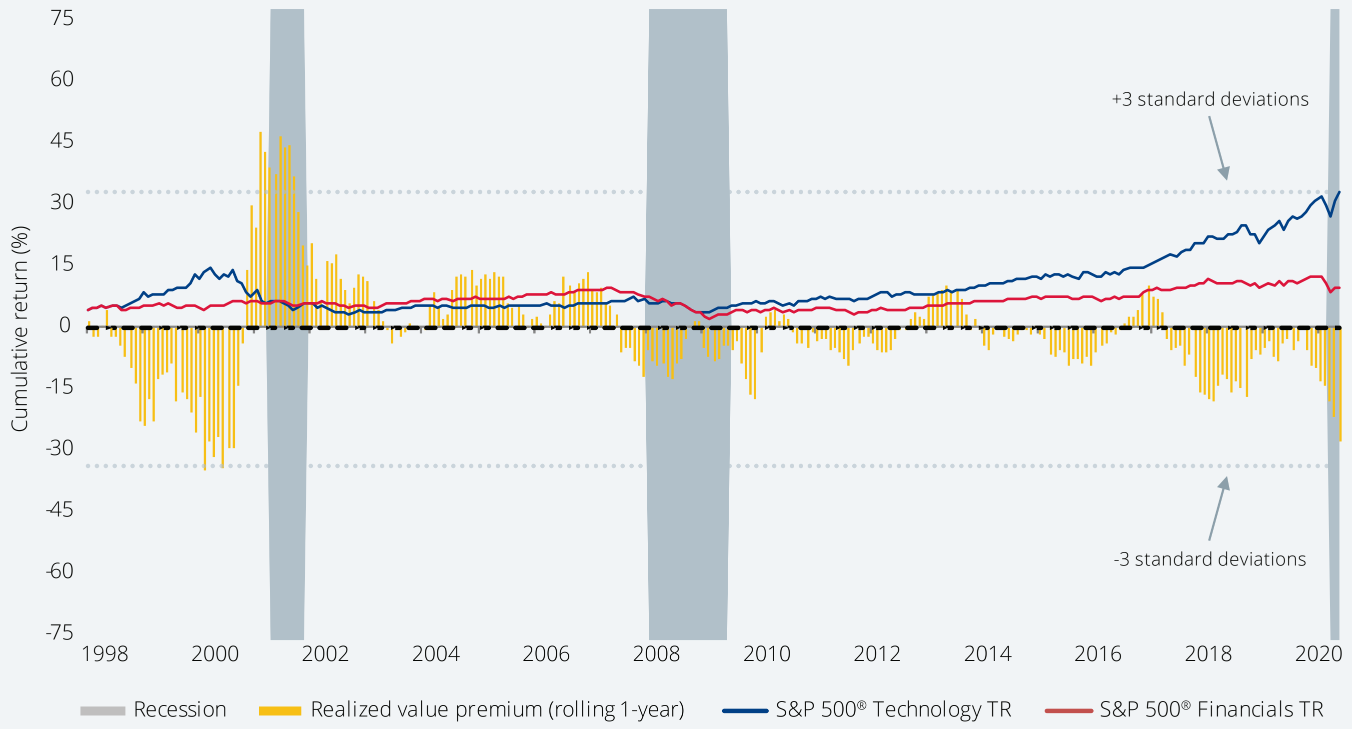
In some ways, the performance gap between growth and value is a tale of two sectors: financials (which are significantly over-represented in value-oriented indices relative to growth) and technology (which is over-represented in growth indices to a similar degree).[1]

Sector weights (%)

	RUSSELL 1000® VALUE	RUSSELL 1000® GROWTH
Tech	6.8	39.6
Financials	18.1	2.9

Data: Morningstar

Déjà vu? Value's underperformance versus growth has reached levels last seen during the tech bubble[2]



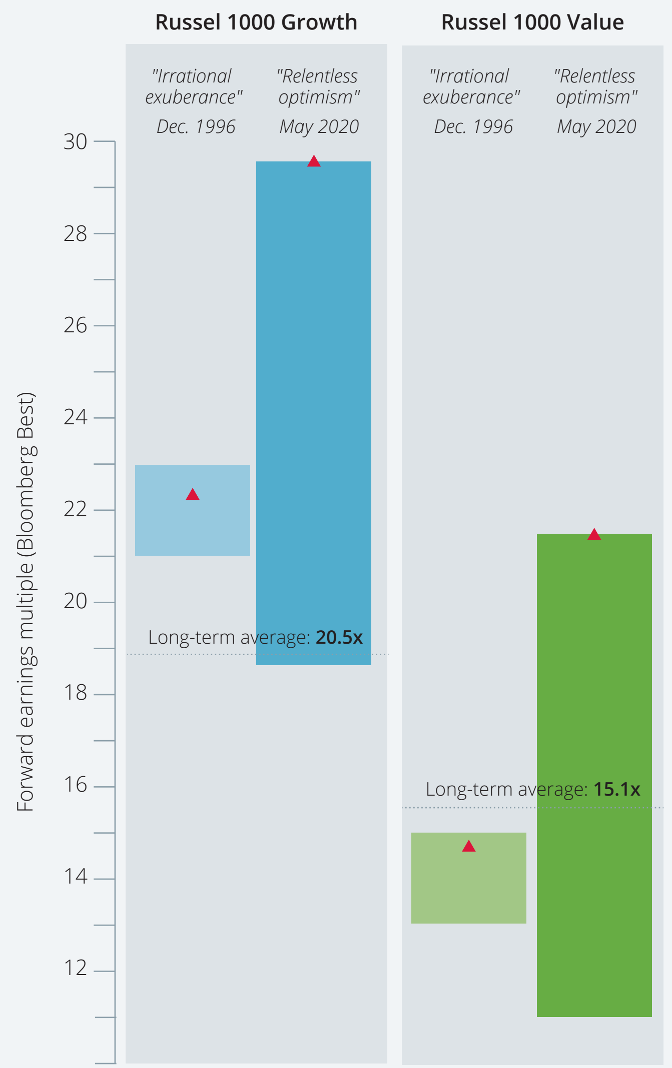
Source: Morningstar, GWI calculations. Represents the cumulative total return of the S&P 500 Technology and Financials sectors and rolling one-year spread between the Russell 1000 Value and Russell 1000 Growth. +/- 3 standard deviations are shown for the realized value premium sample. Returns shown: January 1998 through May 2020.

Perhaps unsurprisingly, the technology sector has outperformed financials by over 900 basis points on an annualized basis since the end of the Great Financial Crisis (GFC).[3] This has been due at least in part to society's ever-growing reliance on technology (a trend that has accelerated as most of the working population continues to operate remotely in response to the pandemic). Meanwhile, the lingering fallout of the GFC has heralded a new era of low interest rates and other fundamental and regulatory changes that have challenged the business models of many traditional financial firms at precisely the same time.

Our view is that these trends are unlikely to persist indefinitely and will ultimately revert. When that happens, investor expectations are likely to reset as well, and the gap between growth and value will close.

"Irrational exuberance" versus "relentless optimism"

Former Fed Chairman Alan Greenspan first coined the phrase "irrational exuberance" in December 1996 in part to describe a bubble in asset prices that would ultimately end with the dot-com crash and subsequent recession in early 2000.[4] In a similar way, today's environment might accurately be described as one of "relentless optimism," with investors expressing confidence in a quick and robust economic rebound by bidding stocks relentlessly higher following their trough in March 2020.



3-month range	20.9 to 23.1x	18.4 to 29.6x	13.3 to 14.8x	11.0 to 21.4x
End of month	22.1	29.6	14.5	21.3
Relative to LT average	1.6x	9.1x	-0.6x	6.2x

Data: Bloomberg Best, GWI calculations (6/2020).

The extent of the disconnect between prices and fundamentals is startling. At the end of May, forward earnings multiples for both growth and value stocks were meaningfully higher than their long-term averages, and are far higher than when Chairman Greenspan introduced the world to the concept of irrational exuberance.

Furthermore, the market's clear preference for growth during both the COVID-19 sell-off and the subsequent rebound (itself an extremely rare occurrence) has lifted growth valuations to a lofty 29.6x as of May 31, 2020. Value multiples are stretched, too, but not nearly to the same extent. Our view is that this disparity — like the yawning gap between technology-sector and financial-sector performance discussed above — is unsustainable.

Value will once again have its day

At Great-West Investments, we maintain exposure to both growth and value in our asset allocation products in a consistent and disciplined fashion. Our view is that value is a premium that should be compensated over time, just as it has been in the past — a notion supported by empirical efforts to isolate factor returns such as those for the Bloomberg Pure Equity Style Factor Indices in the table below.[5] The unprecedented environment in place today — which partially traces its roots back to the Great Financial Crisis of 2008-2009 and has only been exacerbated by the massive economic dislocation that has accompanied the COVID-19 pandemic — has created a perfect storm for value-oriented investments.

U.S. equity style factor returns

STYLE	10-YEAR	20-YEAR	SINCE INCEPTION*
Value	-2.55	100.97	109.76
Growth	8.44	0.02	2.13

Data: Bloomberg

*Inception date 12/31/1999

Over the last 10 years, the growth factor has outpaced value by 10%. But over the last 20 years, value wins in a landslide.

We also think it's worthwhile to point out some of the risks that the current state of affairs represents for growth-only investors, such as the massive concentration risk that exists today in growth-oriented investments. For example, the three largest holdings in the Russell 1000 Growth Index represent nearly one-quarter of the index's total portfolio; the top five represent just under than 30%.[6] Moreover, much of the 6.3% underperformance of the Russell 1000 Value Index relative to the Russell 1000 Growth Index can, in large part, be traced to its 33% underweight to the technology sector. Tech has contributed close to half of the return for the Russell 1000 Growth Index over the last decade and is expected to receive an even bigger weighting following the 2020 Russell indexes reconstitution.

Finally, we worry that investors who focus only on growth at the exclusion of value are engaging in one of the most seductive falsehoods in all of finance: the notion that this time really is different. Sure, the current environment is unprecedented in many ways, but we're skeptical that foundations of finance like the durable and academically proven concept of value have been forever eroded by today's environment.

1 As of 5/31/20, financials represented approximately 18.1% of the Russell 1000 Value Index and 2.9% of the Russell 1000 Growth Index per Morningstar data. Technology was 39.6% of the Russell 1000 Growth and only 6.8% of the Russell 1000 Value Index.

2 The realized value premium is defined as the rolling one-year return of the Russell 1000 Value minus the Russell 1000 Growth Index measured on a monthly step. The largest drawdown of the realized value premium was -35% in February of 2000 vs. -28% through May 2020.

3 The S&P 500 Technology TR Index returned an annualized 19.46% vs. 10.43% for the S&P 500 Financials TR Index from 7/1/2009-5/31/2020.

4 Speech to the American Enterprise Institute, 12/5/1996; Federalreserve.gov/speeches.

5 Bloomberg Pure Style Factor Indices. Cumulative total returns as of 5/31/2020. Pure style factor portfolios are those that isolate securities to a given factor while neutralizing all others. Inception: 12/31/1999.

6 Morningstar. Represents holdings of the iShares Russell 1000 Growth ETF as of 5/31/20.

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