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What does the rotation to value from growth mean for your portfolio?

The big investment theme this week has been the rotation to value stocks from technology, the quintessential growth sector. What does this mean for your portfolio?

Most stocks can be classified as value or growth, depending on certain characteristics or "factors." Index leader S&P Dow Jones Indices uses three factors each to measure growth and value. Growth factors are defined as – three-year change in earnings per share over price per share; three-year sales per share growth rate; and momentum (12-month % price change). Value factors are – book value to price ratio; earnings to price ratio; and sales to price ratio.

In simple terms, what this means is that growth stocks generally have strong growth in earnings and sales, while value stocks will typically trade at lower valuations (compared to growth stocks) because their earnings and sales are growing at a significantly slower pace.

S&P Dow Jones Indices classifies the stocks in the S&P 500 as growth or value and lumps them into the S&P 500 Growth Index or S&P 500 Value Index respectively. Since a substantial number of stocks display both growth and value characteristics, they are members of both the Growth index and Value index. As of April 30, the S&P 500 Growth Index had 273 members, while the S&P 500 Value Index had 395 members, which means that 168 companies (668 – 500) are members of both indices.

Why does this classification matter? Because growth has simply trounced value over the past decade. Figure 1 shows the comparative performance of two Vanguard ETFs based on the S&P 500 Growth and Value indices. $100 invested in the Growth index would have more than tripled to $337 from September 30, 2010 to May 28, 2020. $100 invested in the Value index would have merely doubled to $205 over this period. In percentage terms, the S&P 500 Growth Index delivered total returns of 13.97% over the past decade (ending April 30, 2020), while the S&P 500 Value Index generated total returns of 9.09%.

It should come as no surprise that that the 10 biggest members of the S&P 500 Growth Index are the usual "FANGMAN" (with apologies for that overused and annoying acronym) stocks – Microsoft, Apple, Amazon, Facebook, Alphabet, Visa, Mastercard, Netflix and Nvidia. The top 10 in the S&P 500 Value are a staider bunch – Berkshire Hathaway, Unitedhealth Group, Verizon, Johnson & Johnson, AT&T, Pfizer, Exxon Mobil, Bank of America, Cisco Systems and Chevron.

The tremendous outperformance of technology giants such as Amazon, Netflix, Microsoft and Facebook during the "Covid Correction" appears to have been the final straw for most value-oriented investors –

frustrated by years of under-performance of value stocks – as their services proved to be indispensable for millions of households stifled by lockdowns and social distancing measures. In a recent survey of fund managers, a net 23% of respondents thought value would continue to lag growth going forward (Fig.2).

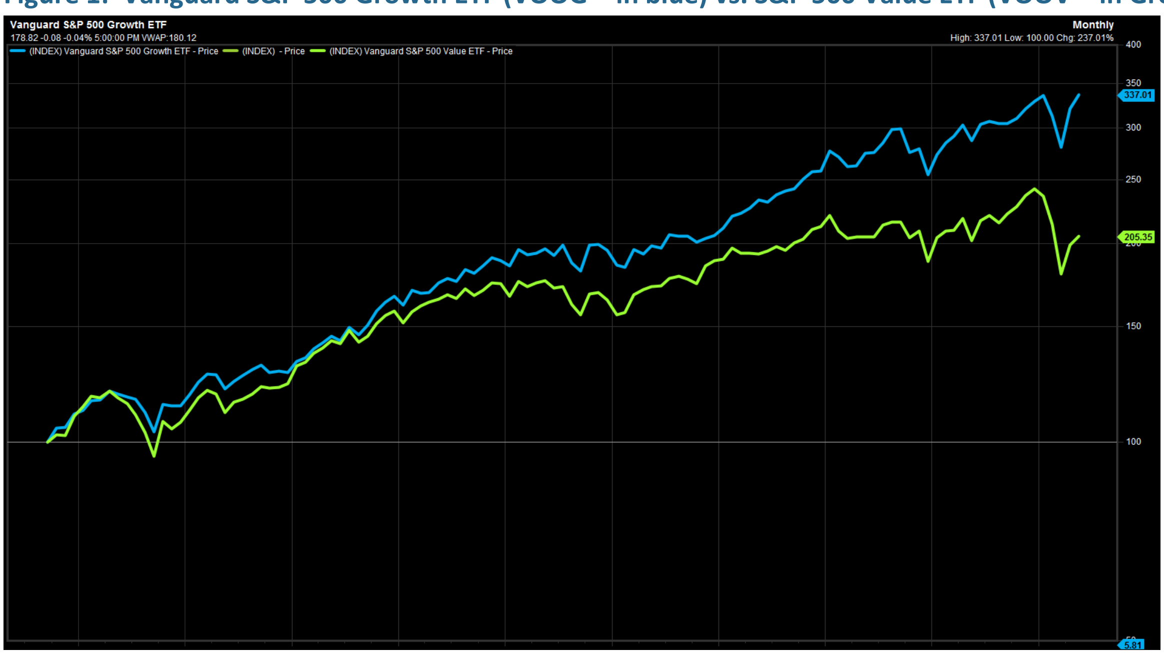
But could a turning point be at hand, as the gap in valuations between growth and value stocks widens to record levels, and the biggest technology companies run the risk of becoming victims of their own success? The regulatory risk faced by tech giants is exemplified by President Trump's threat yesterday to loosen legal protections for social-media platforms, after Twitter incurred his wrath by slapping fact-check labels on a couple of his tweets.

We believe value stocks will (eventually) have their day in the sun. The compelling valuations at which many value stocks trade implies that patient investors may enjoy substantial returns over the long term, with the added benefit of downside protection in these volatile markets.

Diversified portfolios should ideally hold a mix of both growth and value stocks. In the U.S. sleeve of our client portfolios, for instance, we hold growth stocks such as Visa and Qualcomm; value stocks like Berkshire Hathaway and Verizon; as well as stocks that offer a combination of growth and value, such as Johnson & Johnson and Disney.

What about the Canadian market? The TSX has historically been dominated by value players, given that sectors like financials, materials and energy have accounted for 55% to 65% of the total index (with growth stocks like Shopify being the rare exception). A continued rotation into value from growth should therefore benefit Canadian investors' portfolios, although we caution that the return to favor of "slow and steady" stocks may take many months yet.

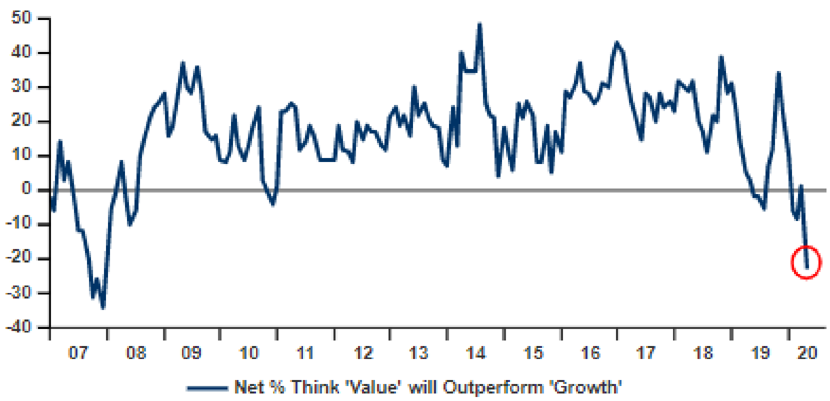
Figure 1: Vanguard S&P 500 Growth ETF (VOOG – in blue) vs. S&P 500 Value ETF (VOOV – in Green)



Source: FactSet

Figure 2: Net Percentage of Survey Respondents who think Value with outperform Growth

Exhibit 6: Net % Think 'Value' stock will Outperform 'Growth' stocks



Source: BofA Global Fund Manager Survey, Bloomberg

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