Heartwood
Investment Management

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Investment Insight

Weekly Insight

Value vs. Growth

An issue receiving some attention recently has been the outperformance of growth stocks relative to their value counterparts. According to MSCI data, since March 2007, value stocks have underperformed growth by over 35% (MSCI World Indices). Last year, 2015, that dispersion of performance was almost 8%.

There have been a number of factors driving this phenomenon. Investors' insatiable hunt for yield has continued to benefit large companies with relatively stable businesses and with reasonable levels of dividend yield. On the other hand, concerns about the persistently modest rate of global economic growth and falls in commodity prices have adversely impacted the more cyclical parts of global equity markets, ie. Mining, Energy and Financials.

More specifically, the Consumer Non-Durables sector (which includes Tobacco, Food, Beverages) has been a major beneficiary of this trend. Since March 2007, the Consumer Non-Durables sector has outperformed the broad World index by over 80%. In contrast, the Major Bank sector, a large part of the value index, has lagged the broader equity market by 50%. The past twelve months has seen further dispersion of returns between these two groups: Consumer Non-Durables has outperformed by 16%, while Major Banks has underperformed by 15% (all data source Factset).

Valuations of these large international stable businesses have of course risen significantly. As an example, Reckitt Benckiser, the household goods company, has seen significant valuation expansion since the financial crisis. Since March 2007, Reckitt Benckiser shares have returned 233% (total return) versus the MSCI UK index which has risen a more modest 34%. Over the same period, the forward price/earnings index multiple has been as low as 12.5x in 2011, but currently stands at 24.2x. However, the company's annual sales growth has slowed from 24.6% in 2009 to just 0.4% for the year end 2015 (all data source Factset).

As noted above, the current uncertain environment has favoured long established companies with reasonable dividend yields, partly as a substitute for the lack of income available from other sources, such as bonds and cash. This trend is not unprecedented but the degree of valuation differential between non-cyclical and cyclical companies is, in our analysis, extreme. We therefore continue to have a bias towards value equities in our portfolios as we believe greater medium term potential returns are available.

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