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MAARTEN NEDERLOF
Head of Portfolio Solutions—Americas

JEFFREY CLARK
Analyst, Portfolio Solutions—Americas

Value, Growth and the True Exposures in Your Portfolio

After a long period of underperformance relative to growth stocks, value stocks have staged a notable comeback in 2022. But some investors have been less exposed to that comeback than they might have expected, going by the labels on the products in their portfolios.

That long period of underperformance has left core equity indexes very "growth-heavy," which has in turn led to style drift in many of the supposedly core active strategies benchmarked against those indexes. Even some value strategies have compromised their discipline to avoid lagging too far behind their growth-oriented peers.

It is not too late to rectify these unintended biases, in our view. The first steps are to measure the factor biases of your portfolio and the contributions being made by each underlying strategy. The next step is to assess whether the risk profile revealed is what you want. If it isn't, the final steps involve rebalancing your existing strategies and, potentially, seeking out and assessing new ones to deliver the exposures you intend.

Executive Summary

- What are value stocks, what are growth stocks, and why have value stocks staged such a dramatic, long-awaited comeback in 2022?
- Our analysis suggests that institutional equity portfolios have become more growth-oriented over recent years.
- This growth bias may often be unintentional: the outperformance of growth stocks has led them to take a bigger and bigger share of core benchmark equity indexes; and even some value strategies have become more growth-oriented in order to avoid lagging performance.
- We prescribe a six-step solution:
  1. Measure the regime sensitivity of your current portfolio.
  2. Assess each manager's contribution to that sensitivity.
  3. Is each manager doing what you expect?
  4. Consider reweighting your portfolio to restore or improve balance.
  5. Consider adding new value managers to the mix.
  6. Assess the "flavor" of available value managers carefully, and choose or diversify among them intentionally.

The Portfolio Solutions team at Neuberger Berman helps clients construct portfolios of active and passive investment strategies, with a particular interest in understanding what drives the returns of each strategy or manager (factor/macro tilts or alpha in the case of active managers), and when these drivers contribute and detract from absolute and benchmark-relative returns. Is a strategy biased to a particular factor for example—such as value, growth, quality or momentum? Is it highly exposed to a handful of macro factors—such as a interest rates, a currency pair, economic growth or the performance of a specific sector or region?

Much of our work lately has been focused on the rotation of performance and portfolio flows back to value after a long period in favor of growth. We have been suggesting to our clients that a robust portfolio of active and passive equity managers be balanced in its regime sensitivity, and not too dependent on a single style of investment.

So, what is the value factor and value investing, and why the sudden interest?

Value Versus Growth

Value investing is the focus on companies whose stock price looks cheap today, relative to their assets, earnings, cash flow or some other measure of their current business. This stands in contrast to growth investing, which focuses on companies that are expected to grow their sales, revenues and profits, often far into the future.

Value investing is a *mean-reverting strategy*: its premise is that a company has some warranted value and its price should not diverge to far from it for too long, one way or the other. To perform well, either the company itself needs to change (by getting new management better able to realize the true value of its assets, for example), or the perceptions of investors need to change, or both.

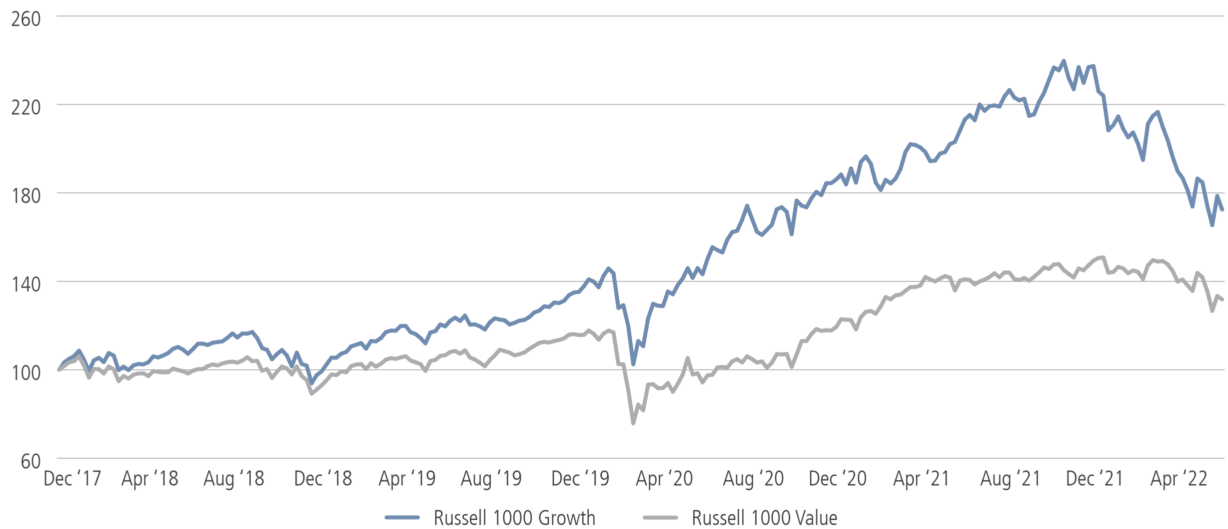
Growth investing, on the other hand, is a *persistent strategy*: its premise is that a company's sales, revenues and profits will grow. For this to perform well, investor perceptions about those growth projections need to stay the same. If a growth company's sales and profits stop growing, it's likely to start behaving more like a value stock.

To illustrate the differences, it helps to think about what a typical growth company and a typical value company look like. If we consider the Russell 1000 Growth Index as a proxy for the universe of U.S. growth stocks, we see that more than two-thirds of its market capitalization is taken up by technology and consumer discretionary companies. These companies may well be generating earnings and dividends today, but we can recognize that many of these businesses are focused on developing new technologies, tools and products or persuading us to buy new things, or breaking into new markets. Therefore, much of their warranted value comes from projections of new earnings streams, often well into the future.

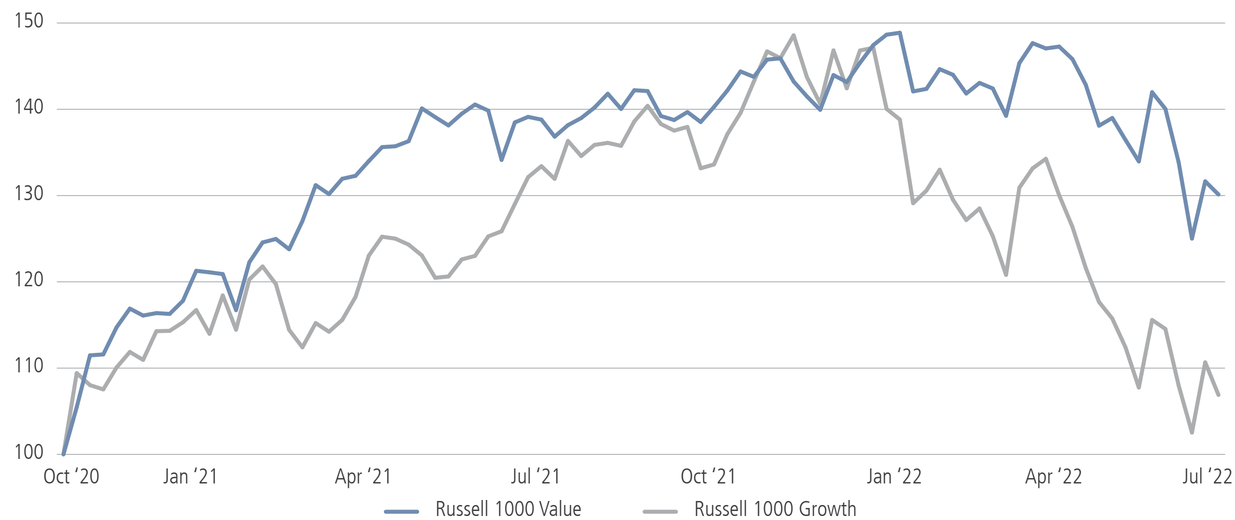
Because those expected cash flows are often far into the future, the warranted value of a growth company can be very sensitive to the rate of interest used to discount those cash flows: the value will be meaningfully higher if interest rates are lower. This is why the valuations of growth stocks rose so significantly since the end of the Great Financial Crisis in 2009, as interest rates declined to historic lows. This, in turn, raised the market capitalization of growth stocks relative to non-growth stocks, giving them a larger and larger share of broad market indexes. Remember, to perform well, investor perceptions of growth stocks need to stay the same, so the outperformance since 2009 would be arrested by a change in the discount rate or drop in expectations for sales, revenue or profit growth.

FIGURE 1: GROWTH STOCKS AND INTEREST RATES

Growth outperformed in a low interest rate environment…



… but underperformed in 2022, as inflation and rates have gone up



Source: Bloomberg. Data as of July 1, 2022; rebased to 100 at December 29, 2017 (top) and October 30, 2021 (bottom).

Now let's think about the typical companies in the Russell 1000 Value Index. It's a bit more diverse, but around two-thirds of its market capitalization is financials, health care, industrials, consumer staples and energy companies. In general, we can recognize many of the companies in these sectors as having more modest prospects for sales, revenue and profit growth, but more actual, here-today assets sitting on their balance sheets for analysts to value.

For these companies to perform well, recall that investors' perceptions of those assets need to change. Over recent months, that change has come in the shape of higher inflation and interest rates. It's a double whammy. The more obvious effect is that higher rates have crushed the valuations of the growth stocks that compete with value stocks for investor capital. Perhaps less obvious is that inflation has raised the value of the assets that are so important in many value companies' businesses, an effect that is much less beneficial to asset-light growth companies. Generally, the book value of assets depreciates over time; but during inflationary periods, a "replacement cost" adjustment that takes account of rising asset prices can more than offset that depreciation.

We can see the effects in figure 1: growth outperformed in a low interest rate environment, but underperformed in 2022, as inflation and rates have gone up.

Value Versus Growth Outside the U.S.

Do we see the same phenomenon in markets outside the U.S.?

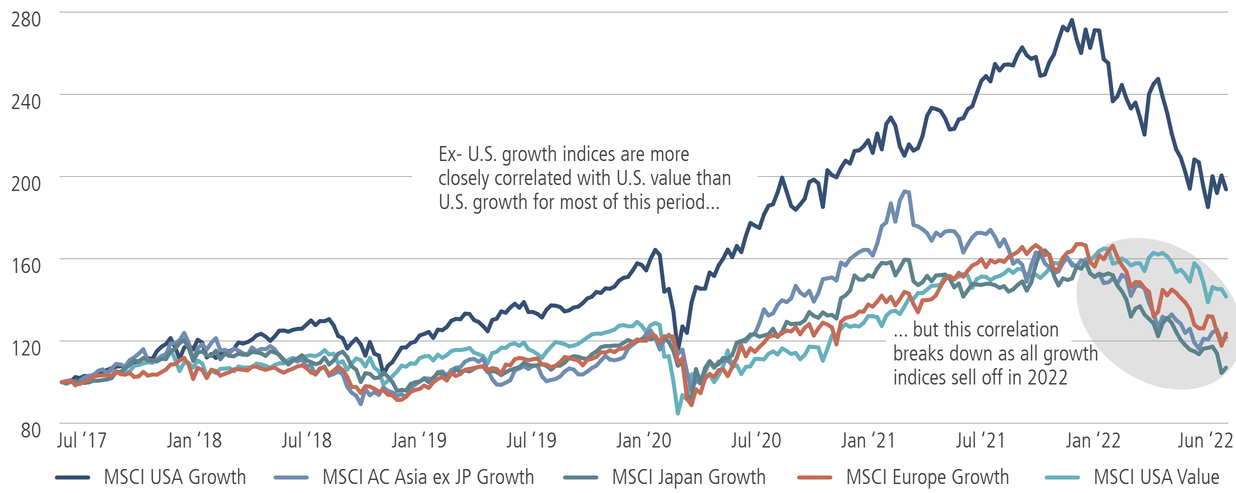
We do, and indeed by looking at stock markets in Europe, Japan and Asia ex-Japan, we see that this phenomenon is about more than just big technology stocks. Information technology accounts for only 12% of the MSCI Europe Growth Index, 22% of the MSCI Japan Growth Index and 27% of the Asia ex-Japan Growth Index, as opposed to 45% of the MSCI USA Growth Index.

This likely explains why, over most of the past five years, these growth-stock indices, especially those for Europe and Japan, have been more closely correlated with the U.S. value index than U.S. growth index. They missed out on a lot of the euphoria around tech stocks, particularly since the outbreak of COVID-19.

But has this sheltered non-U.S. growth indices from the growth sell-off in 2022? It emphatically has not. Figure 2 shows the breakdown of the correlation with U.S. value during this year. Indeed, the lower chart shows that European, Japanese and Asian growth indices have sold off even harder than U.S. growth.

FIGURE 2: GROWTH STOCKS HAVE ALSO SOLD OFF OUTSIDE THE U.S.

Ex-U.S. growth indices were closely correlated with U.S. value in the low interest rate environment…



… but sold off even harder than U.S. growth as inflation and rates have gone up

Source: Bloomberg. Data as of July 1, 2022; rebased to 100 at July 21, 2017 (top) and October 30, 2021 (bottom).

This is not to say the technology sector is unimportant. Investors in the U.S. market that do not address the dominance of that sector as a separate issue are unlikely to achieve balance in their exposure to inflation and interest rates. For investors in other markets where technology is less dominant, however, simply restoring the style balance between growth and value can go a long way to removing unintended biases.

"What do we do now?" many investors are asking us. "Is it too late to add genuinely disciplined value managers to my portfolio?"

Our six-step prescription is simple:

1. Measure the regime sensitivity of your current portfolio.
2. Assess each manager's contribution to that sensitivity.
3. Is each manager doing what you expect?

We believe that investors have been systematically underinvested in value managers because of the long drought in relative performance. There was a belief that the value investing style was "broken." Second, though many investors hold value strategies, those strategies often did not perform as well as expected this year, either because they had drifted in terms of the valuations they were willing to pay, or because they had succumbed to the lure of the mega-cap technology stocks that had become so prominent in broad market indices. While it was possible to buy the "cheapest" mega-cap tech stocks, these names didn't protect their owners as the valuation multiples of growth stocks collapsed.

That brings us to our next three steps:
4. Consider reweighting your portfolio to restore or improve balance.
5. Consider adding new value managers to the mix.
6. Assess the "flavor" of available value managers carefully, and choose or diversify among them intentionally.

Selecting Value Flavors

When considering more disciplined value strategies to replace or complement those whose style has drifted, investors should consider the different "flavors" of value carefully. Portfolio managers make numerous recipe decisions when cooking up both passive and actively managed value portfolios.

Here are some of the important decisions to consider.

Sector Strategy: Does the portfolio tilt toward sectors that deliver better value, or does it tilt to undervalued names across sectors? If the latter, is the sector mix determined by the sector mix of a broad market benchmark? This may be one of the most significant differentiators between value strategies. Quantitatively driven and passive value strategies tend to favor sector-neutrality against their benchmarks. This typically leads to lower tracking error,[1] but it also means lower exposures to the sectors that typically include a bigger share of value stocks, such as financials, consumer staples, energy and utilities, as these have relatively smaller weights in core benchmarks. A value manager that owns the cheapest technology stocks as a large proportion of their value strategy, due to technology becoming a large part of core benchmarks, will not provide much relief during a growth downturn. A manager with sector weights more akin to the value indexes that emphasize value sectors is likely to be much more effective.

Value Drivers: Value investors can choose from many valuation ratios to determine the warranted value of a firm—book value yield, earnings yield, dividend yield and free cash flow yield are just the most common. The particular "flavor" of value strategy can affect performance. Deep value strategies such as those based on book value yield were particularly hard hit in 2019 and early 2020, for example, whereas more widely used "modern" measures such as free cash flow yield proved more robust. Many value managers now favor free cash flow measures, given the poor performance of book yield strategies, but book yield strategies have often proven a more tangible value haven when growth stocks have been selling off, making book yield the closest thing to a widely recognized "value beta." Because the drivers chosen to screen stocks can lead to different returns in different environments, some diversity in approach is helpful.

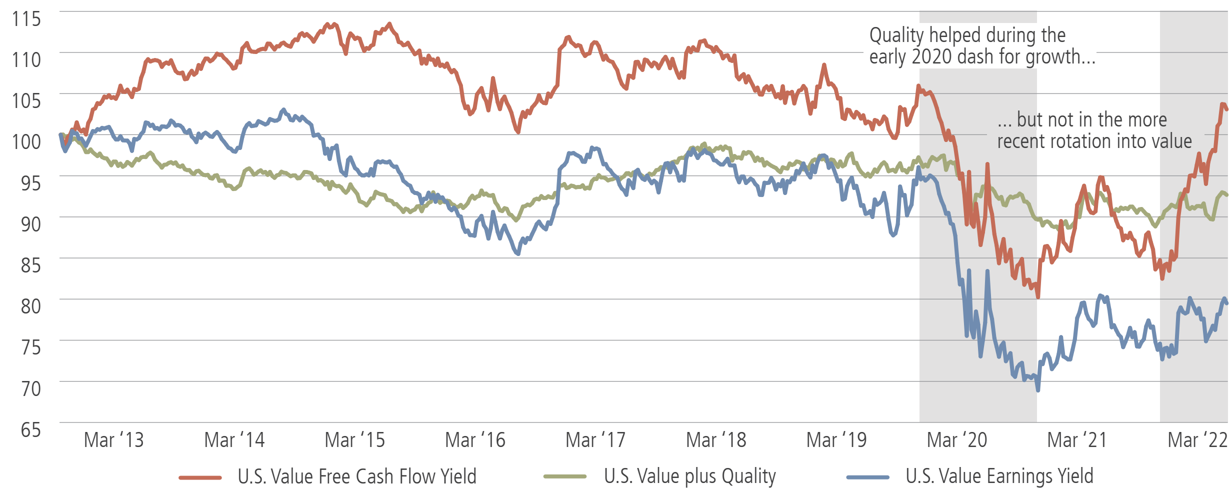
Quality: A great number of value stocks are "cheap" because they deserve to be. Passive value strategies buy broad swaths of the cheapest stocks in a given universe, which can include so-called "value traps" and other "fallen angels." Focusing on value stocks of a higher quality (in terms of, for example, a combination of their profitability and solvency) can reduce volatility.

[1] "Tracking error" is a term that is commonly used to describe the variability of an actively managed strategy relative to its benchmark. Tracking error is calculated by taking the annualized standard deviation of the excess returns of a given strategy, where the excess returns are calculated by subtracting the benchmark from the strategy's returns on a monthly, weekly or daily basis. The most common calculation is to calculate the tracking error over at least 3 years of monthly returns. High tracking-error strategies exhibit greater variability around their benchmark than low tracking-error strategies.

We can see some of these nuances at work in figure 3, which shows the performance of three systematic approaches to value investing since 2013: one based on earnings yield, one based on free cash flow yield, and one that screens for both quality and value.

FIGURE 3. DIFFERENT FLAVORS OF VALUE MEAN DIFFERENT PERFORMANCE

Cumulative returns, three styles of systematic value strategy, 2013 – 2022



Source: Neuberger Berman strategy detective®. Shows the backtested performance of three systematic value strategies whose portfolios are rebalanced monthly to mitigate style drift. Performance data is from September 14, 2012 through July 1, 2022.

All three strategies were hit in early 2020 when growth stocks took off, however the earnings yield strategy was hurt much more than the free cash flow yield strategy. The value-plus-quality strategy held up much better than either of the others in early 2020, as investors sought stable and profitable businesses. It also exhibited lower volatility than the other two strategies throughout the period. More recently, as investors have rotated out of growth stocks and into value stocks, value-plus-quality has lagged the "purer" value strategies—and would not have offset losses in growth strategies as effectively.

This has important implications for selection in the context of portfolio construction. For example, if you're looking for a "pure" value exposure to offset an otherwise growth-oriented strategic portfolio, you may wish to tilt toward systematic free cash flow yield strategies; if you're looking to build a portfolio with a more strategic value tilt, value-plus-quality or a blend of flavors could be the way to avoid long periods of underperformance; and a thorough analysis could enable you to find the "holy grail"—an active manager deploying a disciplined strategy that has a high value factor exposure while avoiding most of the value traps.

Ensure You Benefit From the Value of Value

After a long period of underperformance relative to growth stocks, value stocks have staged a notable comeback in 2022, as rising inflation and interest rates have triggered a reckoning for any asset with "long-duration" cash flows.

Investors' attention has been drawn to the growth-versus-value distinction, too, not least because that long period of value underperformance has left core equity indices very "growth-heavy." That has led to style drift in many of the supposedly core active strategies that benchmarked against those indices. Even some value strategies have compromised their discipline to avoid lagging too far behind their growth-oriented peers. These dynamics have left some investors more exposed to the recent sell off in growth stocks than they might have expected, going by the labels on the products in their portfolios.

It is not too late to rectify these unintended biases, in our view. The first steps are to measure the factor biases and regime sensitivity of your portfolio as a whole, and the contributions to those exposures being made by each underlying strategy. The next step is to assess whether the risk profile revealed is what you want. If it isn't, the final steps involve rebalancing your existing strategies and, potentially, seeking out and assessing new ones to deliver the exposures you intend.

Index Definitions

The **Russell 1000 Value Index** measures the performance of the large cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with relatively lower price-to-book ratios, lower I/B/E/S forecast medium term (two-year) growth and lower sales per share historical growth (five years). The index is completely reconstituted annually.

The **Russell 1000 Growth Index** measures the performance of the large cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium-term (two-year) growth and higher sales per share historical growth (five years). The index is completely reconstituted annually.

The **MSCI Europe Growth Index** captures large- and mid-cap securities exhibiting overall growth style characteristics across the 15 Developed Markets (DM) countries in Europe: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the U.K. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend.

The **MSCI USA Growth Index** captures large- and mid-cap securities exhibiting overall growth style characteristics in the U.S. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend.

The **MSCI Japan Growth Index** captures large and mid cap securities exhibiting overall growth style characteristics in Japan. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend.

The **MSCI AC Asia ex Japan Growth Index** captures large- and mid-cap securities exhibiting overall growth style characteristics across Hong Kong, Singapore, China, India, Indonesia, Korea, Malaysia, the Philippines, Taiwan and Thailand. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend.

The **MSCI USA Value Index** captures large- and mid-cap U.S. securities exhibiting overall value style characteristics. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield.

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Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

www.nb.com