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Why We Believe Value Still Has Value

After 13 years of outperformance by growth stocks, we see growing concern that the style has become dominated by a handful of mega-cap technology companies, as well as evidence of an early-cycle comeback for value. Those who insist that they still don't need a dedicated value allocation offer three strong-sounding arguments.

"This time is different." The valuation metrics of the past are meaningless for today's technology leaders.

"Another year, another 'value comeback'." When value underperforms for 13 years, what is to stop it from underperforming for another year, or two, or five or 13?

"I'm a 'core' investor." Investors who hold index-like or 'core' exposures, balanced between growth and value stocks, don't need to worry.

In this article, we explain why we think each one of those arguments is wrong, and why we believe outperforming value stocks could be the defining trend of the next few years.

At its height in October last year, the market capitalization of the video conferencing platform Zoom had exploded by 800% in 18 months. The company had grown to be bigger than 15 of the world's largest airlines combined. Depending on your view of things, that may reflect unsustainable dotcom-era valuations of technology growth stocks or just the reality of the new world we all live in.

Those who regard such valuations as unsustainable tend to cite the sudden and violent rotation from growth to value stocks on November 9 last year, when the first phase-three trial data for a coronavirus vaccine were published, as an early sign of what is to come. By contrast, those who believe "Vaccine Monday" was a mere blip in the ongoing dominance of growth tend to counter with the following three arguments.

"This time is different"

The growth skeptics like to compare today's stock prices with the book value of the companies in the index. We show the difference between this ratio for the Russell 1000 Growth Index and the same ratio for the Russell 1000 Value Index in figure 1, and it reveals a dramatic picture: the valuation premium for growth over value stocks today is well in excess of that seen during the dotcom boom of the late 1990s, one of the great growth-stock bubbles in history.

FIGURE 1. ARE CURRENT GROWTH-STOCK VALUATIONS MORE EXTREME THAN DURING THE DOTCOM BOOM?

Russell 1000 Growth Index price-to-book ratio minus Russell 1000 Value Index price-to-book ratio, 1995 – 2021

Source: Bloomberg. Data as of January 12, 2021. For illustrative purposes only. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

But what is book value? Generally, speaking, it is the value of the assets reported on a company's balance sheet, minus liabilities—but also minus intangible assets. And intangible assets include goodwill, software, trademarks, and the intellectual property inherent in the company's workforce and its research and development program—some of the most valuable aspects of a modern technology business. They will nearly always look expensive relative to book value.

But hold on a moment. The value of technology companies was located mostly in tangible assets during the dotcom boom, too, but that didn't mean those companies were not overvalued. The most telling thing back then was not their lack of tangible assets, but their lack of sales and profits. In the first flush of excitement about how the internet was going to change the world, investors put ambitious valuations on companies that hadn't yet figured out a way to make money or hadn't even got an obvious product or service to sell.

This time around, things are definitely different. Few would argue that Amazon, Microsoft, Apple or Alphabet, or even Facebook, Twitter and Netflix, are not well-established businesses offering successful products and services and clear profit-making models, protected by robust "moats" against their competitors. Things could still go wrong for these companies, but their shareholders are hardly buying into some vague dream about the future.

So, what happens when we compare today's index prices with sales, forward earnings and realized earnings? You can see that in figure 2.

It's a much less dramatic picture than the price-to-book chart. The growth-stock valuation premium based on earnings appears much more reasonable than during the dotcom boom, although the premium based on sales is approaching a similar steepness. Still, it's worth reiterating that the dotcom boom was one of the great bubbles in history: strip it out, and today's growth-stock premiums are many times greater than the long-term averages.

FIGURE 2. THIS TIME IS DIFFERENT FROM THE DOTCOM BOOM… BUT NOT THAT DIFFERENT

Russell 1000 Growth Index valuation ratio minus Russell 1000 Value Index valuation ratio, 1995 – 2021

Source: Bloomberg. Data as of January 12, 2021. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Is that expensive? That depends to some extent on how different you believe the business environment is for growth stocks, relative to 20 years ago, five years ago or even one year ago. The coronavirus crisis appears to have meaningfully accelerated the automation and "digitalization" of our lives as consumers, employees and businesspeople. Some of that remote working, shopping and networking is likely to roll back once lockdown restrictions end, but probably not all of it. Zoom may not completely replace air travel, as current relative market capitalizations suggest, but we are unlikely to give up video conferencing on the day our offices open and our passports become valid again.

This time is different on growth-stock valuations, then—but not that different. We may not be in a historic bubble; growth stocks may not even be unsustainably expensive; but it is hard to argue that they are cheap.

"Another year, another 'value comeback'."

Cycles do not typically die of old age. A change in investment sentiment usually requires a fundamental catalyst. Without that, growth stocks could well continue to outperform value stocks. We acknowledge that investors have a right to be cynical when someone tells them this is the year when value will finally make a comeback. The same prediction seems to get rolled out every year. The question is, what's the fundamental catalyst for that comeback?

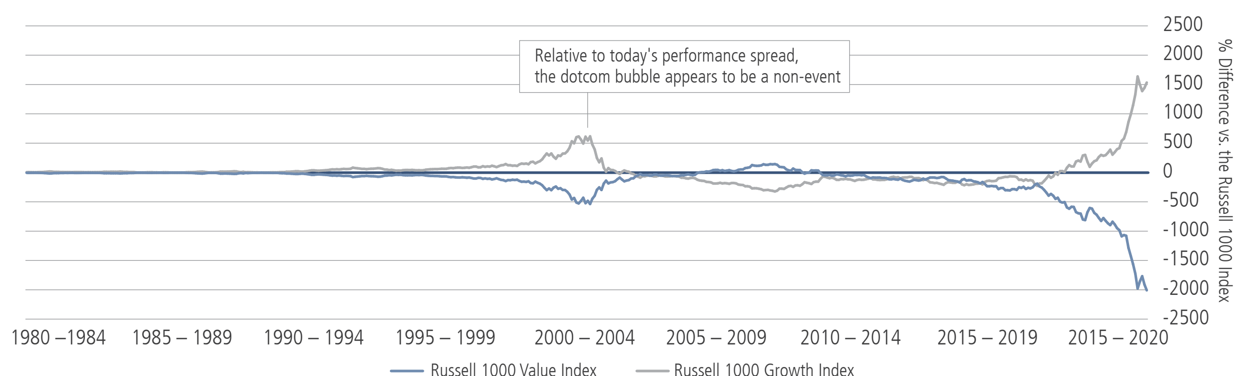
We think that the low bases set during 2020 are likely to make 2021 a year of meaningfully higher growth, moderately higher inflation and a higher year-on-year change in interest rates than we have become used to over the past decade. Time will tell whether this leads to a sustained macroeconomic change, but for this year, at least, it could change investors' view of growth and value stocks in two ways.

First, the growth environment matters. In an environment of steady but low growth, investors primarily look for assets that are expected to generate earnings growth in excess of prevailing GDP growth. That, as we have seen, puts growth stocks in favor. By contrast, in a relatively high-growth environment it is easier to find growing earnings and investors instead shift focus onto how much they are paying for those earnings. That "early-cycle" dynamic has tended to put value stocks in favor.

Second, the movement of interest rates matters. When investors put a value on future corporate earnings, they must apply a discount rate to calculate their value in today's dollars. Interest rates are the basis for that discounting, and the higher they are, the lower the present value of future earnings goes. Moreover, the further into the future the earnings are expected to be booked, the bigger is the effect of the changing discount rate. The greater proportion of the earnings of growth stocks tend, by definition, to be further into the future than those of value stocks, which makes them more sensitive to changes in interest rates—in other words, they exhibit "longer duration."

FIGURE 3. THE PERIOD OF MAJOR GROWTH OUTPERFORMANCE WAS AFTER 2015

Cumulative return spread between the Russell 1000 Growth and Value indices and the Russell 1000 Index, 1979 – 2020



Source: Bloomberg, Neuberger Berman. Data as of December 31, 2020. All indices as indicated in the charts are on a total return basis. For illustrative purposes only. Information is obtained from sources deemed reliable, but there is no representation or warranty as to its accuracy, completeness or reliability. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

It is likely for these reasons that, while the outperformance of growth over value stocks is now in its 13th year, it really only took off after 2015. By then, the "Taper Tantrum" of 2013 had made central banks reluctant to map out a path toward higher interest rates and the 2015 sell-off in commodities and emerging markets had revealed serious doubts about global economic growth. The latest, precipitous leap in the chart corresponds with the collapse of global rates toward zero during the coronavirus crisis. Interest rate-sensitive growth stocks benefited significantly from the view that rates would stay lower for longer. A reversal of these growth and rates trends could lead to an equally rapid switch in market leadership.

"I'm a 'core' investor."

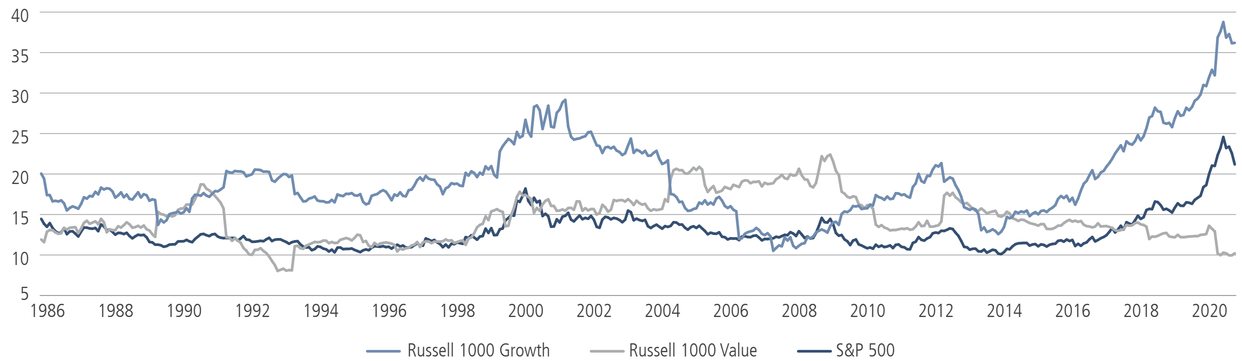
Let's assume that you look at figures 1 through 3 and conclude that growth stocks are due some mean reversion and it would not be a good idea to be caught with too much growth exposure.

It would be tempting to allocate away from your growth managers and into core or index-like exposures and consider the job done. Some of you might already be in that position. Others might point to allocations to the leading value managers and argue that you definitely don't need to worry about a rotation out of growth stocks.

It's worth thinking about what happens to core index composition when we see the kind of outperformance that we see in figure 3, however. That outperformance represents a substantial increase in the market capitalization of growth stocks relative to value stocks, and because most benchmark indices are market capitalization-weighted, that has led to growth stocks becoming a larger and larger proportion of those indices.

Figure 4 shows how the five largest stocks in the Russell 1000 Growth Index account for almost a third of its market capitalization and, over the 18 months to the end of 2020, 50% of its total return. But even in the core S&P 500 Index, those same five stocks represent one-fifth of market capitalization and, again, almost 50% of the total returns of the same trailing 18 months. Allocating away from growth strategies and managers to benchmark-like investments could help to lessen exposure to these stocks—but not as much as one might think.

FIGURE 4. GROWTH AND CORE INDICES HAVE BOTH BECOME CONCENTRATED IN THE SAME HANDFUL OF TECHNOLOGY GROWTH STOCKS
Combined market capitalization of the five largest stocks as a proportion of each index, 1986 – 2020



Contribution to return and average weight in each index, June 28, 2019 – December 31, 2020

	Russell 1000 Growth Index		S&P 500 Index	
	Average Weight in Index	Contribution To Index Return	Average Weight in Index	Contribution To Index Return
AAPL	9.03%	11.34%	5.19%	6.22%
MSFT	8.60%	6.38%	5.11%	3.52%
AMZN	6.46%	5.24%	3.80%	2.96%
GOOGL	5.01%	3.04%	3.19%	1.84%
FB	3.42%	1.66%	2.02%	0.97%
Total	**32.51%**	**27.66%**	**19.31%**	**15.52%**
% of Index Total Return		**49.80%**		**49.60%**

Source: BofA U.S. Equity & Quant Strategy, Bloomberg. Data as of December 31, 2020. Note that the chart shows the weight of the five largest stocks at each given point in time and that the constituents of that group have changed over time: the five stocks listed in the table were the five largest stocks in the respective indices on December 31, 2020. For illustrative purposes only. This material is not intended as a formal research report and should not be relied upon as a basis for making an investment decision. The firm, its employees and advisory accounts may hold positions of any companies discussed. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

What if you pair a core exposure with an allocation to some value strategies? That is likely to help some more, but even here we think it is important not to be complacent.

Look at figure 5. It shows how many of the 10 largest large-cap value funds in the Morningstar universe have at least one of the five mega-cap technology-related growth stocks in their top 10 holdings. Four of the 10 have two of those stocks in their top 10; one even has Alphabet, Apple and Microsoft. And of the five that do not hold these stocks in their top 10, two are index funds that would be unable to hold them in any case.

FIGURE 5. HALF OF THE 10 BIGGEST U.S. LARGE CAP VALUE FUNDS HAVE ONE OF THE FIVE BIG TECHNOLOGY GROWTH STOCKS IN THEIR TOP 10 HOLDINGS

	Alphabet in top 10?	Apple in top 10?	Amazon in top 10?	Facebook in top 10?	Microsoft in top 10?
Fund 1	✓	✗	✗	✗	✓
Fund 2	✗	✓	✗	✗	✓
Fund 3 (Index Fund)	✗	✗	✗	✗	✗
Fund 4	✗	✗	✗	✗	✗
Fund 5	✓	✓	✗	✗	✓
Fund 6	✗	✗	✗	✗	✗
Fund 7	✗	✗	✗	✗	✗
Fund 8	✓	✗	✗	✗	✓
Fund 9 (Index Fund)	✗	✗	✗	✗	✗
Fund 10	✗	✓	✗	✗	✓

Source: Morningstar. Data as of December 31, 2020. The table shows the 10 largest funds by assets under management categorized by Morningstar as U.S. Large Cap Value. This material is not intended as a formal research report and should not be relied upon as a basis for making an investment decision. The firm, its employees and advisory accounts may hold positions of any companies discussed. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable.

We think these statistics are truly remarkable. It is hard to imagine how any one of these five could credibly be categorized as value stocks. Moreover, we believe that many other funds in this category, outside the top 10, also hold substantial positions in these stocks, to mitigate the risk of underperforming the core index or their core- and growth-oriented competitors, after so many years of growth outperformance.

Whatever the reason, when allocating to value as a diversifier alongside growth and core investments, in our view owning these stocks doesn't help. We think investors should check the top holdings of their value managers before they assume their portfolios are prudently balanced by style exposure. You may have more growth than you think. Neuberger Berman value strategies managed by the authors of this paper have been materially underweight technology stocks for the past five years and have not held any of the stocks identified as the cause of concentration in the growth or core large-cap indices over that time.

Genuine Balance Could Be Important in 2021

We would not claim there is a bubble in growth stocks, but we do think it is clear that growth stocks are not cheap—especially relative to value stocks. We also believe that economic conditions during 2021 could be more favorable to value stocks than they have been for many years—and that this early-cycle environment has the potential to persist beyond 2021. And finally, after 13 years of outperformance, and five years of really marked outperformance, growth stocks have assumed a substantial share of the market capitalization and exposure of even core indices and strategies—indeed, they are now showing up even in leading value strategies.

In short, we believe a genuine balance of value and growth could be important for maintaining relative performance over the coming months, and that achieving that balance will require a detailed assessment of which stocks portfolio strategies are holding.

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INDEX DEFINITIONS

The **Russell 1000 Index** measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000 Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 90% of the U.S. market.

The **Russell 1000 Value Index** measures the performance of those Russell 1000® Index companies with lower price-to-book ratios and lower forecasted growth values. The index is market cap-weighted and includes only common stocks incorporated in the United States and its territories.

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 higher price-to-book ratios and higher forecasted growth values.

The **S&P 500 Index** is a capitalization weighted index comprised of 500 stocks chosen for market size, liquidity, and industry group representation. The S&P 500 Index is constructed to represent a broad range of industry segments in the U.S. economy.

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