# Value investing: is this the start of a new narrative?

March 2023

2022 was a good year for value investing. After several tough years of underperformance, the value investment style outperformed the broader market. This has led investors to ask whether the value rebound can continue. In our view, there are several reasons to believe that the prospects for value investing remain attractive and we could potentially be at the start of a new style shift in the market.

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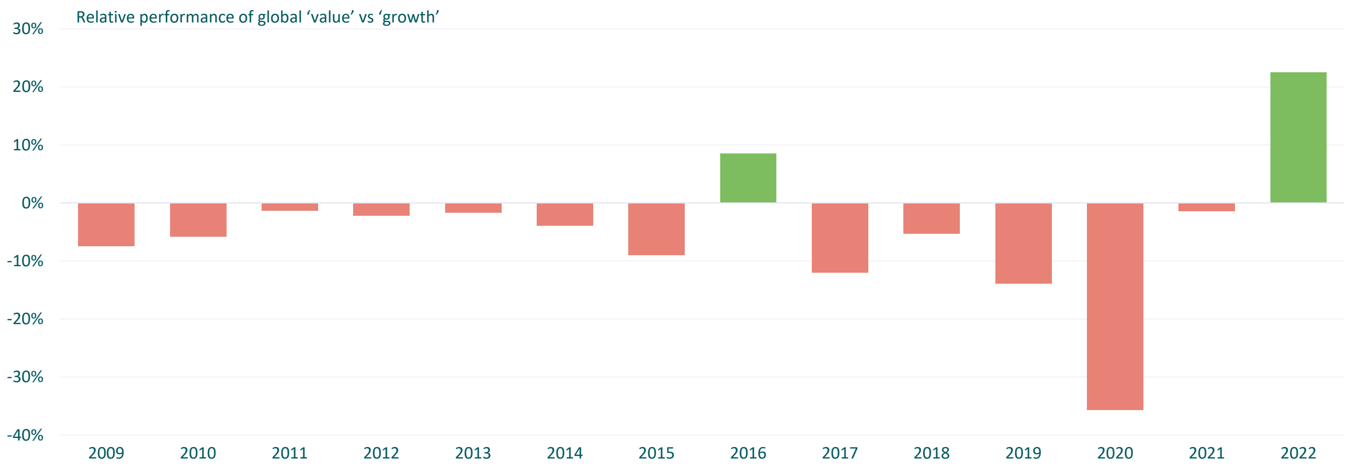
## Value was resilient in 2022

The value investment style was one of the few bright spots amid last year's turmoil in financial markets. Value stocks, that is lowly-valued, out of favour companies, were relatively resilient and outperformed the broader market by a significant margin. They also outpaced 'growth' stocks by an even greater amount (figure 1). (Growth stocks are generally expected to deliver above-average increases in earnings and profits.)

Figure 1: Back to life
Value outperformed growth in 2022 after years of underperformance




Past performance is not a guide to future performance.

Source: MSCI World Value – Growth, Refinitiv Datastream, 31 December 2022

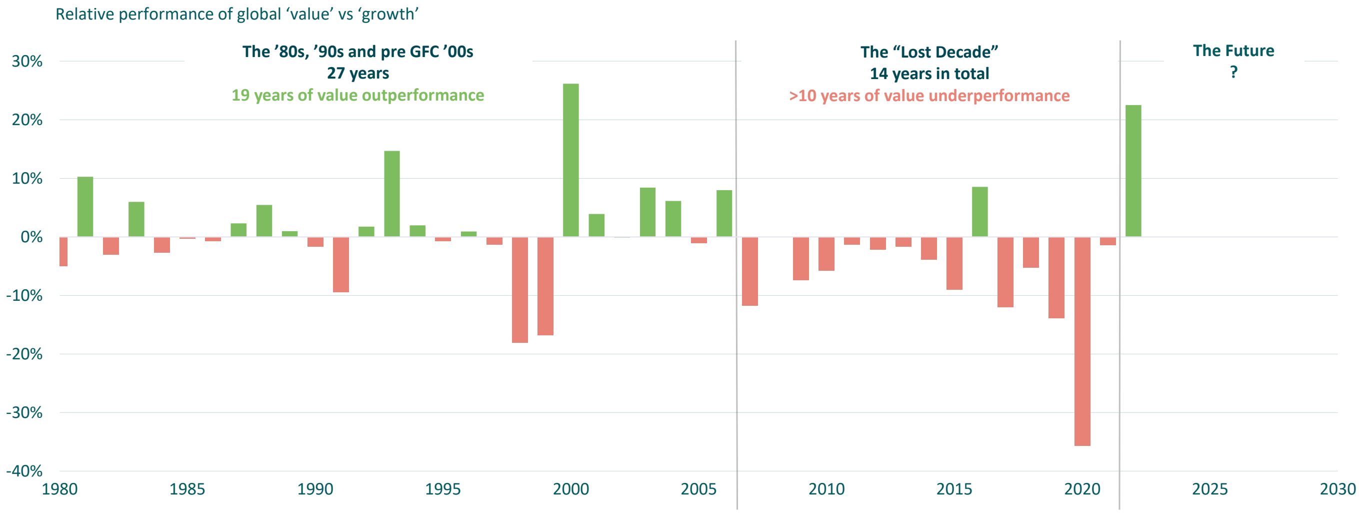
More than ten years of underperformance, relative to growth, had led to suggestions that value investing was dead. As dedicated value investors, we did not agree with this assessment. We continued to believe that valuation is a core anchor to successful long-term investing and during the challenging 'lost decade', we have waited patiently for this to be realised.

## Looking back in time

Now that value has returned to favour, we think there is a need to remind investors about value's long-term potential. For the past few years, expensive growth stocks have driven the market – this has meant investors have simply had to buy growth stocks to outperform the market. However, if we look further back in time, we can see that in the 1980s, 1990s and early 2000s value had a sustained period of outperformance (figure 2). Value investing became an established strategy because it worked for extended periods, across different business cycles.

In our view, value's underperformance in the past decade is an aberration. However, recent history has arguably had a powerful effect on investors' thinking and value's previous performance seems to have been forgotten. We believe that value investing is not just a short-term phenomenon with occasional periods of outperformance; we are convinced that identifying unloved stocks with low valuations has the potential to be a successful long-term strategy.

Figure 2: Lessons from history
Value's recent underperformance has overshadowed past outperformance

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## A challenging period

One way of potentially highlighting value's prospects is to try and understand why value investing stopped working. In our view, one of the main factors contributing to value's underperformance in the past decade was the measures implemented after the global financial crisis (GFC) of 2008/9. This saw major central banks slash interest rates and embark upon quantitative easing (QE) policies (purchasing financial assets such as government bonds) to stimulate the economy. This was followed by another huge injection of QE during the COVID-19 pandemic in 2020.

We think the value style can cope with declining interest rates, but it struggled when interest rates went to zero. In this environment, investors stopped paying attention to valuations. With a risk-free rate of 0% (the amount investors can expect on an investment without any risk), they were able to justify paying high multiples for what were perceived to be higher quality and fast-growing companies.

In addition to the challenge of QE, we think globalization trends and the rise of Chinese companies represented other significant headwinds for the value style.

## A new narrative

But encouragingly, the factors that supported growth's outperformance for a decade could be ending. Interest rates have risen sharply over the past year as central banks have sought to curb high inflation. We have also seen a switch from QE to quantitative tightening (QT), with central banks planning to unwind their huge bond holdings. There are also signs of a retreat from globalization (indicated by a growth in nearshoring).

As previous trends go into reverse and new dynamics emerge, such as the energy transition, we believe the environment for many companies will also change. And when there are shifts in the market, we believe there is often migration between what is perceived as value and what is growth.

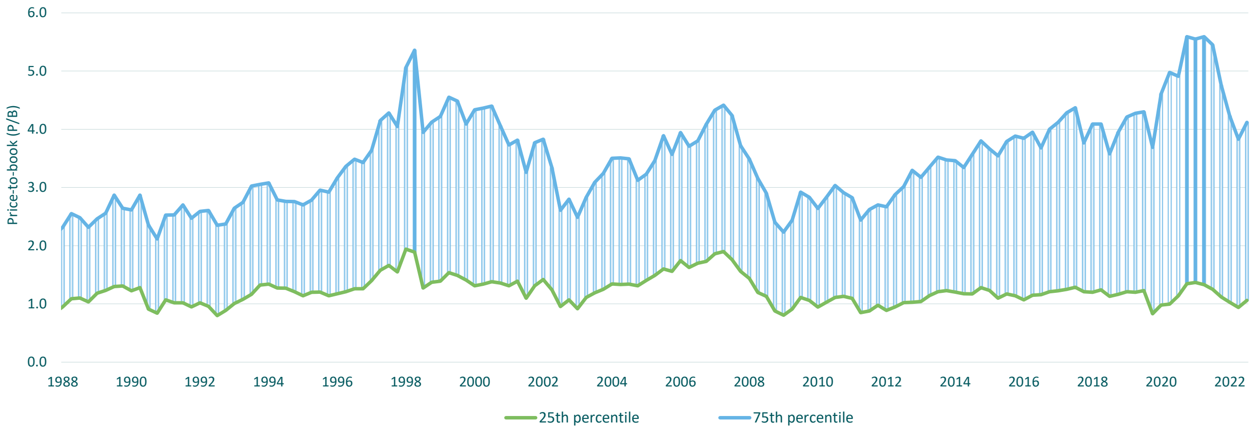
In a new regime, investors might take a closer look at stocks that were previously ignored and shun those that have been in favour; value stocks could become the new growth stocks and vice versa. For example, banks, which have had a tough time post the GFC with increased regulation and zero interest rates, could experience a change of fortunes in a higher interest rate environment. The energy sector is another unloved area (despite last year's gains) that could potentially benefit from robust demand and the energy transition.

On the other hand, many popular mega-cap technology stocks have retreated over the past year as rising interest rates led investors to question their elevated valuations. Given the potential for this migration to continue, we think the cheapest end of the market offers not just attractive valuation opportunities currently, but also in many cases attractive growth as well.

## Wide opportunity set

Despite a good outcome last year, we still think the recent value rebound has further to go. In our view, the decade-long underperformance of value has not yet come close to fully unwinding. The valuation spreads between the cheapest stocks in the market and the most expensive remain historically very wide, as figure 3 shows for the European market.

Figure 3: Wide gap between cheap and expensive stocks in Europe
MSCI Europe Index: Price-to-book spread between 25th and 75th percentile




Past performance is not a guide to future performance. Information is subject to change, and is not a guarantee of future results

Source: Refinitiv Datastream, 31 December 2022. Highlighted bars indicate periods where price-to-book spread is greater than the current price-to-book spread

As we go through the year, we are likely to see the market wrestle with some big issues, including, but not limited to, the ongoing war in Ukraine; the path of global inflation and central bank policies; and the possibility of an economic recession. Although these uncertainties could cause some market volatility, as patient, valuation-focused investors, we are not unduly troubled given the wide opportunity set we see in the market currently.

With such a diverse range of potential outcomes, it will be important to have a very balanced portfolio. However, given the wide valuation spreads and the encouraging backdrop for value style, we feel we can still generate a diversified, reasonably balanced portfolio with very attractive valuation characteristics combined with decent fundamentals.

## M&G's focus on value

At M&G, the search for value underpins our approach to investing. We believe that valuation is a key element in identifying good investments – a disciplined focus on valuations is essential, in our view, to finding assets whose true worth is being mispriced by the market.

We have considerable experience and expertise in searching for undervalued opportunities across different markets and asset classes. We offer regional and global 'value' equity strategies that invest purely in lowly valued companies that are deemed mispriced. We also manage a number of equity and multi-asset strategies that employ a strict valuation focus to help them identify attractively valued or underappreciated investments.