January 2023

Fish Don't Know They're in Water;
Do Today's Investors Know a Regime Shift has Occurred?

I spent the mid-1980s studying for the (then relatively unknown) CFA exams and designation in the still nascent field of institutional investing. Much of the CFA program at that time offered lessons on how to operate in a rising rate environment, the challenge of the prior 40 years.

I was an analyst at an insurer and was assigned to "roll" maturing short-term T-Bills. Back then, short-term notes earned 13% yields. This was not long after Paul Volker had broken the back of runaway inflation expectations in 1981. However, not everyone believed inflation had been slayed yet. After 40 years of rising rates, understandably, the familiar fear that run-away inflation would return was pervasive.

David Foster Wallace famously introduced the idea that, "fish don't know they're in water" highlighting that the most obvious, ubiquitous and important realities are often the hardest to see and accept. Regime changes are similar. It will take a while for investors to accept that a change from a disinflationary period to an inflationary period has occurred, and thus valuation opportunities will be impacted.

Investors who actively study financial history can see inflationary periods, followed by disinflationary periods, and vice versa, and are more likely to accept the changed reality. They tend to surmise how best to adapt to the emerging reality and earn an investment running start.

The period from 1981-2020 was in fact a disinflationary period where interest rates ultimately softened. Although rates declined immediately, it took until the 1990s when rates fell below 7.5% for equity investing to become attractive again, since historically equities overall see an average long-term return of 9.5%. Around 2011, equity investors learned that as rates fell dramatically, the present value of growth stocks' future earnings increased, allowing the growth style of investing to earn excess returns (note value vs. growth chart on the following page).

COVID-19 lockdowns, stimulative federal policies and supply disruption were dramatic enough shocks to start an inflection to rising inflation and rates. Further events transpired, inflation grew dramatically and has, in retrospect, cemented the bottom of disinflationary rates to July 2020.

Not surprisingly, like in the early 1980s, many investors are expecting a return to the market norms that were pervasive the last couple of decades. Further, we have seen an emerging expectation that determined central bankers will be able to rapidly contain inflation below 2% before long and give advantages back to the growth style of investing. However, a Bank of America study looking at the past 40 years, demonstrates that once inflation has risen above 5%, it takes on average 10 years to get inflation contained to 2% again.

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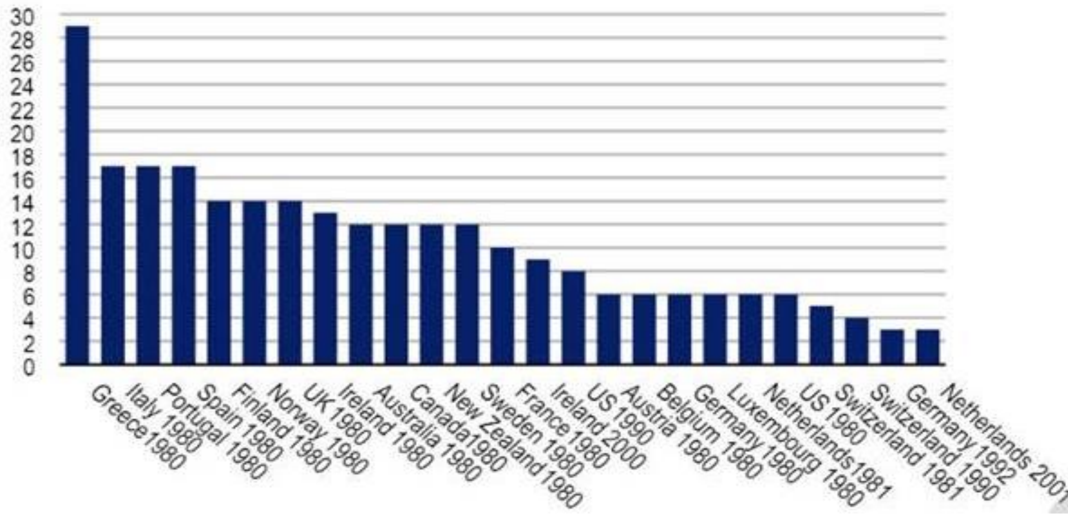
Cases of Inflation Above 5% in Advanced Economies 1980-2020, Years to Decline to 2%



Source: BofA Global Research.

We have to go back 80 years to 1941 to find a similar period where rates shifted from disinflation to inflation.

Value vs. Growth 10-Year Rolling Performance (Annualized) (06/30/1926 – 03/31/2019)

Source: Eugene Fama & Kenneth French. Ronald Blue Trust. 2019. 2019-2022 is an estimate by Sionna based off S&P 500 Value and S&P 500 Growth Index Data.

The experience from 1941 to 1951 shows a dramatic advantage to the value style of investing in the immediate aftermath of the switch (13% annualized advantage over growth). Value's outperformance was largely sustained until rates fell low enough in 2011 to begin a long-term outperformance of the growth style, similar to the deflation experience in the 1930s. However, over the century, the overall advantage in returns was for the value style.

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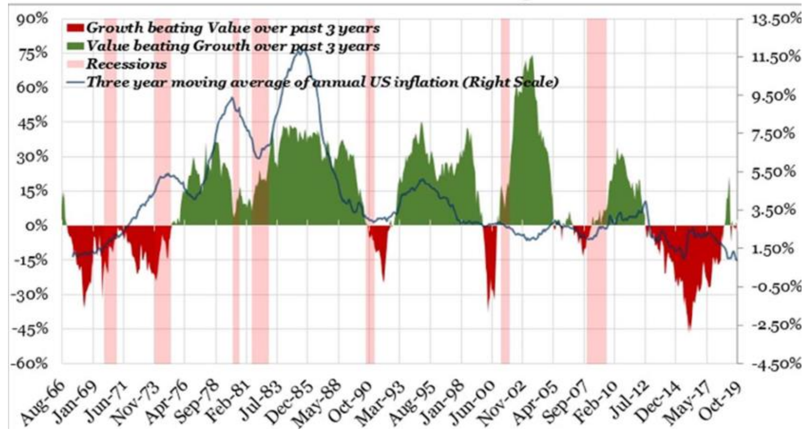
Further, Professor George Athanassakos' research concurs and demonstrates that when inflation is 2.5% or better, the value style outperforms growth by 11% in rolling three-year periods.

Annualized Three Year Average Monthly US Value Premia to P/B Ratio Based Value and Growth Strategies: 1966-2019

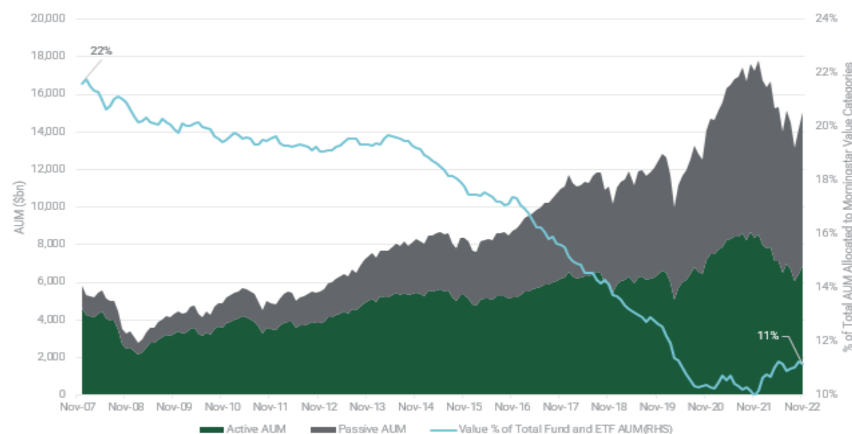


Source: George Athanassakos. Ben Graham Centre for Value Investing. October 2021

Lessons from history suggest investors should rebalance their excess allocation to growth down to an underweight, or at least a balance with value. In the century of data from Fama and French, value has compellingly outperformed growth 80% of the time in 10-year periods. It is curious that investors remain so reluctant to shift assets back to value – could this be recency bias at work? Southeastern Asset Management, a respected value manager, shared its analysis of the variability of assets from 13F SEC Filings of similar value managers over time. AUM for value peaked in 2006 at $371.1B and had fallen to $148.9B as at the end of 2021, a decline of 59.8%.

Further, in the retail space, the following chart demonstrates that allocation to mutual funds and ETFs within the value category are at near 15-year lows. This highlights the drain of allocation to value as investors sought short-term excess returns in the growth style and alternative assets.

As % of U.S. Mutual Fund and ETF AUM



Source: Brandes, Morningstar. U.S. Open End Funds and ETFs in International and US equity categories. Value categories include Small Value, Mid-Cap Value, Large Value, Foreign Large Value, Global Large-Stock Value, and Foreign Small/Mid Value.

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However, like the early 1980s, many investors who do not recognize the regime change, largely appear to be discounting underperformance as temporary. Some are justifying inaction with comments that the revaluation has largely occurred, thus it is too late to switch. But as we all know, the early bird often gets the worm (and the most excess returns). And this chart below clearly shows that more is still to come.

Source: Yardeni.com. November 2022.

At Sionna, we are bottom-up stock pickers and we continue to find many companies offering solid value expectations. Our portfolios today are showing relatively generous expected returns of around 30%. Investors' low allocation to value is supporting the bargains we are finding today and creating an opportunity for us to take advantage of. We expect this advantage could be present for several years. We are cautiously optimistic that the 1941-1951 outperformance of value of 13% annualized relative to growth over the decade could be a possibility. Last year was a great running start for those noticing that a regime change had occurred, and we believe there is even more to come.

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For more background of these themes, please see the following Sionna pieces:
Canadian Equity Pieces: A Reversion Expected, Canada Cheapest in a Decade
Value Pieces: Regime Change, Waiting for Dawn, Value Earnings Outpace Growth Earnings, The Value Minsky Moment is Near

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