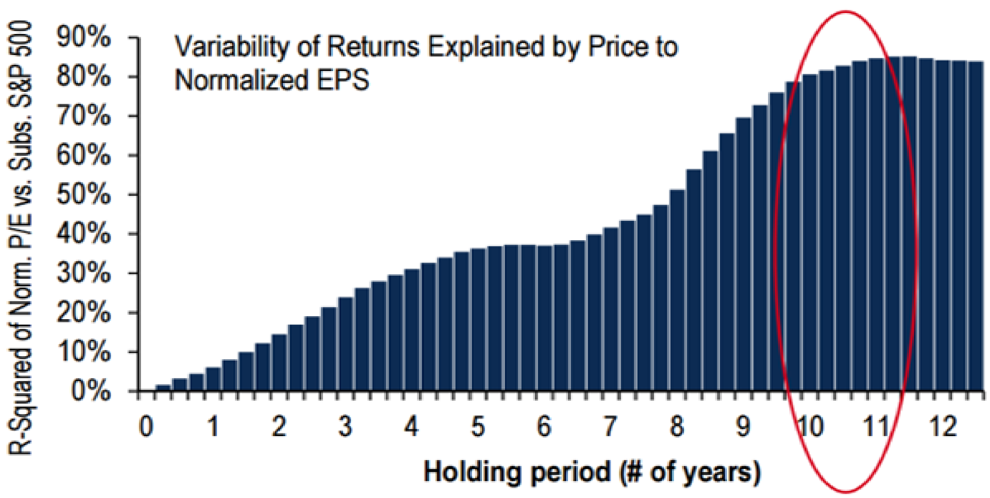
December 2023

Lessons from History: Odds are Value is a Compelling Buy Now

Fundamentals are the cornerstone of valuations of markets and securities in the long run. However, throughout the ages, philosophers, economists and strategists have struggled to accept that people are occasionally (yet predictably) irrational, which gets priced into markets, making market predictions challenging. Although there is not a completely reliable/foolproof predictive tool, a study of market history can provide some useful guideposts to steer wary investors.

Normalized P/E's Predictive Power on S&P 500 Returns



- Market pricing includes a melange of fundamentals and human irrationality

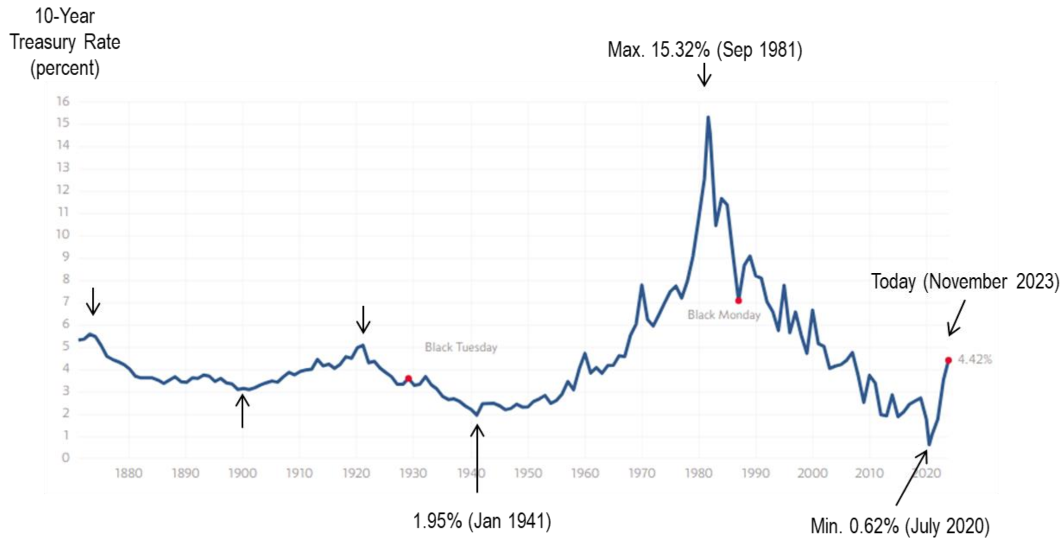
Source: Bank of America Merrill Lynch. Strategy Snippet. The Most Contrarian Theme: Long-Term Fundamental Investing. March 2017.

The predictability of the P/E multiple to explain future returns rises each year until approximately 9 years, where it can explain approximately 80% of returns.

The book, *Factfulness*, by Hans Rosling reminds us that human thinking can be faulty due to ten irrational instincts or tendencies. He suggests that our best antidote is to seek out and anchor our impressions on known facts. When selecting individual stocks, we can rely on financial statement facts, and when looking at macroeconomic valuation market shifts, we can lean on facts/fundamentals from market history.

We will share some historical charts that we believe illustrate how investors have interacted with market fundamentals previously, which appear to offer some rough guideposts in today's market.

Bonds are a comparator asset class to equities and the yield of long bonds can impact stock valuations. The following chart illustrates the 10-year government bond yield over +150 years.



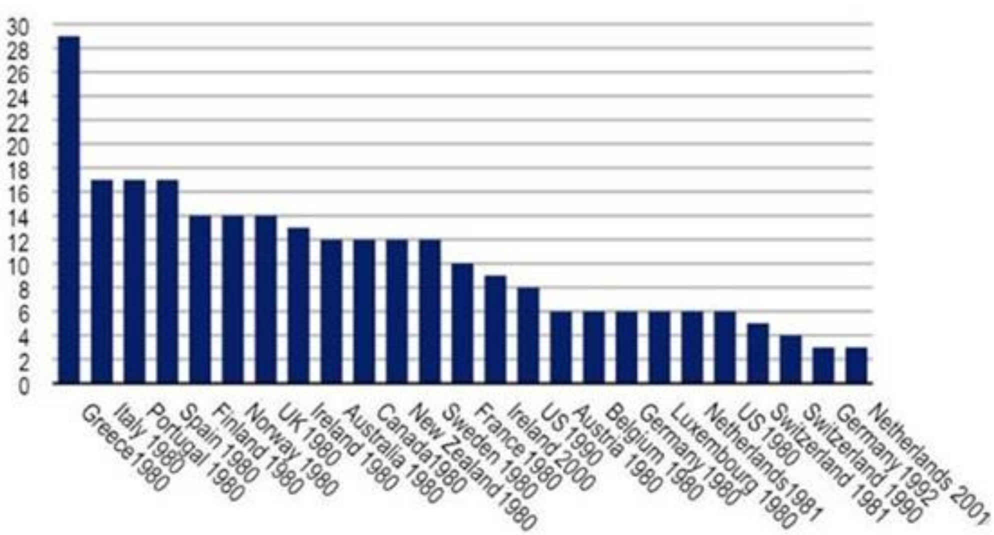
Source: MULTPL. US Treasury, November 22, 2023.

Historically, there has been a rough pattern of approximately 20-year cycles of inflationary periods followed by similarly lengthy disinflationary periods. Occasionally, the cycles are much longer, which was witnessed around the American Civil War and WW2. July 2020 marked a historic disinflationary low and the subsequent beginning of an inflationary cycle. History suggests the coming leg will be a roughly 20-year inflationary cycle.

This regime shift in fundamentals appears to be resisted by many players with forecasts of a rapid return to the previously targeted 2% inflation level. However, the below chart of experiences in developed nations suggests turning inflation back down after rising to 5% can take time – on average 10 years.

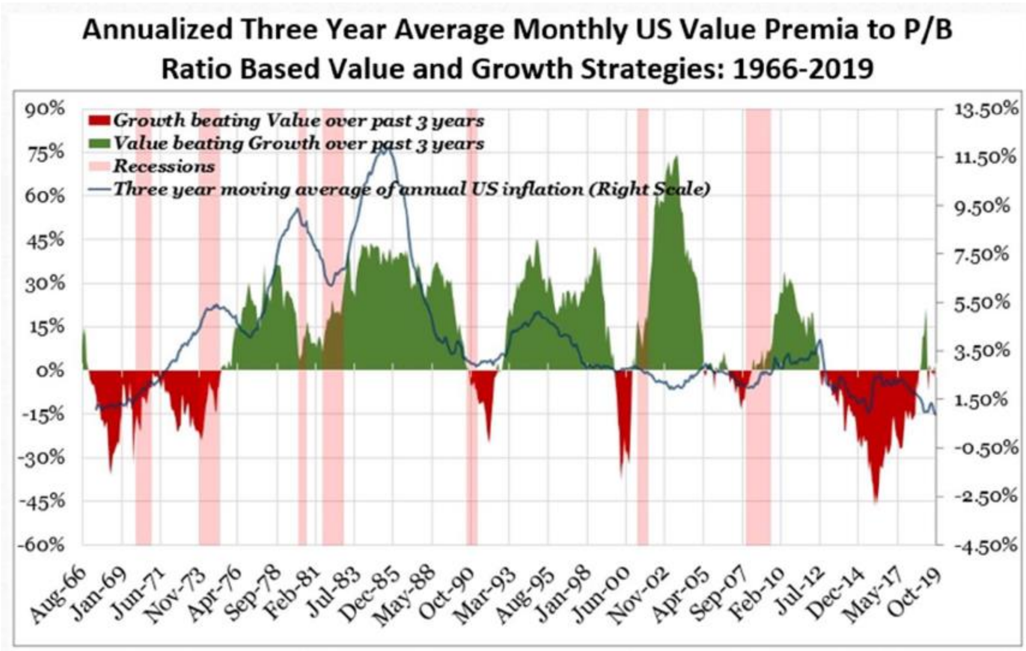
Exhibit 1: Cases of inflation above 5% in advanced economies 1980-2020, years to decline to 2%

Once inflation is above 5% in advanced economies, it takes on average 10 years to drop to 2%



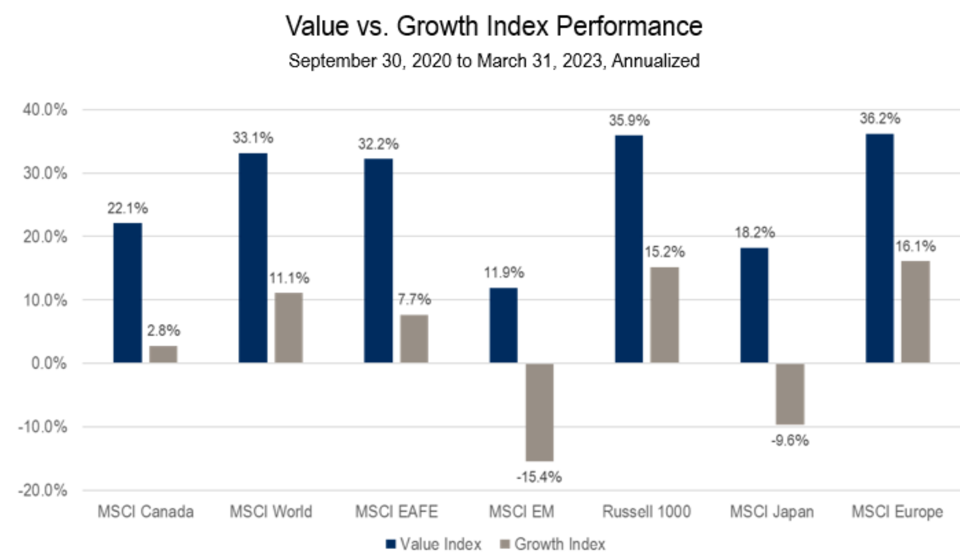
Source: BofA Global Research.

If we are to face some level of inflation over the next 20 or so years, how best to invest in equities? Ivey Business School Professor, George Athanassakos, has some market research to rely on. He took nearly a century's worth of data from Fama and French on the value style versus growth style and studied how the styles performed relative to each other in environments with north of 2.5% inflation.



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

He concluded the value style outperformed the growth style over three-year rolling periods by 11% annualized. It's been a few years since the bottom of 10-year rates in July of 2020. Have Professor Athanassakos' conclusions started to pan out?

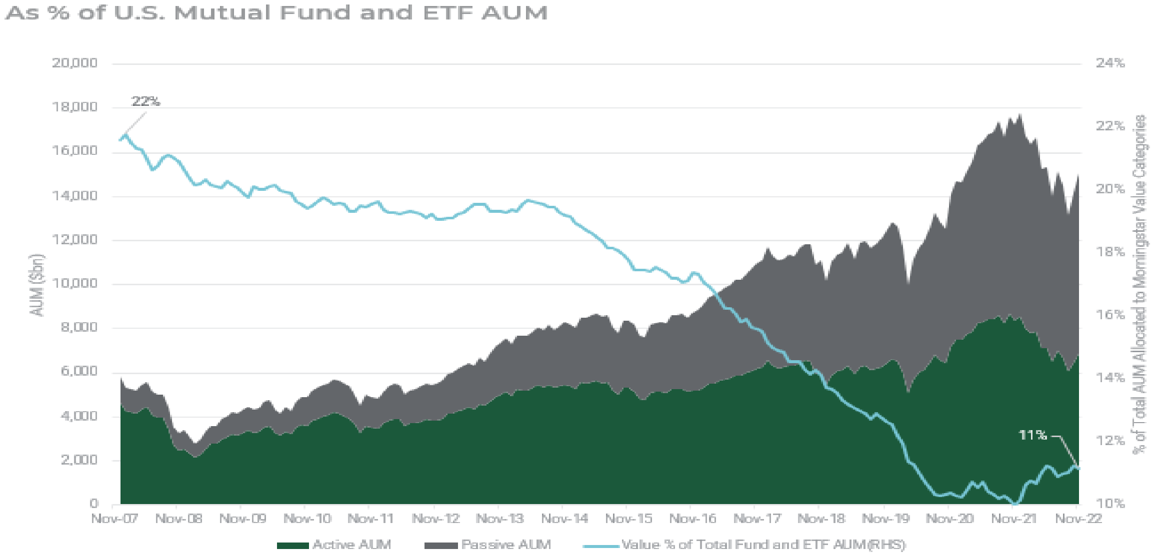


Source: FactSet, MSCI, Sionna Investment Managers

A survey of multiple markets over this recent inflationary period in all instances showed value outperforming growth by 11% or more.

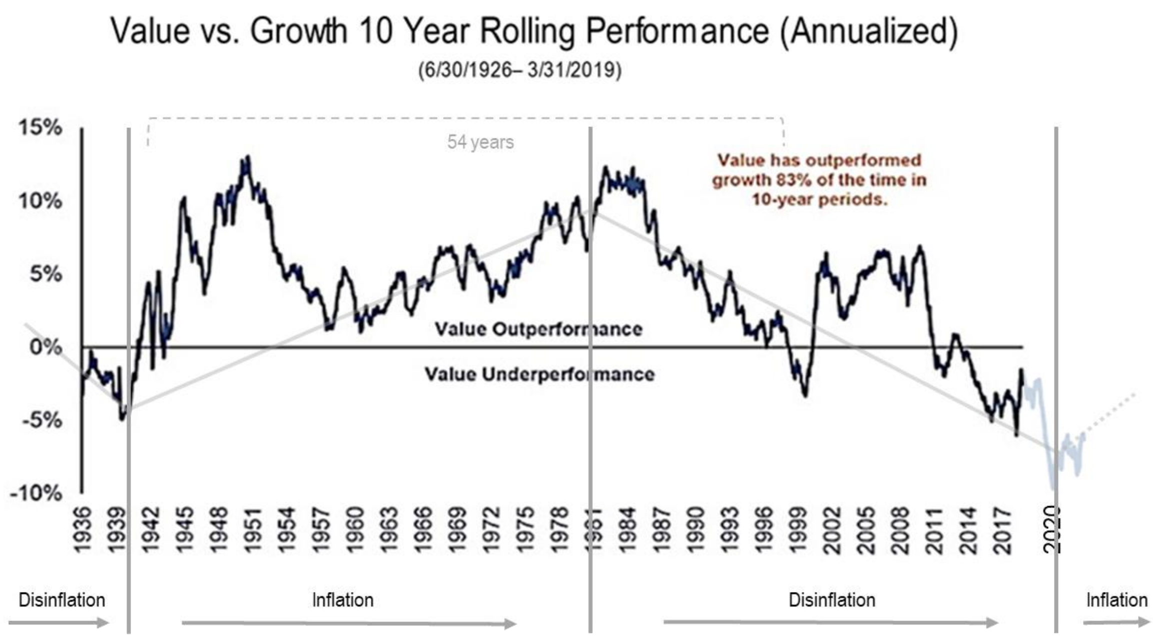
Discussions with our local and global value manager peers suggest few investors have turned their sights to the value style, missing some of this early "easy money" opportunity.

Allocation to Value Style Remains Modest



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.

It's been 82 years since the last turn from a disinflationary period to an inflationary period in 1941. Before this turn, the growth style had outperformed value over 10-year periods consistently for at least 15 years. By the end of 1942, war-fuelled inflation was 10.9% and rapidly led to value outperforming. For 54 years, value consistently outperformed the growth style over rolling 10-year time horizons from 1944 until 1998.



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

So, what does this all mean?

After a 39-year disinflationary cycle, which is the only environment most of us have worked in, it's not simple or easy to rapidly shift gears and adapt to a new regime. This new environment will require all of us to enlarge our skill base.

The shift from disinflation to inflation in 2020 suggests that what worked over the last four decades is unlikely to be as consistently effective in an inflationary environment. We collectively know disinflation from experience, but few have a toolkit to outperform during inflationary periods. However, both market history and recent market experience suggests the value investment style will outperform over the long term in this environment. Investors would be wise to increase their allocation to the value approach.

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