# Value's Back... And It's Only Just Begun

***Looking for a sign that value is back? Look no further than rising interest rates and elevated inflation focusing investors on the value comeback underway.***

The current market environment remains one of the most challenging in recent memory, given the many shifts in the dominant macroeconomic forces of the last decade. This paradigm shift for investors has also brought an end to the growth-led market frenzy that unfolded following the last crisis in 2008-2009. Investors had once again decreed the death of value investing, as they have tried to do so many times before; this prophetic failure arrived just in time for value's impressive comeback that began in 2020. Investors may be struggling with what to do: Is it time to revisit or increase allocations to value?

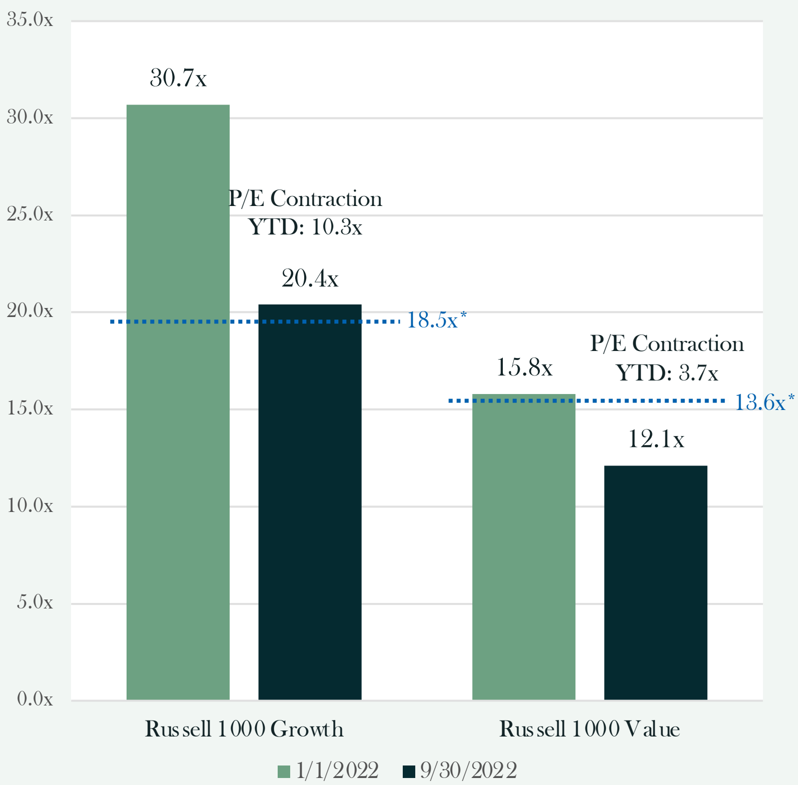
Led by the Federal Reserve, the tightening of monetary policy from the "free money" programs has clearly been one of the most impactful changes. Inflationary pressures last seen in the 1980's from higher energy prices to supply shortages have forced the Fed to reverse its policies and raise interest rates significantly in an effort to lower inflation, even in the face of a potential recession. This is in sharp contrast to the past several years, which saw interest rates hit 5,000-year lows, with the recent move higher just now bringing interest rates back to the more normal levels seen over the last 30 years.[1]

[1] Holodny, E. (n.d.). *The 5,000-year history of interest rates shows just how historically low US rates are right now.* Business Insider. https://www.businessinsider.com/chart-5000-years-of-interest-rates-history-2016-6

Given the market is a discounting mechanism, higher interest rates will negatively impact current valuations, no matter the investment style. Mathematically, as the interest rate rises, future cash flows are worth less today as they are discounted back to the present. The farther in the future and the greater the amount of the cash flow, the more meaningful the impact from higher rates. Valuation multiples are a simple way for investors to quantify the discounting of cash flows for a security: as rates rise, valuation multiples will decline, all else equal.

Businesses with high growth rates forecasted many years into the future previously traded at extreme multiples, leaving them far more susceptible to the pressure of even small interest rate increases which dramatically affect their valuation multiples. Compared to businesses with more consistent, near-term cash generation, future cashflows have a less meaningful contribution to their valuations and thus, moderate the impact of rate increases. While overly simplistic, this difference is an important contributor to the difference in multiple compression seen between growth and value this year. With valuations of value stocks now trading below long-term averages, the market appears to have discounted higher interest rates into current prices and may represent a lower-risk entry point for value compared to growth, which is still trading at a premium. (chart below)

## RUSSELL 1000 GROWTH AND VALUE: YTD22 P/E CONTRACTION




- Value stocks were less susceptible to valuation contraction in 2022 versus growth stocks.
- Growth multiples compressed by 10x as of 3Q22— twice as much as value multiples.
- Growth remains above long-term average; value is now trading below its long-term average.
- Growth may be at greater risk of further declines.

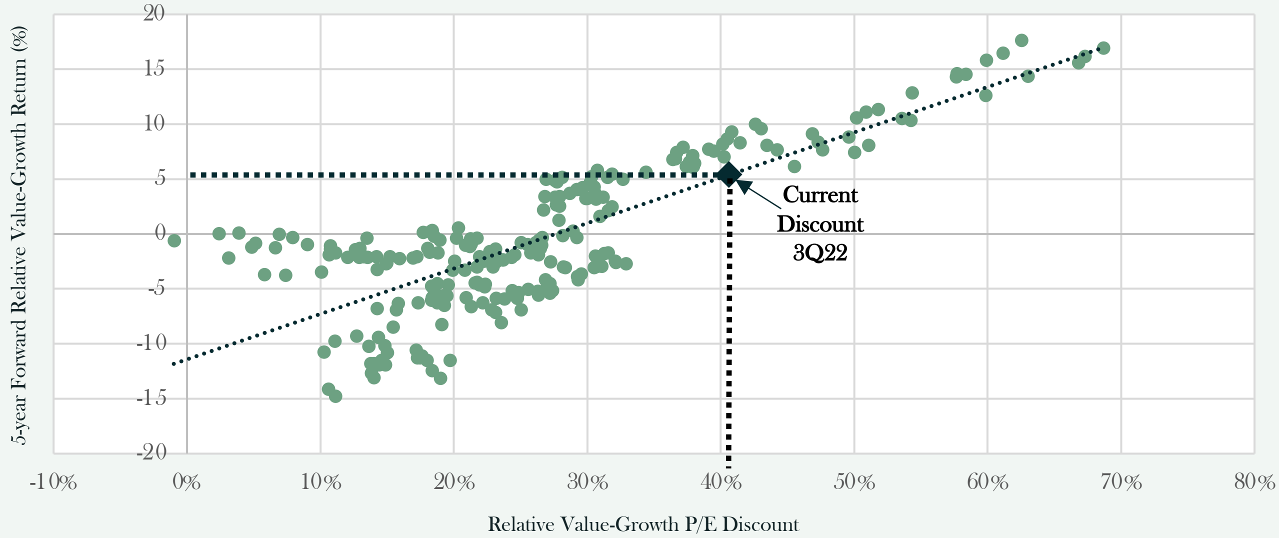
*20-year Average NTM P/E
Sources: Barrow Hanley; FactSet.

One might ask, "Why the focus on valuation starting points?" The answer is because it matters! Historically, starting valuations have shown strong correlations to forward returns of the market, as demonstrated by Robert Shiller who pioneered the CAPE (cyclically-adjusted-price-to-earnings) ratio. Extending this analysis to look at the relative valuation multiple of the Russell 1000 Value compared to the Russell 1000 Growth demonstrates an interesting and similar relationship.

Looking back over monthly data from the last 25 years for the Russell 1000 style indices, a clear trend emerges. Value has historically traded at a discount to growth on forward price-to-earnings ratios, which is not unexpected given the difference in growth rates. However, when that discount becomes extreme, it has been an attractive entry point for value. In fact, when value's discount has grown to 40% or more, value has outperformed growth by more than 5% per year when looking at forward 5-year relative returns—with a 100% success rate! As of the end of the third quarter of 2022, this discount was 41% even with the significant outperformance seen since 2020. Based on the linear trend line, this starting discount would equate to 5.4% annualized value outperformance for the forward 5-year period. Value is back and it's only just begun. (chart below)

## FORWARD 5-YEAR RELATIVE VALUE-GROWTH RETURN BASED ON STARTING P/E DISCOUNT

25 Years Rolling Monthly as of September 30, 2022



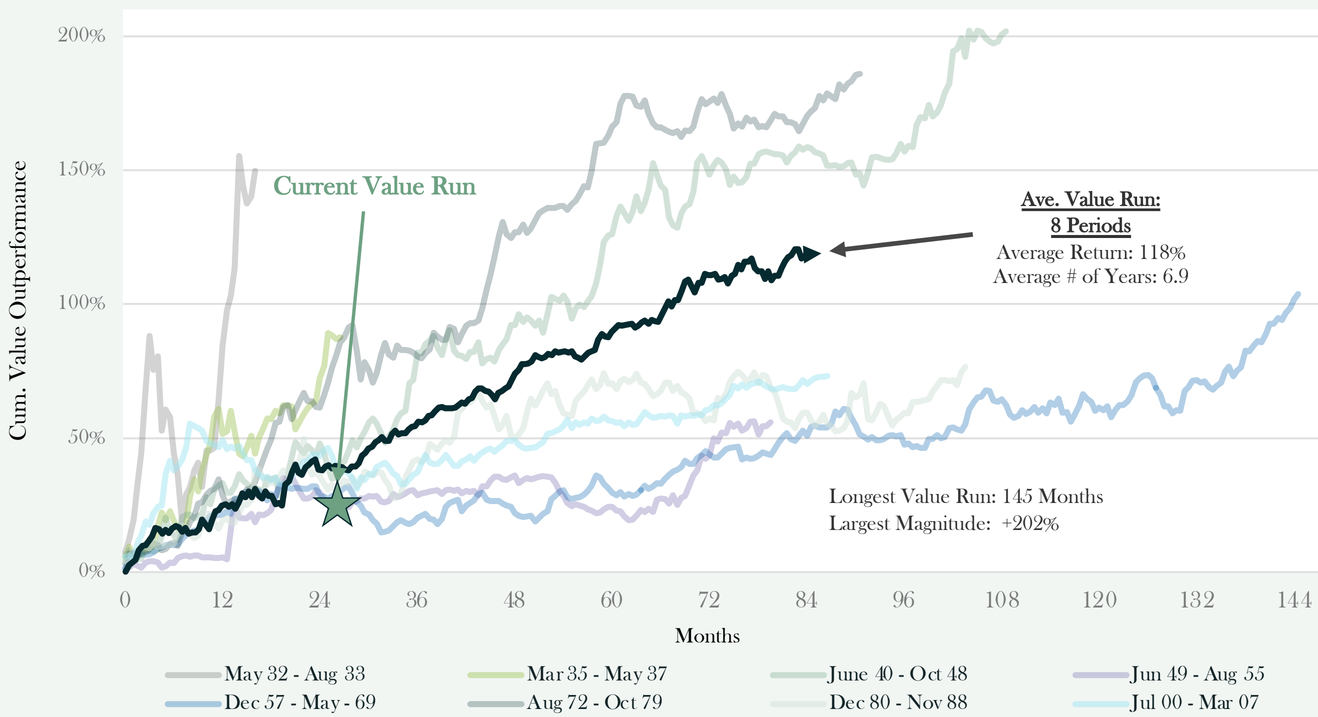

Sources: Barrow Hanley; FactSet. Relative Return refers to the Russell 1000 Value minus Russell 1000 Growth. Relative P/E discount based on forward P/E multiples of the Russell 1000 Value divided by Russell 1000 Growth. Trend references the linear best-fit equation of the above data set. Returns shown are annualized.

- Valuation starting point matters for forward returns. Analyzing the relative discount of value P/E multiples relative to growth shows a correlation to the subsequent 5-year forward returns.
- Forward returns for value appear favorable given the current valuation discount of 41%. Based on the trend of historical data, that starting point would equate to 5.4% annualized value outperformance over the following 5-year period.
- Over the last 25 years, every discount of 40% or greater for valuations as a starting point has delivered outperformance of 5% or greater (annualized) for value relative to growth.

Evidence continues to support the continuation of the ongoing value rally underway. While history may not repeat, value rallies have historically spanned roughly 7 years, leaving multiple years of potential relative performance gains ahead. Value performance relative to growth over time has been cyclical, and typical cycles can last many years, even decades. (chart below)

## OUTPERFORMANCE OF VALUE AFTER GROWTH-LED MARKETS

1926 – September 2022




Fama-French data 1932-1978; Russell 1000 Growth and Value data 1978-2017.
Source: Barrow Hanley.

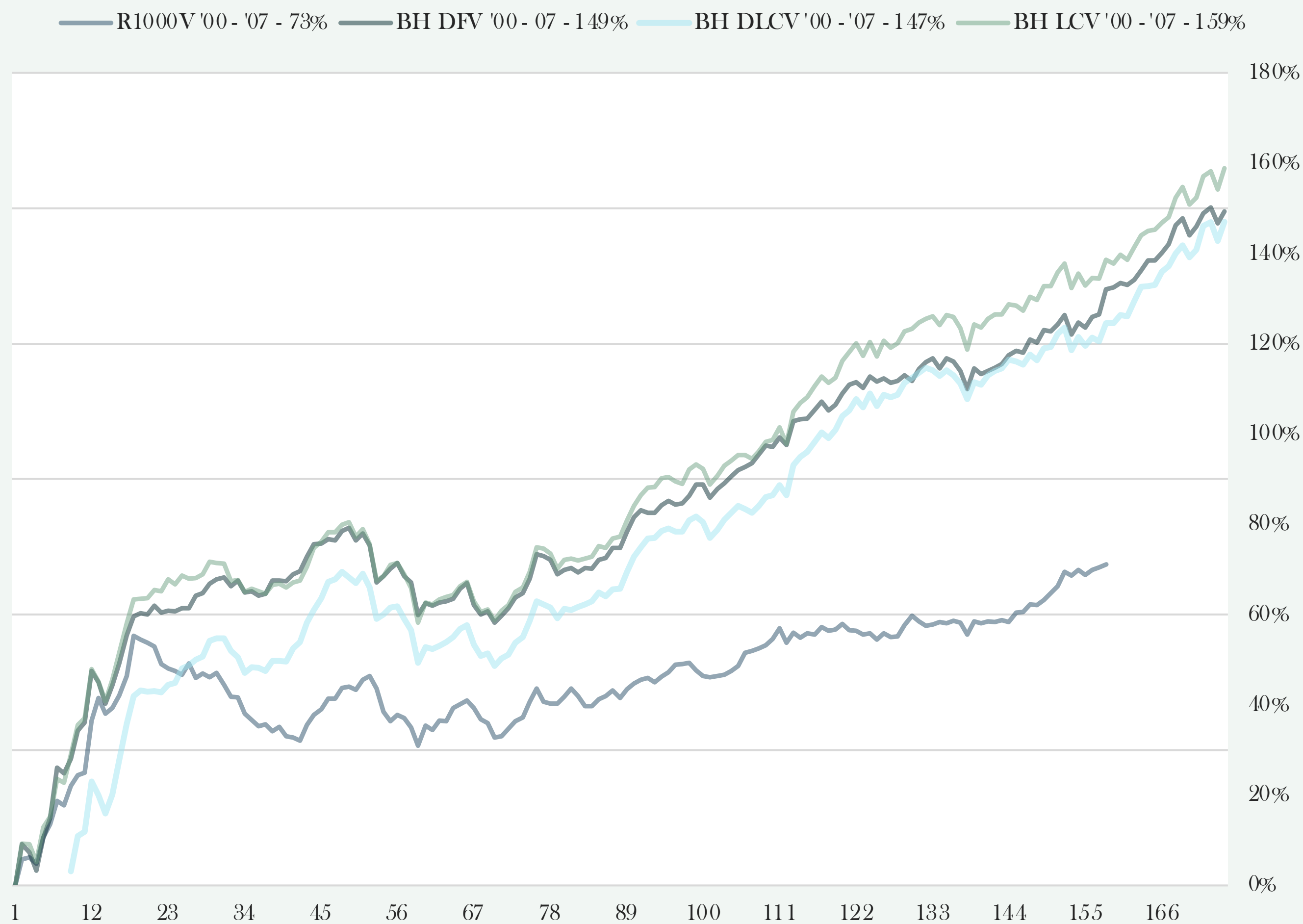
- There have been eight periods of value runs since 1932, with average excess value return of 118% duration about seven years.
- An expanding economy, reasonable earnings growth, and rising interest rates and inflation turned the tide for value stocks.
- If past is prologue, we are in the early stages of value's performance reversal versus growth.

The Barrow Hanley team has seen multiple market cycles, with the stability of the team and the consistency of the process driving confidence in our approach. A hallmark of Barrow Hanley has been, and remains, the unwavering philosophy of traditional value investing, and we continue to believe the current environment is very attractive to consider allocating or increasing investments in the value style.

As a result of that disciplined value approach, historical performance across Barrow Hanley's strategies has produced significant outperformance in past value cycles. (chart below) Investors who deviated from their value discipline, or abandoned it altogether, may find challenging performance periods ahead. Now is the time for allocators to revisit their investment mix to add or increase their exposure for the anticipated continued outperformance of value in the years to come.

## OUTPERFORMANCE OF BARROW HANLEY STRATEGIES AFTER MOST RECENT GROWTH-LED MARKET:

Post Technology Bubble of 1999-2000




BH Strategy Composite Performance (gross of fees)
Sources: Barrow Hanley; FactSet; Frank Russell Company
Strategies shown are based on the composites and not individual accounts. Past performance is not indicative of future results.

## ABOUT BARROW HANLEY GLOBAL INVESTORS

Founded in 1979, Barrow Hanley is a diversified investment management firm offering value-focused investment strategies spanning global equities and fixed income. Recognized as one of the few remaining firms dedicated exclusively to value investing, Barrow Hanley enjoys a boutique culture with a singular focus to assist clients in meeting their investment objectives. Barrow Hanley stewards the capital of corporate, public, multi-employer pension plans, mutual funds, endowments and foundations, and sovereign wealth funds across North America, Europe, Asia, Australia and Africa.

## IMPORTANT INFORMATION



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