RESEARCH PAPER

VALUE VS GROWTH STOCKS DURING THE COVID-19 PANDEMIC

REDHAWK® WEALTH ADVISORS

The purpose of this research paper is to provide an overview of value stocks and growth stocks and how they behave in certain market conditions. We will cover various market cycles and draw a comparison of how value stocks have performed versus growth stocks. The genesis of this research paper came from the request of clients who are invested in the Redhawk High Dividend Stock (RHDS) portfolio and they wanted to know why value stocks have been underperforming during the sharp recovery period after the COVID-19 pandemic. The goal of this paper is to gather relevant facts and draw conclusions based on the data and not to make predictions as to when value stocks will come back in favor.

Redhawk has clients who are invested in the Redhawk High Dividend Stock (RHDS) portfolio, which is comprised of value orientated stocks of well-run companies that have strong balance sheets and pay at least a 2% annual dividend. The primary objective of the portfolio is income and it is currently paying a 3.55% annual dividend.

Definitions

What is a value stock?

A value stock is a stock that trades at a lower price relative to its fundamentals, such as price, earnings, or sales, making it appealing to certain investors. A value stock is a security trading at a lower price than what the company's performance may otherwise indicate. Investors in value stocks attempt to capitalize on inefficiencies in the market, since the price of the underlying equity may not match the company's performance. Common characteristics of value stocks include high dividend yield, low price-to-book ratio (P/B ratio), and/or a low price-to-earnings ratio (P/E ratio). Value stocks are often underrated or ignored by the market, but they may eventually gain value. One of the primary reason's investors are drawn to value stocks is because of the dividends they pay.

What is a growth stock?

A growth stock is a company that is anticipated to grow at a rate significantly above the average growth for the market. These stocks generally do not pay dividends. This is because the issuers of growth stocks are usually companies that want to reinvest any earnings to accelerate growth in the short term. When investors invest in growth stocks, they anticipate that they will earn money through capital gains when they eventually sell their shares in the future. Growth stocks often look expensive, trading at a high P/E ratio, but such valuations could be cheap if the company continues to grow rapidly which will drive the share price up. Since investors are paying a high price for a growth stock, based on expectations, if those expectations are not realized growth stocks can see dramatic declines.

Background

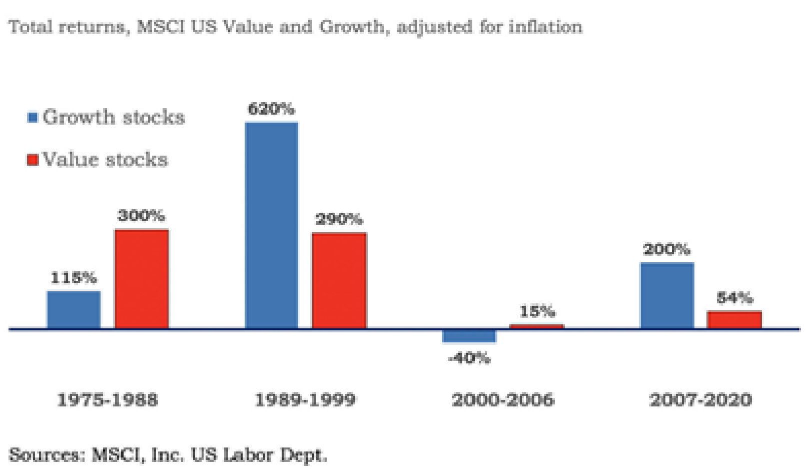
Since the aftermath of the financial crisis, value stocks have substantially underperformed growth stocks, despite growth stock's rising valuations and value stock's cheapening multiples. Trying to explain why this phenomenon has occurred is challenging and there are several contributing factors that we will cover in this paper.

In a general sense, value investing has always seemed attractive because it tends to outperform throughout the entire market cycle and not just during bull markets like with growth investing. Historically, the value strategy has tended to outperform in bear markets, usually outperforming growth over the full market cycle1.

History shows us that (see the chart below):

- Growth stocks, in general, have the potential to perform better when interest rates are falling, and company earnings are rising. However, they may also be the first to be punished when the economy is waning.

- Value stocks, often stocks of cyclical industries, may do well early in an economic recovery but are typically more likely to lag in a sustained bull market like we have had over the last 10 years.



Looking at the chart above, the value versus growth performance has been segmented into four periods since 1975. For the first years, value handedly beat growth. For the next 11 years, it was growth's turn. During the next 7 years during a lackluster market from 2000 to 2006, value stocks had a small gain while growth stocks lost nearly half their real value. Finally, since the end of 2006, growth stocks have dominated.

We all know that Warren Buffet is the best-known value investor and his fund, Berkshire Hathaway (BRK-A), has significantly underperformed the S&P 500 (^GSPC) during 2020 (see the chart below). It is interesting to note that the underperformance coincided with the COVID-19 pandemic.

Source: Yahoo Finance. Data through 8/24/2020.

Let us look at some more data. When we compare the iShares S&P 500 Value ETF (IVE) (the purple line in the chart below), the iShares S&P 500 Growth ETF (IVW) (the light blue line), and Berkshire Hathaway (BRK-A) (the pink line), you can see that growth has been outperforming value since 2009, with substantial outperformance since COVID-19.

Source: Yahoo Finance

Current Environment

During 2020, value stocks in general have significantly underperformed growth stocks (see the diagram below). This is somewhat surprising since COVID-19 was the driving force that moved the markets into bear territory and yet value stocks should outperform in volatile markets as investors seek safety. The fact that growth stocks (primarily large-cap growth stocks such as Facebook, Amazon, Apple, Netflix, and Google – commonly called the FAANG stocks), have been able to achieve better performance while value has lagged seems contrarian. Yet, many investors feel that the FAANG stocks are more dominate now than before the pandemic. They weathered the COVID storm the best, primarily because they were considered "essential," had existing e-commerce models already in place with high usage rates and adapted rapidly to a contactless service model.

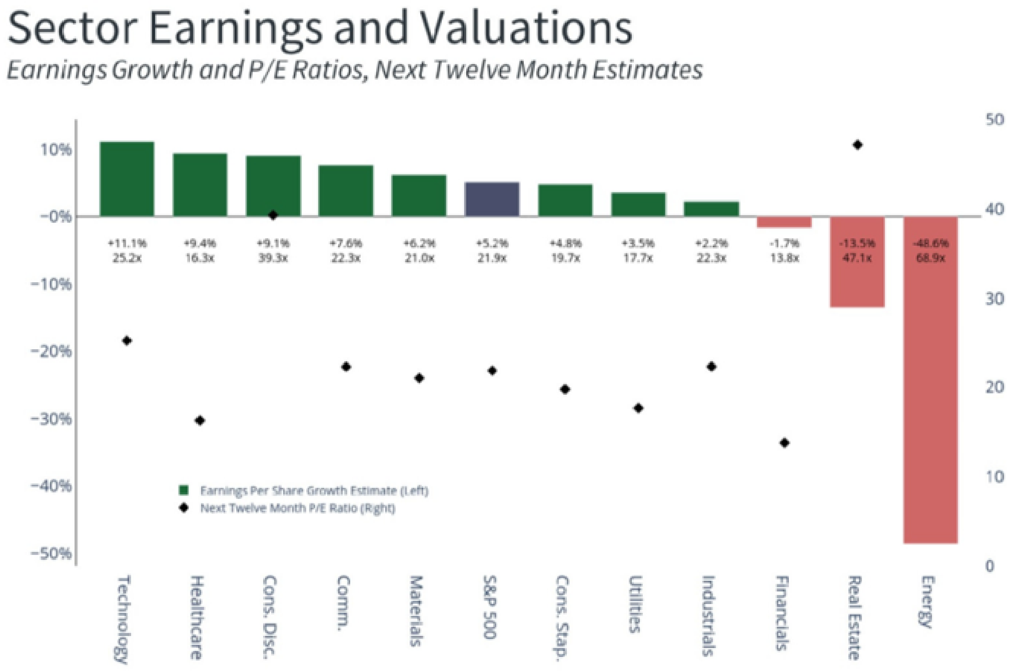
Source: John Hancock year-to-date through 8/21/2020.

To make the current environment more complex, one of the defining characteristics of the first half of the year was the steep drawdown in the market because of COVID-19 which was followed by a similarly sharp recovery. As a result, many of the "riskier" investments which were hit the hardest also saw the largest recoveries once the situation stabilized. Also, many areas of the stock market, especially those related to tech, experienced only small declines. In fact, many technology-driven companies have seen their stock prices benefit from the shift to remote work and online retail.

This is one reason that the NASDAQ and "FAANG" stocks have made new highs even as the COVID-19 crisis continues. Many of these stocks tend to be classified as growth stocks and are large cap companies, which has allowed those investment styles to outperform their value and small cap counterparts. It is important to note that what most investors consider to be "technology" stocks are not part of the Information Technology sector. Many large household tech names are included in the Consumer Discretionary (Amazon) and Communication Services (Netflix) sectors as well.

As is always the case, an important principle when investing for the long run is to be aware of but not overreact to short-term trends. After such large market moves, this is more relevant than ever. Currently, Information Technology, Healthcare, Consumer Discretionary, and Communication Services sectors are estimated to have the highest earnings growth over the next year. At a time when the economy and corporate earnings are uncertain, this has been highly baked into the market for growth stocks.

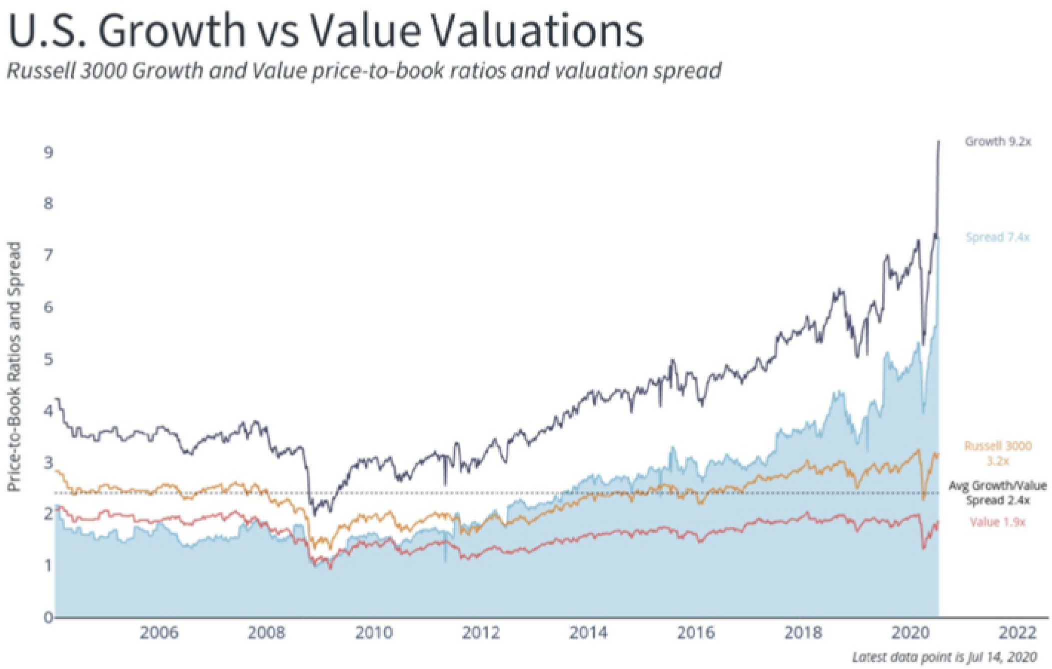
However, these sectors also have the highest level of valuations (see the chart below). One reason that market dynamics often flip is that seemingly attractive investments become overpriced, which then lowers their expected returns. This paves the way for other stocks, sectors, and styles to generate higher returns. While growth stocks have done extremely well recently, their valuations have greatly surpassed value stocks and the broader market.



Source: Refinitive and Standard and Poor's. Data through July 20, 2020.

Below are two charts that put these market dynamics in perspective:

In general, large caps and growth stocks have outperformed since the market bottom just a few months ago. This is partly due to on-going uncertainty around the economy and corporate earnings, but also due to large tech companies performing well during this period. However, valuations have become very expensive as well, as growth stocks have a price to book ratio of 9.2X compared to 1.9X for value stocks (see the chart below). Although growth stocks have outperformed significantly, they also have much higher valuations. This price to book ratio spread has skyrocketed recently.

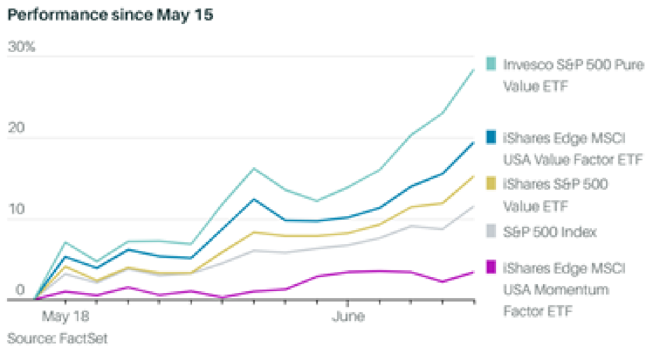


Source: Clearnomics, Refinitive, and FTSE Russell. Data through July 20, 2020

As depicted in the chart above, this is one of the best times over the last 20 years to have value stocks relative to growth stocks and to add to that narrative, value is inexpensive because it is out of favor and investors are so focused on growth. Value has only been this cheap since 2003 and 2008, after which value outperformed momentum by 22% and 69%, respectively, over the subsequent 12 months. The best time to have value stocks is during a recession because valuations are extraordinarily cheap.

Short Lived Pivot to Value

From May 15 through June 5, the Invesco S&P 500 Pure Value ETF (RPV), which is a fund that selects and weights stocks based on valuation, surged nearly 29%, while the broader S&P 500 index gained 12% (see the chart to the right). Given value stocks' current low weighting in the indexes, the rebound in value stocks could happen without driving the broader market higher.



What is interesting is that history suggests that this pivot may continue. Since 1998, each time the index tracked by the Value Factor ETF exceeded the index tracked by the Momentum Factor ETF by more than 5% over a week, the former has beaten the S&P 500 by an average of more than 8% over the next 12 months, according to Framsted.

Companies in the value category are generally more reliant on debt to fund themselves than the market. The Federal Reserve's plan to buy corporate bonds, especially debt of investment-grade companies that had been recently cut to junk (commonly called "fallen angels"), has made investors confident that the cheaply traded companies are likely to flourish as borrowing becomes less expensive.

Summary

It is impossible to determine with certainty when value stocks will be in favor again, or which sectors will do well over the years to come. To start moving higher, a catalyst or bullish narrative is required. Investors and institutional money managers need a reason to shift some of their holdings into value names that have not been performing well and rotate out of market leaders like the FAANG growth stocks. Some of the best stretches of performance for value stocks going back to the 1930s have come when the economy was emerging from a recession6.

Many investors strongly believe that companies such as Amazon and Netflix are the companies of today as well as tomorrow and have terrific fundamentals. But the risk "growth" investors take is that they pay a lot extra for that growth. Amazon stock currently sells for 112 times last year's per-share earnings. So, investors are paying $112 for each dollar of after-tax profit the company made last year. Consequently, someone buying Amazon stock here is not just betting that Amazon will be great today but that it will be even greater tomorrow. Meanwhile Verizon Communications, one of the top "value" stocks in the market, sells for just 12 times last year's earnings, or barely one-tenth as much. Someone buying Verizon is not taking a big gamble on future growth. They are happy with what they own right now and enjoy the current 4.1% dividend yield.

"We think the medium-term odds are now, rather dramatically, on the side of value," writes AQR Cliff Asness in a blog post. "It has certainly been excruciating getting here, but here we are, and it's never looked cheaper looking forward."2

When profit growth is accelerating and earnings are becoming more abundant, investors do not need to pay a premium for expensive growth stocks and that is when value tends to work well. Cheaper valuations become more attractive during rebounds, allowing value stocks to outperform.

Value stocks generally perform better during economic recoveries, but the group is likely to benefit from particularly strong tailwinds this time around. Not only are the shares more beaten-up than normal, but an unprecedented amount of stimulus money is being pumped into the economy by the government.

Acknowledgements

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