Thought Piece

Counterpoint Investment Insights

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Piet Viljoen
Portfolio Manager

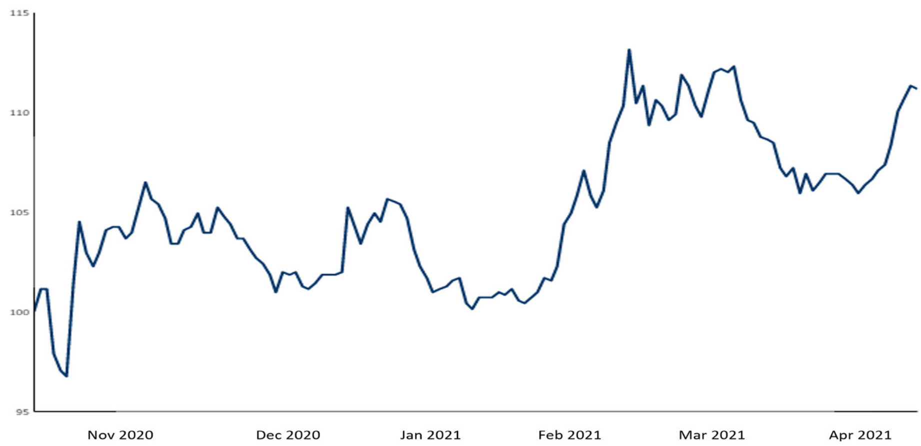
"Value has outperformed Growth since early November 2020."

Can the outperformance of Value continue?

Zoom buttons on digital devices allow us to examine images from different vantage points. They also provide an apt metaphor for modes of strategic thinking. Some people prefer to see things up close, others from afar. Both perspectives - worm's-eye and bird's-eye - have virtues and pathologies. But they should be vantage points, not fixed positions.

As Chart 1 shows, on a worm's-eye view, Value has outperformed Growth since "Vaccine Day" in early November 2020.

Chart 1: MSCI World Value Index versus MSCI World Growth Index since November 2020

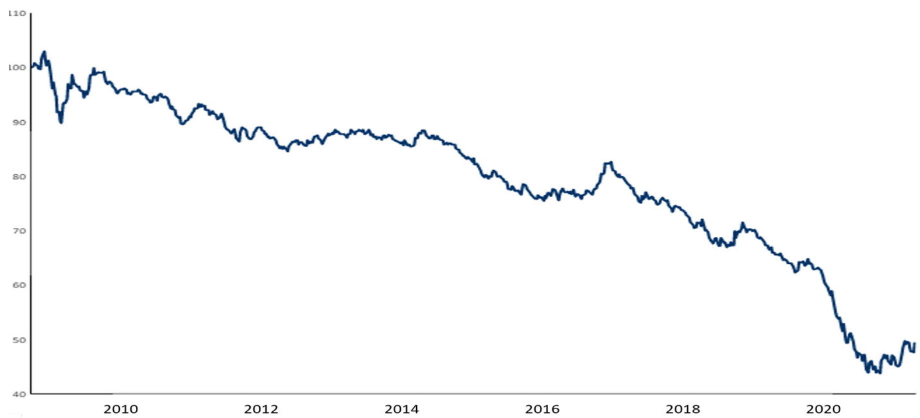


Source: Refinitiv Eikon

But, if one zooms out a bit in Chart 2, it's clear that Value has been underperforming for more than a decade.

Chart 2: MSCI World Value Index versus MSCI World Growth Index over past 10 years MSCI

"Value has underperformed for more than a decade."



Source: Refinitiv Eikon

COUNTERPOINT ASSET MANAGEMENT

Famously, David Foster Wallace told a story at a commencement speech in 2004, about two young fish swimming along. They happen to meet an older fish swimming the other way, who nods at them and says "Morning, boys. How's the water?" The two young fish swim on for a bit, until eventually one of them turns to the other and says: "What the hell is water?"

The point he was trying to make wasn't that the older fish was so wise that he could explain what the water was, but that the water in which we swim is the stuff we take for granted. It is common knowledge – the things everyone knows that everyone else knows.

"Value has underperformed for so long, that it has become the water in which we swim."

Value has underperformed for so long, that it has become the water in which we swim.

And because it is common knowledge, Value's underperformance is simply accepted, unchallenged. We don't even give it a second thought. How do you even start debating that which everyone accepts as a given?

Well, a good start would be to define this water that we, as investors, are swimming in today. Here are a few ideas:

1. Capital markets allocate resources efficiently, based on demand and supply. It's only in communist countries that politicians allocate resources.
2. We live in a deflationary world, with low and declining interest rates.
3. In this world, the Fed will always bail out the system.
4. We live in a world in which doing anything other than maximizing top-line growth is value-destructive. Current profits don't matter, only the cash flows in the distant future. Amazon has taught us well.
5. In this world, growth is hard to find. So we lever up to juice returns. Sure, every now and then someone falls over (LTCM, banks during the Global Financial Crisis, Greensill, Archegos, etc) but hey – see point number 3.

Another way of describing how hard it is to change common knowledge is to imagine a set of walls that hold our perceptions in place. These walls, which protect the equilibrium of the water in which we swim from new information, are extremely high.

Another word for these "walls" are vested interests. And vested interests in the market can be fully attributed to the incentives that have driven corporates and their executives to create certain kinds of:

1. Asset portfolios
2. Business models
3. Capital structures
4. Human capital
5. Product lineups
6. Brands and marketing profiles
7. Cost structures

All the while emphasizing top-line earnings growth in an environment in which cost inflation and pricing power were tertiary considerations, at most.

"Because it is so hard to imagine, the implications of a shift in the zeitgeist-defining narrative are enormous."

Because it is so hard to imagine, the implications of a true change in the water, of a shift in a zeitgeist-defining narrative, are enormous. If the common knowledge about something like inflation or globalization or market structure changes, everything changes. Remember when the water changed to favour growth over value? No, neither do I – but if you look back at history, it actually happened around 12 years ago.

To have any hope of knowing, with any measure of certainty, when the water has changed, much less predicting the outcomes of such a transformation, we need to understand the key observable factor or factors the crowd believes the crowd **needs** to be true.

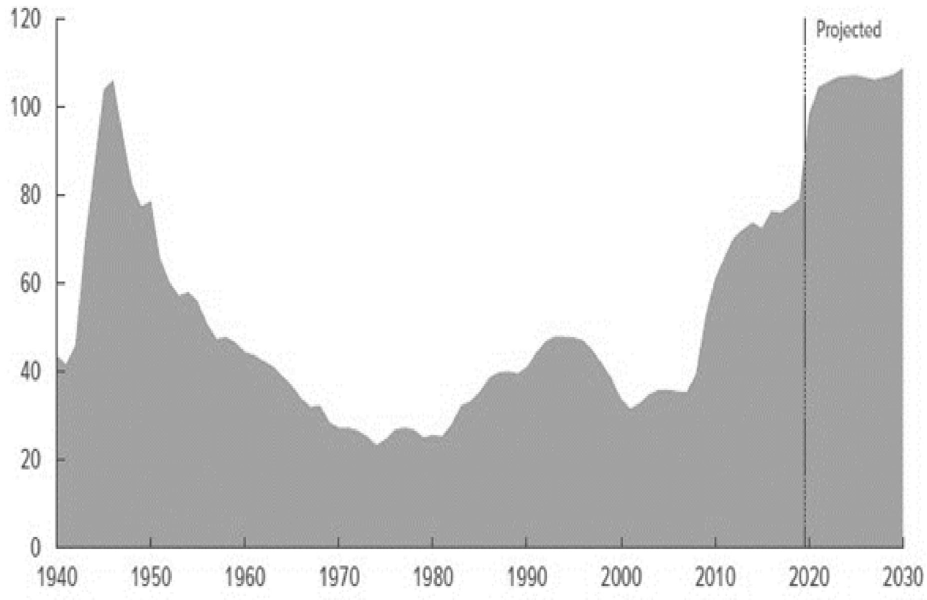
Today, I believe that factor is that debt is freely available and on reasonable terms. Debt is the oil that greases commerce's gears. Debt – of the government kind - is that which greases the gears of the life-support devices of economies undergoing a "great reset". Debt – of the junk kind – is that which greases the gears of zombie companies everywhere.

"High debt levels are not the result of low and declining interest rates and low declining economic growth rates - they are the CAUSE."

Just like a drug addict needs an ever-increasing dosage to get the same high, economies worldwide need ever-increasing levels of debt to just stay on an even keel, let alone grow. Today, our central bank pushers have increased our debt dose to toxic levels. High debt levels are not a result of low and declining interest rates and low and declining economic growth rates - they are the CAUSE of low and declining interest rates and low and declining economic growth rates. The junkie has overdosed; life is ebbing away.

Chart 3: US Debt to GDP

Percentage of Gross Domestic Product



Source: Congressional Budget Office

"Debt to GDP levels are too high, and need to be reduced."

Something's got to give.

It's clear from Chart 3 that monetary and fiscal authorities have a problem. Debt to GDP levels are too high, and need to be reduced. There are only three ways for this to happen:

1. Wiping out the debt through a default, but thereby risking a depression
2. Implement an austerity program so as to pay back the debt, but thereby risking a recession
3. Inflate GDP in nominal terms, thereby increasing the Debt:GDP denominator and reducing the ratio

The first two options are likely unpalatable to most democratically-elected governments, and even those that are less democratic. The third option – inflating the denominator – is a tried-and-tested method, regularly implemented globally. This is exactly what MMT (Modern Monetary Theory) says we should be doing: Use massive government spending programs to stimulate the economy, facilitated by ramping up the money supply. To bring the junkie back from the brink, we need a shot of adrenaline.

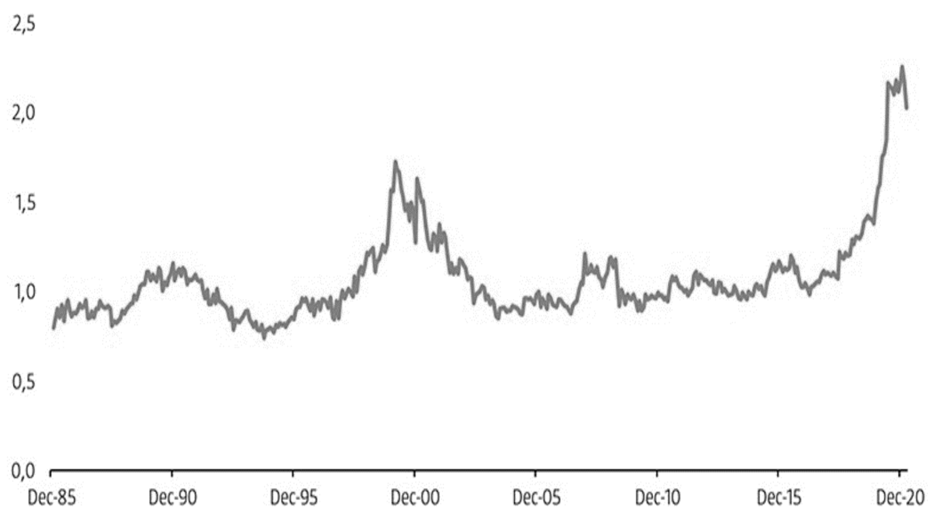
Will we all be swimming in MMT soon?

High rates of nominal growth can be achieved through infrastructure projects (you can't be against clean energy, can you?), incomes policies like Universal Basic Income (you can't be against equality can you?), price controls (you can't be for gougers, can you?). In such an environment of abundant growth (at least of the nominal kind), companies, that under the current regime are growth-constrained, will also be able to grow. And it is likely that this cohort of companies – currently classified as "value" stocks – will become more popular.

"Value has never been this cheap, relative to growth."

Importantly, Value outperformance doesn't require high nominal Growth rates, although it will help. Value will do well, because ... well, Value is good value. In fact, Value has never been this cheap relative to growth. The chart below sho how cheap value stocks are relative to growth stocks. And we all know how good things eventually happen to cheap assets. And that - finally - seems to have started.

Chart 4: Composite valuation spread between expensive and cheap stocks



Source: Robeco

"A more reliable route to wealth preservation and growth is to rely on human behaviour."

Notoriously, macro forecasting is not the most reliable way of growing or protecting wealth. (the latter being what I believe my job to be - despite the socially more acceptable goal of "outperforming one's peers".) A more reliable route to wealth preservation and growth is to rely on human behaviour. And it is in the realm of human behaviour that a few solid reasons for a long stretch of "value" outperformance can be found. A recent article by Jeremy Hosking highlighted a few, which I have paraphrased:

1. **Fund manager behaviour** is entrenched and will therefore extend and intensify the value-runway. Today, stock pickers have built highly concentrated portfolios based on their allegedly superior analysis. Their over-confidence has been reinforced by the historic success of the strategy. This has happened not only in active strategies, but also so-called "passive" ones, as indices are also highly concentrated. In the S+P 500 index today, the entire energy and materials sector has a similar weight to one compay: Apple. It has taken 15 years to get where we are today. It is probable that it will take a similar time frame for the market to undo this situation.

2. **Style rigidity.** Characterising active investment managers into Value and Growth styles leaves the industry particularly exposed when the spread in valuations between Growth and Value is inordinately wide (Chart 4). It is a mandate breach for a growth manager to own value stocks - or indeed vice versa. These managers are prisoners of their own marketing strategies. If there were more investors who could easily rotate between "Value" and "Growth" styles – "swingers", as Jeremy calls them - the process of arbitraging out the valuation gap would be short. Today, there are very few swingers, so it will likely be a drawn-out process. (I recently wrote a piece on the problems with strict definitions of Growth and Value, and why the ability to swing is so valuable. You can find it here.)

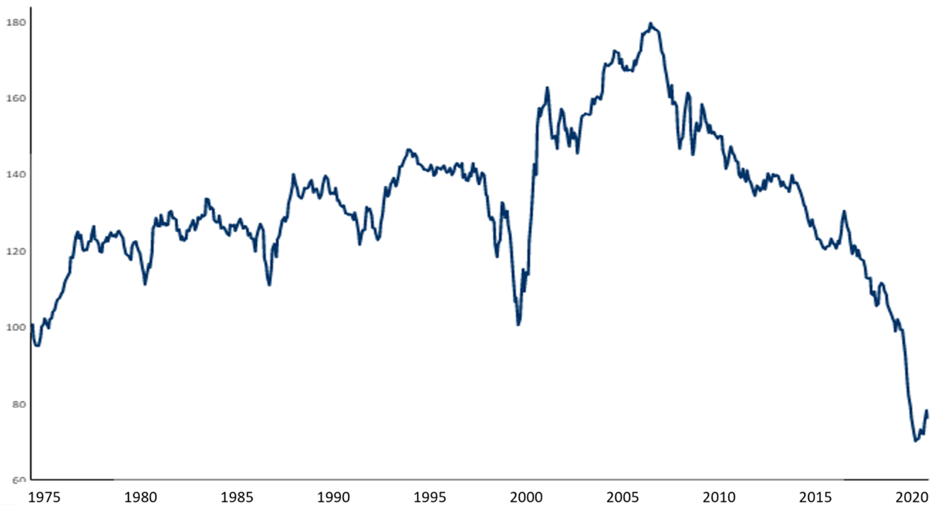
3. **ESG Activism.** What if a powerful investment case emerges for ESG-pariahs, such as companies who operate in industries considered "dirty", but that are - for the time being at least – nonetheless necessary? Such firms are disproportionately members of the "Value" investment class today, being asset intensive, cyclical and often with significant carbon footprints. However, their products have demand inelasticity. Their cyclicality is driven by supply changes. Historically, shareholders experienced poor shareholder returns in these firms, because of managements' propensity to expand output too rapidly. Increasingly such firms are now precluded from expanding output due to tightening regulation and a higher cost of capital. This sets up an interesting proposition of increased returns and reduced environmental impact.

"There are both good and fundamental reasons why Value is set for an extended period of outperformance."

So, there are both good fundamental and behavioural reasons why Value can continue its recent run, and, more interestingly, is set for an extended period of outperformance.

After looking at short and medium term pictures of Growth vs Value, let's zoom out a bit more and look at the long term picture in Chart 5. This shows a pattern of regular swings between the two styles, lasting for around 4 to 7 years. It also shows the extent of the recent value outperformance – only a tiny blip at this stage.

Chart 5: MSCI Value Index versus MSCI Growth Index since 1975



Source: Refinitiv Eikon

"As a valuation-based investor, I can confidently say: "Come on in, the water's just fine!"

Piet Viljoen
Portfolio Manager

*For more information on the **Counterpoint SCI Value Fund** and the **RECM Global Fund** (to be renamed **Counterpoint Global Value Fund**, please visit www.cpam.co.za or contact info@cpam.co.za*

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