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PZENA Investment Management

CATALYSTS FOR CHANGE

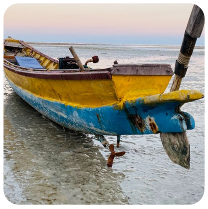
How to spot the coming shift from growth to value

Ride the winners. That's the obvious investment strategy favored at the end of a cycle. It's easy, really. Just select the few dominant technology "masters of the universe" that everyone loves, sit back and enjoy the multiple expansion.

It's happening again this cycle. And, true to form, valuation spreads between cheap and expensive stocks have reached all-time highs all over the world. Further, questions about whether value will ever work again, or whether there is a new definition of value, have become commonplace. It is reminiscent of the late 1990s internet bubble when Michael Lewis' 1999 book The New New Thing described all you needed to know. Investors then, like investors today, were mesmerized by unfettered growth opportunities.

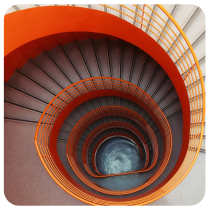
But value's day is coming. Paying less than the present value of future cash flows remains a winning strategy for long term investment success, and the environment today makes this path even more attractive than normal. We believe that the seeds for unwinding today's extremes have been planted, especially as our COVID-dominated world has led us into a recession that history shows is the key marker for the shift.

Consider the following four possible catalysts that could already be signaling that a shift is upon us:



1 RECESSION

The recession is in place and the path toward economic recovery is becoming clear. We examined recessions in the US over the last 100 years and in Japan over the last 45 and the evidence is compelling. The US experienced 14 recessions during the past century, and looking at the five-year returns from the beginning of the recessions, value outperformed the broad market by an average of 530 basis points per annum[1].

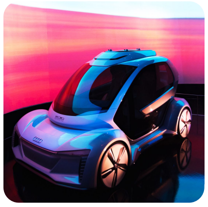


2 INTEREST RATES

Interest rates stop falling, bringing multiple expansion for growth stocks to an end. Interest rates have been in structural decline for the past 40 years. This has led us to a world where one can buy value stocks at P/E's of 10, just like any time in the past 70 years, while average growth stock multiples have doubled from 30 to 60 times. Even if rates don't rise, it's hard for us to see the tailwind enjoyed by growth stocks continuing.

3 GROWTH EXPECTATIONS

(Irrationally) exuberant growth expectations for the technology "masters of the universe" revert to normal. Consider the math using Microsoft as an example. Microsoft's stock price is up 10 fold over the past 10 years, or 25 percent per year, helped by strong growth in cloud technology replacing on-premise hardware demand. During this period, Microsoft's operating income has doubled, growing at an 8% annualized rate. To justify an 8% return starting from today's stock price, operating income would need to grow at 10% for the next 20 years to levels greater than 6x where it is today. Yet market analysts estimate that cloud penetration of data needs has reached 30% – 35%, and that the possible maximum penetration for the cloud will be approximately 70%, therefore, we are about halfway to saturation. So where will that growth come from?



4 DISRUPTION

The conventional wisdom that technological change comes entirely at the detriment of the existing franchises proves to be mistaken. Let's consider the case of electric cars and Tesla versus VW. Conventional wisdom, and stock price, suggest that the answer is obvious — Tesla will win. But even if Tesla grows, does it make sense that VW (and other incumbent auto companies) must shrink? Tesla's stock is one of the darlings, rising over tenfold during the past five years. VW's stock has barely changed in the same period. But there are ultimately only two ways to win in auto manufacturing: (1) charge higher prices — in other words maintain a brand premium, and (2) manufacture at lower costs. It seems inevitable that these truths will apply to electric vehicles, and that VW will succeed in porting their brand strengths (think Porsche and Audi) and scale advantages into the electric vehicle competition. In fact, VW leads all competitors in the number of new electric vehicles that will be introduced over the next several years.

IN UPCOMING WEEKS:

Brief studies of each of these possible catalysts for the turn from a growth to a value cycle.

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FURTHER INFORMATION

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[1]Source: Cabinet Office of Japan, Federal Reserve Bank of St. Louis, Kenneth R. French, MSCI, Sanford C. Bernstein & Co., Pzena analysis. Data use 14 US recessions from 1929 - 2009 and eight Japan recessions from 1977 - 2012. The US universe is all NYSE, AMEX, and NASDAQ stocks defined by Kenneth R. French data library and excluding the smallest 30% of companies based on market capitalization to replicate our investable universe. The Japan universe is the MSCI Japan Index. Value is defined as the cheapest quintile of stocks on a price-to-book basis for each respective universe. All returns equally weighted in US dollars. Past performance is not indicative of future returns. Does not represent any specific Pzena product or service

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