FIRST QUARTER 2021 COMMENTARY

Pro-value cycles have historically been long and durable. The evidence suggests we are in the early stages of what may be a powerful period of value outperformance.

HOW LONG WILL THIS VALUE CYCLE LAST?

Since mid-2018, economically sensitive and cyclical names have been hard hit by uncertainty stemming from the trade war, falling interest rates, and late cycle fears. The disparity in valuations between these shares and large technology stocks was turbo charged last spring by investors reacting to the pandemic, resulting in historically high valuation dispersion. News of an effective vaccine in November finally gave the market visibility to a path out of the pandemic, and the outperformance of value stocks since then has been significant.

This pattern of behavior is not new. Value typically underperforms going into a recession when there is uncertainty around the severity and duration of economic impact. For the disciplined value investor, these darkest periods – when sentiment is lowest – provide the opportunity to plant the seeds for outperformance through fundamental research. Once fears give way to facts, the companies cast out of favor re-rate, and in fact become momentum stocks themselves.

As this scenario plays out yet again, investors find themselves asking the following questions:

1. How long will the value rally last?

2. How much more can value stocks outperform after such a steep rally?

While there is no way to answer these questions with certainty, history suggests that there is plenty more to come.

VALUE CYCLES ARE LONG AND ENDURING

Reviewing value cycles of the past 50 years helps put the recent period into context (Figure 1); the recent outperformance of value appears to be nascent compared to history. On average, pro-value periods have lasted 62 months and delivered 138 percentage points of outperformance. This compares to 6 months and 39 percentage points thus far this cycle.

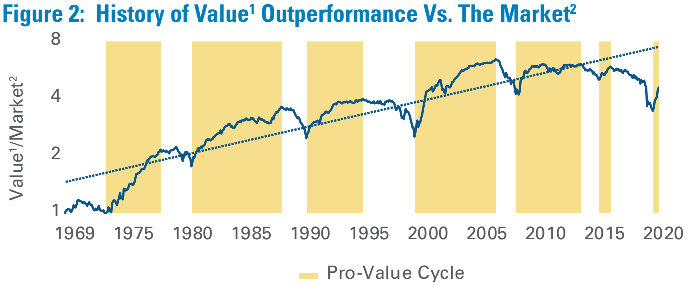
Figure 1: Pro-Value Periods over the Last 50 Years

Pro-Value Cycles	Value[1]	Market[2]	Relative Performance	# Months
Jul '73-Mar '78	134.8%	7.6%	127.2%	57
Dec '80-Aug '88	414.7%	150.3%	264.4%	93
Nov '90-Aug '95	248.4%	117.1%	131.3%	58
Mar '00-Feb '07	190.6%	13.7%	176.9%	84
Dec '08-Jun '14	250.3%	142.8%	107.5%	67
Feb '16-Jan '17	40.2%	19.6%	20.6%	12
Average	**213.2%**	**75.2%**	**138.0%**	**62**
Cycle To Date				
Oct '20-Mar '21	60.3%	21.0%	39.4%	6

Source: Sanford C. Bernstein & Co., Pzena analysis
[1]Cheapest quintile price to book of the ~1,000 largest US stock universe (equal-weighted data). [2]Cap-weighted universe data.
We define a cycle as when the relative performance of value vs. the market from the last peak or trough is at least +/-1500 basis points and has persisted for a minimum of 12 months. Returns do not represent any specific Pzena product or service. Past performance is not indicative of future returns.

Moreover, as Figure 2 illustrates, there appears to be a connection between the length and magnitude of pro-value cycles and their preceding anti-value cycles. The current value rally follows the second worst anti-value cycle of the past 50 years, in both duration and magnitude. Whereas the last pro-value cycle – subdued by comparison – followed a fairly mild anti-value cycle, we believe the length and depth of the most recent anti-value cycle bode well for a long and enduring pro-value cycle. We also observe that the outperformance in prior pro-value periods was earned over the course of the entire cycle, not just in its early phases. Recall that on average value outperforms the market by about 400 basis points *annualized* for the five years following a recession.

Figure 2: History of Value[1] Outperformance Vs. The Market[2]



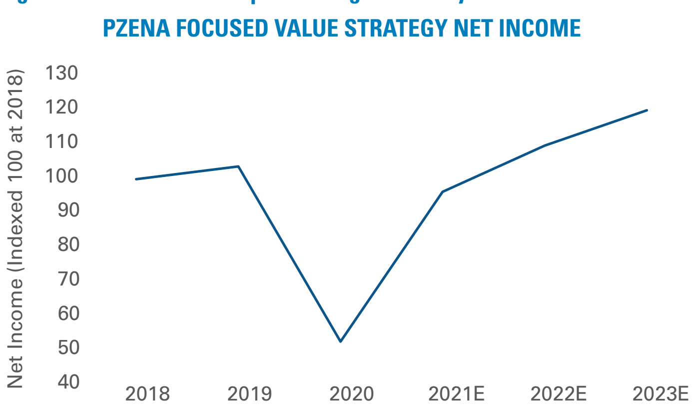
Source: Sanford C. Bernstein & Co., Pzena analysis
Blue solid line within chart represents a relative index displayed using a logarithmic scale.
[1]Cheapest quintile price to book of the ~1,000 largest US stock universe (equal-weighted data). [2]Cap-weighted universe data.
We define a cycle as when the relative performance of value vs. the market from the last peak or trough is at least +/-1500 basis points and has persisted for a minimum of 12 months. Returns do not represent any specific Pzena product or service. Past performance is not indicative of future returns.
Data in US dollars through March 31, 2021.

RECOVERY MATH

There is no doubt that businesses were hit hard by the economic collapse spurred by the pandemic. However, management teams did not sit still. Rather they cut costs and restructured operations to an extent that may not have been possible absent such an acute crisis. As a result, earnings recovery is likely to be swift and powerful. Cyclical companies, whose earnings were most impacted by the lockdown, should see the strongest earnings growth, as revenues recover, and operating margins expand as expenses are held in check. Additionally, unlike other cyclical downturns, many businesses are coming out of this downturn with depleted inventories. A combination of inventory re-stocking and investments to reconfigure supply chains – to make them more resilient to an economic shock and trade politics – should provide an even greater surge in top and bottom lines than in a typical cyclical recovery.

The Pzena Focused Value portfolio provides a good example of the recovery these deeply undervalued businesses might enjoy over the next couple of years (Figure 3). Earnings of the companies in our portfolio were cut nearly in half in 2020. Yet Wall Street analysts project a classic V-shaped rebound in earnings this year – nearly doubling to approach 2019 levels – and a 32% compound annual growth rate in earnings out to 2023. We are seeing a similar trajectory of earnings collapse and recovery in our global portfolios.

Figure 3: Value Stocks' Rapid Earnings Recovery



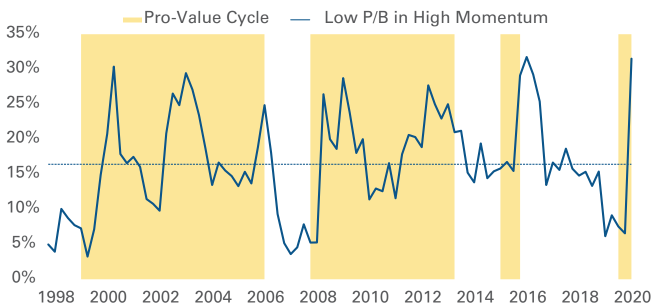
Source: FactSet, Pzena analysis
Net income based on March 31, 2021 holdings of our Pzena Focused Value strategy's representative account. 2021 - 2023 earnings based on consensus estimates as of March 31, 2021. For illustrative purposes only. All data in US dollars.

WHEN VALUE BECOMES MOMENTUM

During last March's sell-off, investors found it difficult to look through to the end of the pandemic. That is understandable, as it is extremely difficult to figure out when economic activity will return, and impossible to determine when investor sentiment will improve. For disciplined value investors, it is the darkest periods – when sentiment is at its lowest – where the hard work is most rewarded as earnings and sentiment typically recover, often in a sudden, unexpected, and extreme manner.

One of the interesting features of a value cycle is how the momentum characteristics of value stocks change over time, attracting a wider circle of investors. Figure 4 shows the 22-year history of sentiment for value stocks, as represented by the percentage of value stocks among the top third in positive price momentum. Value cycles start with a sudden and sharp move from extremely out-of-favor to in-favor, as we saw in the fourth quarter of 2020. After an initially sharp increase in the percentage of cheap stocks within the high momentum cohort, the percentage tends to remain broadly above average throughout the value cycle. The jagged nature of the line reflects rotation and the increasing participation of momentum-oriented and more mainstream investor types.. The line moves down as formerly inexpensive stocks cycle out of the cheapest quintile and are replaced with newly out of favor stocks not yet experiencing a re-rating. Once these stocks catch the attention of the broader market, and prices catch up to fundamentals, they move into the positive momentum category, and the blue line heads back up. It is the continuation of this dynamic in markets, until valuation spreads return to more normal levels, that explain the long durations of value cycles that we have observed historically.

Figure 4: Percent of Cheap Stocks Among High Momentum Stocks



Source: FactSet, FTSE Russell, Sanford C. Bernstein & Co., Pzena analysis
Blue line represents low price-to-book (the cheapest quintile) stocks that also qualify as high momentum stocks within the Russell 1000 Index. We define high momentum for this analysis as the stocks within the best tertile of stock price performance during the previous 12 months. This analysis was done on a quarterly basis from 12/31/1998 – 3/31/2021. The pro-value cycles represented by the shaded areas was calculated using the same methodology discussed in the footnotes of Figures 1 and 2. Past performance is not indicative of future returns.

This represents the value approach in a nutshell: having the fundamental research and discipline to buy good businesses when their path of profitability is at its most uncertain typically pays off when earnings recover, and sentiment improves.

CONCLUSION

Returning to our original questions, we believe a number of factors point to the likely start of a long and enduring value cycle, including:

- the starting point for value is attractive, particularly relative to the overall market valuation
- the brevity of the current value rally to date compared to past value cycles,
- strong projected earnings growth for value stocks, and
- significant opportunity for re-rating as sentiment continues to improve.

This value rally began as in past cycles; sentiment improved dramatically over a relatively short period of time. The relatively modest outperformance of value compared to past value cycles, and the extreme depth of the previous anti-value cycle, all portend a strong recovery. Although these recoveries can be bumpy as uncertainties are resolved, the evidence indicates we are in the early stages of what may be a powerful period of value outperformance.

FURTHER INFORMATION

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