PZENA Investment Management

SECOND QUARTER 2021 COMMENTARY

We found value held up better and long-term corporate profitability remained steady in past periods of higher inflation. Investors' focus should be on valuation.

INFLATION AND VALUE INVESTING

Inflation, its effect on the market, and its implications for our portfolios have been frequent topics in recent client conversations. Whether caused by disrupted supply chains, shortages, government spending, or pent up demand from pandemic lock-downs, inflation metrics around the world have been ticking up, and it is impossible to know whether these inflationary forces will be transient or longer lasting.

As bottom-up investors, we do not try to forecast the many moving parts of inflationary pressures from a macro perspective, but rather look at the impact of a multitude of issues, including inflation, on a company-by-company basis. However, to provide some context to the inflation discussion, we studied how value stocks performed during various inflationary environments, and the profitability of businesses in those same environments. In short, we found:

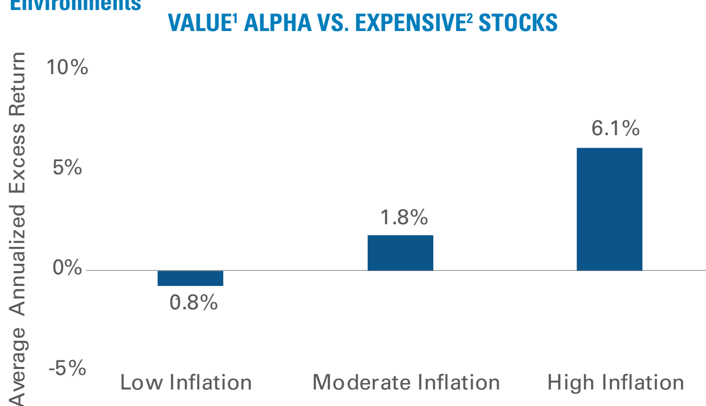
- value performed somewhat better during periods of higher inflation
- inflation ultimately had little impact on long-term corporate profitability, and
- value remains the only alternative in equity and fixed income markets today that offers a double-digit earnings yield.

CHEAP VS. EXPENSIVE STOCK PERFORMANCE ACROSS INFLATIONARY ENVIRONMENTS

We studied how expensive and cheap stocks performed during various periods of inflation over the past 60-plus years. The results are illustrated in Figure 1.

Cheap stocks have done well at higher levels of inflation, and, as periods of higher inflation often occur in conjunction with economic recoveries, this is consistent with our findings in our 3Q20 newsletter, that value outperforms in the five years following the start of a recession.

Figure 1: Cheap vs. Expensive Stock Performance Across Inflationary Environments



Source: Federal Reserve Bank of St. Louis, Sanford C. Bernstein & Co., Pzena analysis
[1]Cheapest quintile price to book vs. [2]most expensive quintile within ~1,000 largest US stock universe (equal-weighted data); returns do not represent any specific Pzena product or service. Chart calculated using monthly average of rolling 5-year annualized returns. Inflation bucket cutoffs are set such that each regime has the same number of observations. Low inflation cutoff is below 2.17% and high regime is above 4.44%. Inflation is measured on a 5-year annualized basis rolling monthly. Data in US dollars 1960 – June 2021. Past performance is not indicative of future returns.

While on the surface cheap stocks seem to struggle in periods of low inflation, that conclusion lacks the nuance drawn out by looking at individual periods of low inflation. There were three unique, uninterrupted low inflation rate regimes: the mid-60's, the period just prior to the global financial crisis, and the period following the global financial crisis until today (See Figure 2).

Figure 2 – Three Low Inflation Periods

Low Inflation Period	Duration (months)	Average Performance		Average Inflation	Interest Rate (10-Year Treasury)	
		Cheap[1]	Expensive[2]		Start	End
'65-67	34	18.6%	15.8%	1.6%	4.2%	5.3%
'03-08	55	13.4%	3.2%	2.1%	4.5%	3.5%
'09-21	138	8.5%	14.5%	1.9%	3.2%	1.5%

Source: Federal Reserve Bank of St. Louis, Sanford C. Bernstein & Co., Pzena analysis
[1]Cheapest quintile price to book vs. [2]most expensive quintile within ~1,000 largest US stock universe (equal-weighted data); returns do not represent any specific Pzena product or service. Chart calculated using monthly average of rolling 5-year annualized returns. Inflation bucket cutoffs are set such that each regime has the same number of observations. Low inflation cutoff is below 2.17%. Inflation is measured on a 5-year annualized basis rolling monthly. Data in US dollars 1960 – June 2021. Past performance is not indicative of future returns.

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All three periods showed solid returns for value stocks; however, the most recent period has been dreadful from a relative performance perspective versus expensive stocks. Because the duration and level of value underperformance has been greater this period than the prior two, value underperformed in low inflationary regimes overall.

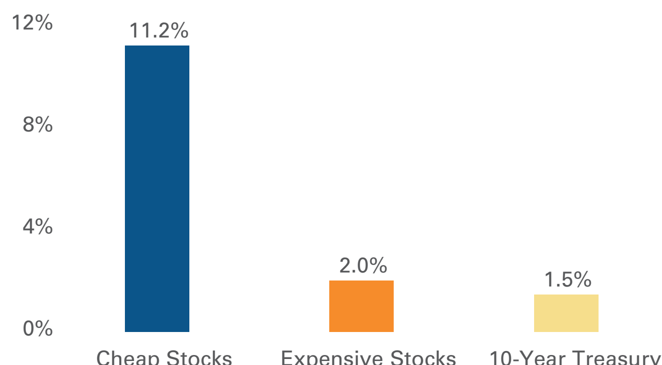
Recency bias might lead one to believe that value no longer works in low inflationary environments. We believe, however, there could be a more nuanced reason. We suggest that what made the most recent low inflationary environment unique was an interest rate at period inception that was lower than at any point during the previous two cycles, and it dropped throughout the period by more than it had in any previous low inflationary period. We believe the extremely low and falling interest rates had a profound effect on the valuation of growth stocks.

VALUATION IS MORE IMPORTANT THAN INFLATION

While the two previous low inflation environments saw period ending price-to-earnings (PE) multiples of cheap and expensive stocks that were within roughly +/- 15 percent of the start of the period, the most recent period has been far different. The PE of expensive stocks has doubled since 2009, while value's multiple is roughly unchanged. As pointed out above, we argue that the extremely low and falling interest rates led to lower discount rates, which mathematically have a stronger impact on expensive stocks than cheap stocks.

Following a four decade decline in interest rates, leaving them near record lows, investors should question what might happen to expensive stocks, which are near all-time highs, should interest rates start to rise. At this point cheap stocks are the only alternative in the equity and fixed income markets with a double-digit earnings yield (Figure 3).

Figure 3: Cheap Stocks Still Offer Double Digit Earnings Yield

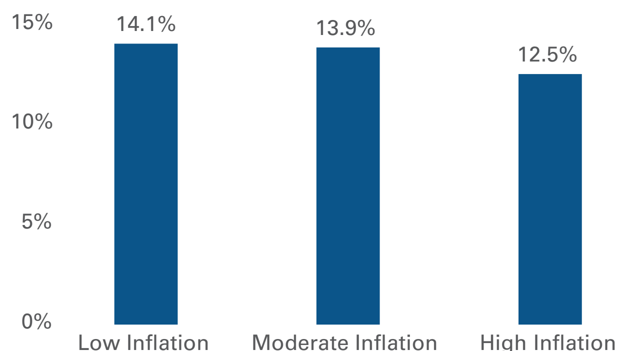


Source: Federal Reserve Bank of St. Louis, Pzena analysis
Cheapest/Expensive earnings yield are based on the median stock within the cheapest and most expensive quintile based on price-to-normal earnings. The quintiles are measured on an equally weighted basis within the ~1,000 largest US stock universe. Price-to-normal earnings are Pzena's estimates. Data as of June 30, 2021. Past performance is not indicative of future returns.

INFLATION HAS HAD LITTLE IMPACT ON CORPORATE PROFITABILITY

Turning to corporate profitability, we looked at the ROE of the market and found it was indistinguishable in low and moderate inflation environments, and roughly 150 basis points lower in high inflation environments (Figure 4). It is notable that we haven't experienced a high inflation environment in 28 years, meaning the vast majority of the observed high inflation datapoints happened during an era in which corporate America was less efficient and more capital intensive than it is today.

Figure 4: Similar ROEs Across Inflationary Periods



Source: Federal Reserve Bank of St. Louis, Sanford C. Bernstein & Co., Pzena analysis
Return on equity is based on trailing 12 months and calculated using a simple average within each inflation regime; universe is the largest ~500 US stocks. Inflation bucket cutoffs are set such that each regime has the same number of observations. Low inflation cutoff is below 2.17% and high regime is above 4.44%. Inflation is measured on a 5-year annualized basis rolling monthly. Data in US dollars 1960 – June 2021. Past performance is not indicative of future returns.

WHAT WE ARE SEEING

While the companies in our portfolios are mostly reporting higher wage and input costs, they are also noting an ability to raise prices and potential profitability. Our auto holdings represent a good example of an industry that has historically been able to increase pricing at the rate of inflation. Recently, however, auto companies have been aggressively raising prices beyond inflation based on several factors, including tight inventories due to industry-wide production cuts during COVID-19, increased household wealth in developed countries, and a global semiconductor shortage, which should last until mid-2022.

Paris-based Rexel, the world's second largest distributor of low-voltage electrical equipment to professionals in residential, industrial, and commercial markets, is another example of a company that should thrive in a higher inflationary environment. The company's product lines have historically faced deflationary pressures, so anything pushing pricing higher would obviously be positive. We expect most well positioned companies to adapt to a higher inflation environment and maintain profitability roughly in line with other inflation regimes.

CONCLUSION – STAY THE COURSE

This value cycle has been driven by extreme value dispersion between cheap and expensive stocks that was a decade in the making and catalyzed by the attractive earnings growth profile of cheap stocks over the next several quarters. Value doesn't need inflation to work, but, should inflation pressures persist, historically a higher inflationary regime appears to be a tailwind.

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