In today's low equity risk premium environment, value stocks' double-digit earnings yield is consistent with their historic outperformance.

Rising interest rates and elevated stock multiples, driven primarily by multiple expansion, have brought down the equity risk premium (ERP), leaving bonds more attractive relative to stocks than they have been in quite some time.

In this essay we'll show:

- Low ERP environments have historically been advantageous for value stocks.
- Stocks overall have underperformed bonds when the ERP is low.
- Earnings yields are supportive of the current case for value.

VALUE FLOURISHES IN LOW EQUITY RISK PREMIUM PERIODS

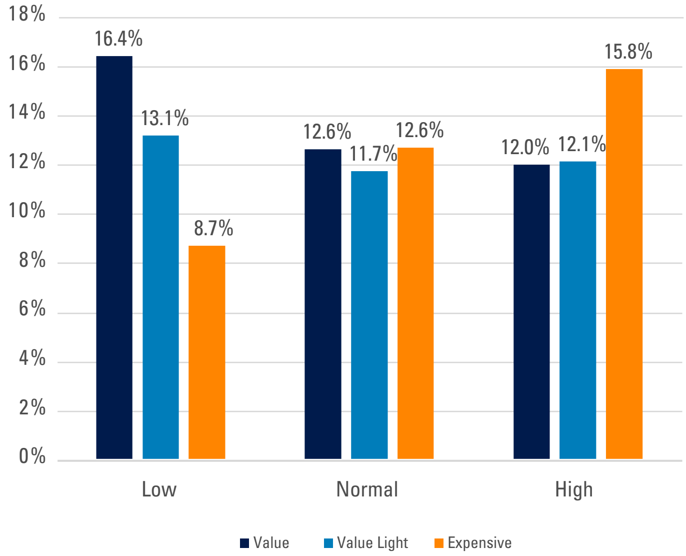
The ERP is a function of the prospective potential return for stocks relative to bonds. There are several methods for calculating the ERP. We calculate the ERP by solving for the cost of equity in a discounted cash flow model of the market, based on consensus analyst estimates, and compare that to the 10-year Treasury yield. It can vary widely from extremely low, for example in 1981, due to a modest PE for stocks versus 15% Treasury yields, to very high, such as at the depths of the global financial crisis, when bond yields were moderate, while stocks were trading at a generational low PE ratio.

As yields approached 5% in the fourth quarter, 200 basis points higher than the average over the past two decades, investors rightly asked whether the risk–reward trade-off of equities made sense, given their high-teens average multiple and low to mid-single-digit earnings yield. In other words, are stocks earning a sufficiently high ERP to justify investing in them over bonds?

Historically, during low ERP periods like today, value significantly outperformed value-light stocks[1], and expensive stocks trailed both value and value-light by a wide margin (Exhibit 1).

Exhibit 1: Value Has Flourished In Low ERP Periods

5-Year Annualized Equity Returns By ERP Regime



Source: Sanford C. Bernstein & Co., Pzena analysis
Value = stocks within the cheapest quintile based on price/book of the 1000 largest US stocks (ranked by market cap).
Value Light = 2nd cheapest quintile. Expensive = most expensive quintile. The quintiles are measured on an equally weighted basis.
Equity Risk Premium is calculated using a discounted cash flow model of consensus analyst estimates and the 10-year Treasury yield.
The monthly ERP data is segmented into tertiles, categorizing them as Low, Normal, or High regimes.
Total return US dollar data from January 1, 1980 – December 31, 2023.
Does not represent any specific Pzena product or service. Past performance is not indicative of future returns.

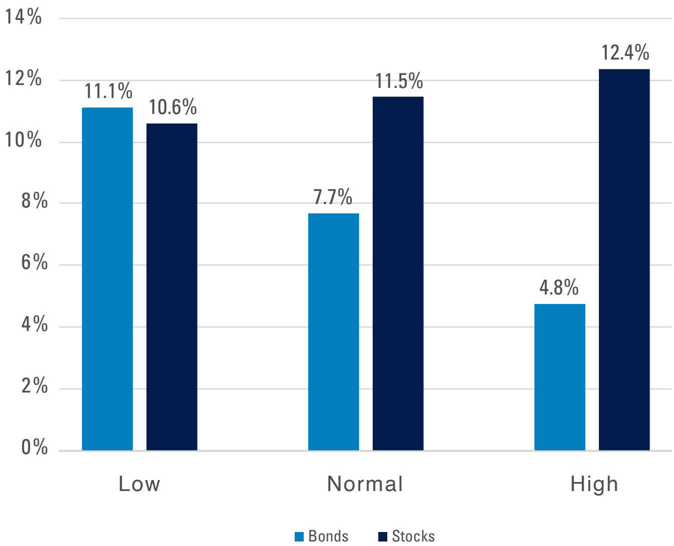
STOCKS VS. BONDS

Unsurprisingly, as ERPs come down, forward stock returns relative to bonds also generally come down. Value's superior return when the ERP is low is even more impressive considering bonds have outperformed stocks overall by 50 basis points per year (Exhibit 2) in these periods.

[1] Value-light stocks are the second cheapest quintile on price/book.

Exhibit 2: Bonds Have Outperformed in Low ERP Periods

5-Year Annualized Returns By ERP Regime

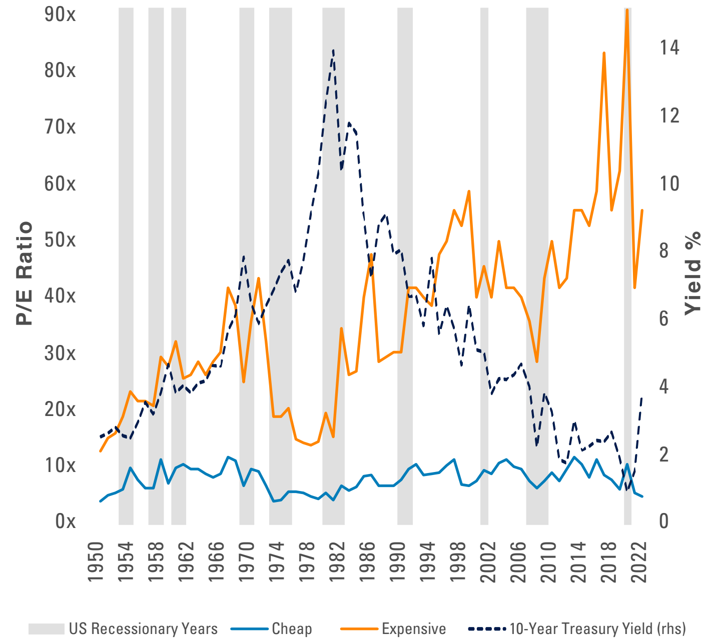


Source: Robert J. Shiller, Sanford C. Bernstein & Co., Pzena analysis
Bonds = Bond returns based on US 10-year Treasuries.
Stocks = 1000 largest US stocks (ranked by market cap) on a cap-weighted basis.
Equity Risk Premium is calculated using a discounted cash flow model of consensus analyst estimates and the 10-year Treasury yield.
The monthly ERP data is segmented into tertiles, categorizing them as Low, Normal, or High regimes.
Total return US dollar data from January 1, 1980 – December 31, 2023.
Does not represent any specific Pzena product or service. Past performance is not indicative of future returns.

The poor performance of expensive stocks is the primary driver of the tepid performance of stocks overall in these periods, as they trailed value stocks by a wide margin and even trailed bonds by 250 basis points per year.

As we have previously mentioned, the nearly 40-year decline in interest rates had an outsized impact on expensive stocks, which saw their multiples expand significantly when ERPs were higher. Meanwhile, cheap stocks have always traded in the same 7–10× earnings range, regardless of the environment for interest rates and ERPs (Exhibit 3). If interest rates once again move higher, we could see a contraction of the elevated multiple of expensive stocks, which would be consistent with the historical performance of expensive stocks in low ERP periods.

Exhibit 3: P/E Ratios Have Compressed as Rates Have Stopped Falling

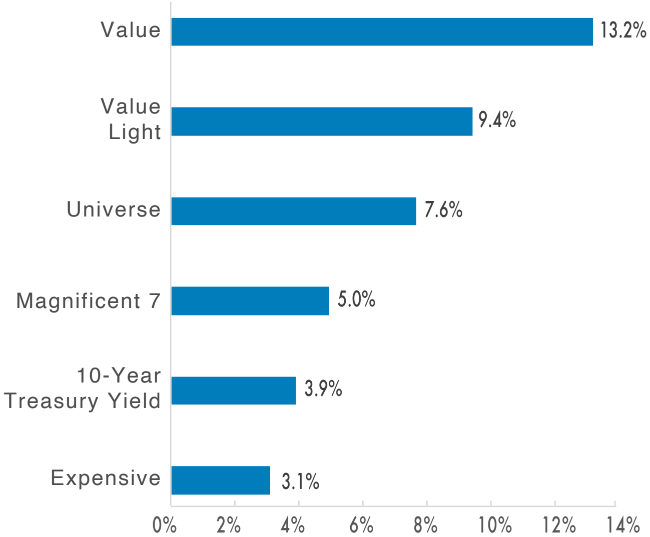


Source: Kenneth R. French, Pzena analysis
The solid lines show the market-cap weighted trailing P/E ratios for the most expensive and cheapest (value) quintiles of the US market.Annual December data from 1950 - 2022. Universe is all NYSE, AMEX, and NASDAQ stocks defined by Kenneth R. French data library.

CURRENT EARNINGS YIELDS ARE FAVORABLE TO VALUE STOCKS

For long-term investors, we believe the choice is clear. While rising interest rates have made bond yields more attractive than they've been for quite some time, stocks by and large still maintain earnings yields well above bonds. Value offers a significantly higher earnings yield than the universe, and is the only style offering a double-digit earnings yield, as it excludes high-flying, low-earnings-yield stocks, including the Magnificent Seven (Exhibit 4).

Exhibit 4: Cheap Stocks Currently Have Superior Earnings Yields



Source: FactSet, Pzena analysis
Yields are based on the median stock within each cohort. Value = cheapest quintile. Value Light = 2nd cheapest quintile. Expensive = most expensive quintile. The quintiles are measured on an equally weighted basis based on price-to-normal earnings within the US 1000 universe (1000 largest US stocks ranked by market cap.). Universe uses the median stock within the entire universe. Price-to-normal earnings are Pzena's estimates. Magnificent 7 = Apple Inc, Microsoft Corp, Alphabet Inc, Amazon.com Inc, NVIDIA Corp, Meta Platforms, Tesla Inc.
Data as of December 31, 2023. Does not represent any specific Pzena product or service.

CONCLUSION

Today's low ERP has historically been an advantageous environment for value stocks. More importantly, we believe that the far superior earnings yield for value stocks should make them an attractive addition to any portfolio.

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