Value investing: no longer "why" but "how"

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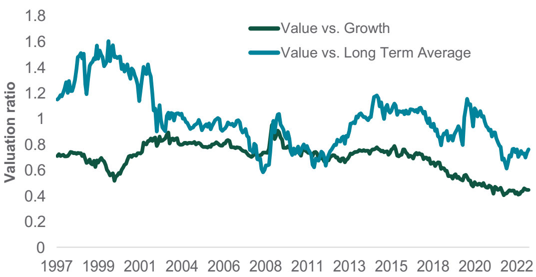
- European value equities offer attractive long term potential, trading at nearly 25% discount to their historical average
- Combining Value with Quality and Momentum can significantly improve risk adjusted returns
- Avoiding extreme bets in specific sectors and countries can help avoid unintended risk exposures and control carbon intensity

European value stocks: attractive long-run returns at affordable prices

Value investing has historically been a source of significant excess returns. This also holds true for European equities in which the annualised value premium, determined by the price to book ratio, has equaled 2.97% since 1990 through 2023.[1]

More recently, the post-pandemic period has seen a strong performance from European corporates. In the last three years, profit margins have improved by +350 bps and stand at a multi-year high. Value stocks have led this profit resurgence within the European equities and have outperformed growth stocks by 2.2% annually over the last three years. Earning growth in the value cohort hasn't entirely reflected in price performance,[2] causing value stocks to become increasingly more affordable. As a result, the valuation dispersion between growth and value remains at an extremely high level; with value stocks currently trading at nearly 25% discount **(Exhibit 1)**.

Exhibit 1: Valuation ratios for European value stocks



Source: FactSet, MSCI. Data from 1/1/1997 to 12/29/2023. Valuation ratios computed using 12 month forward price to earnings for MSCI Europe, MSCI Europe Value and MSCI Europe Growth Indices.

Not all value portfolios are created equal

A number of approaches exist for value investing in Europe. Despite similar stated objectives, these strategies can differ significantly due to varying portfolio design choices, leading to dispersion in both investment outcomes and sustainability goals. We believe in a diversified approach to value investing incorporating three key design features:

1. **Avoiding value traps:** Steer clear of firms that have lost their earning potential and focus on profitable, winning firms that are most undervalued.
2. **Targeting compensated risks:** Focus on risks that are rewarded in order to achieve consistent performance across all market cycles
3. **Applying a sustainable approach:** Capture significant reduction in carbon footprint relative to conventional value portfolios

This approach can help investors effectively and efficiently deliver the value exposure while seeking improved risk-adjusted returns and a lower carbon intensity profile relative to other portfolios.

Complementing value with quality and momentum

Focusing on high quality value stocks with positive momentum can help identify companies that are operating from a position of strength and avoid those that are likely to be value traps.

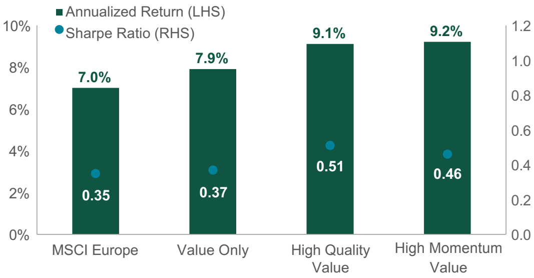
To evaluate these benefits, we formed three hypothetical portfolios. The first is a value only portfolio that invests in the top half of companies in the MSCI Europe by value factor. The second portfolio is at the intersection of top half by value factor and top half by quality factor. The third portfolio is at the intersection of top half by value factor and top half by momentum factor. While all value portfolios have outperformed MSCI Europe over the period, the value portfolios conditional on Quality and Momentum outperform by an additional 1.2% annualised **(Exhibit 2)**.

No less important is the volatility reduction benefit that may arise. The value only portfolio has higher volatility compared to the benchmark. Adding quality and momentum will reduce the volatility. Putting these together – higher returns and lower risk – we see a significant improvement in the Sharpe Ratio of the portfolios.

Controlling uncompensated risk exposures

A European value oriented portfolio may embed significant unrewarded risks emanating from extreme bets to specific sectors and countries. These active exposures have shown to be the source of heightened volatility and we believe that a sector and country neutral approach can help avoid uncompensated risks. As an example within MSCI Europe, in 2020, Information Technology outperformed Energy by 48% and in 2022, Energy outperformed Real Estate by 75%. These large swings in sector performance have significant implications to a portfolio. They not only impact the absolute and relative return outcomes, but also expose portfolios to embedded macro risks in sectors such as interest rates and commodity prices.

Exhibit 2: Performance and Sharpe ratio of hypothetical value portfolios

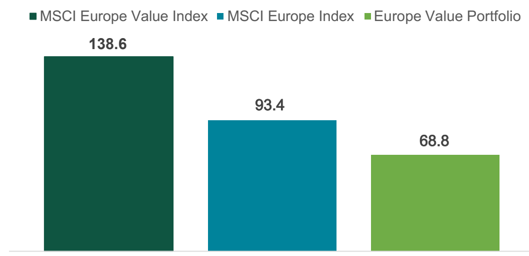


Source: NTAM. Data from 01/01/1996 to 29/12/2023. Portfolios formed using Northern Trust Factors. Portfolios, are cap-weighted and rebalanced quarterly. All results shown are gross of fees. For illustrative purposes only.

Value investing traditionally comes with higher carbon intensity

Conventional value approaches tend to have a high carbon footprint, including emissions. This is usually the result of extreme overweight to carbon intensive stocks that may look cheap, but do not incorporate any future costs of climate risks into their current financials. It is essential to recognise the interaction between climate and financial data to achieve a strong value exposure without exposing the portfolio to climate risks. A robust risk management approach avoiding unrewarded exposures has shown to achieve substantial reduction in carbon footprint without altering the value profile of the portfolio **(Exhibit 3)**.

Exhibit 3: Carbon intensity of value portfolios vs. benchmark (weighted average, Co2/$m sales)



Source: FactSet, MSCI. Data as of December, 29 2023

Strategy design and implementation matter

While we expect the value premium in European equities to persist, it is critical to select a strategy designed to target value precisely to achieve desired outcomes. Portfolio design is a critical determinant in long-term success. Integrating quality and momentum enhances the potential for higher risk-adjusted returns, while incorporating a thoughtful approach to avoiding unrewarded exposures not only acts as a safeguard for unintended risks, but also aligns with sustainable investment practices.

FOOTNOTE

1 Source : Kenneth French Data Library
2 3 year earning growth for Value stocks at 23.3 p.a. outpaces 9.1% earning growth in growth stocks

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