Allocating Across Value

As of March 2021

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A Value Roundtable Conversation

Harbor has the benefit of sharing thoughts and perspectives with a diverse set of asset management partners around the globe – up and down the cap spectrum, across different styles and geographies. The Harbor Lens offers views from Harbor's investment professionals alongside curated insights from our network of talented investment partners.

Since the COVID-19 vaccine announcements in late 2020, we have seen value investing outperform growth investing significantly, with many leading growth names experiencing volatility. In our view, valuation opportunities combined with accelerating growth, high inflation, and rising real interest rates could serve as a catalyst for a sustained value rebound.

We assembled a group of value experts from Harbor's subadvisers to discuss the tenets and nuances of value investing, and what value investors may expect in the current environment. While both Aristotle Capital Management, LLC ("Aristotle Capital") and LSV Asset Management ("LSV") are very much active value investors, their approaches and styles within the value universe differ. Aristotle Capital employs a fundamental approach with a focus on quality that tends to result in a portfolio with a more relative value style, while LSV takes a quantitative approach that tends to result in a portfolio with more deep value exposure.

James Wilson (JW): What is your definition of value investing?

James Henderson (JH): At Aristotle Capital, we look at value investing a little differently than many. Our definition starts with a high-quality business, a business we believe has or can create a competitive advantage. That identified competitive advantage must be sustainable throughout our normal holding period of 3 to 5 years. Once that company is identified, we employ a disciplined valuation model to ensure that the price we would be paying for the business is a discount to our appraisal of intrinsic business value. That valuation model, in many respects, is similar to what a private equity investor may employ in valuing a business that is to be acquired in full. Lastly, we identify investment catalysts that can unlock that value. For us, a catalyst can be thought of as differentiated thought. What do we see in the business that is not well understood in the marketplace? A combination of the three (Quality, Valuation and Catalysts) drive our concept of value.

Bhaskaran Swaminathan (BS): Value investing is about buying companies that are trading at prices significantly below their intrinsic value. This means buying companies with strong expected cash flows and good balance sheets whose solid future earnings prospects are temporarily discounted by the market due to various behavioral psychological reasons such as overconfidence, extrapolation bias, etc.

JW: Disruption and innovation are topics frequently discussed today. How do you account for these trends in your process?

JH: The investment team at Aristotle studies and discuses long-term secular trends. Secular trends are often driven by innovation transforming businesses and industries in some very important ways. More recently, the adoption of cloud-based computing, the roll out of 5G, the electrification of the auto industry, has changed those industries significantly. Conversely, brick and mortar retailing, energy producers, entertainment content providers are all seeing disruptions in their business models. As we identify these long-term secular trends, we incorporate our studies in our process by focusing our attentions on the disruptors and avoid the disrupted.

BS: The key distinction to draw in value investing is between quality value and distressed value. Quality value refers to firms that are profitable and strong cash flows that can withstand disruption and innovation, in other words withstand dynamic change in the marketplace. Distressed value are companies that are on their way out. On the other hand, markets can also overvalue current disruptors and innovators, ignoring the possibility that current disruptors may also be disrupted in the future by other disruptors. Disruptive innovation is an ongoing process that is the key driver of long-term mean reversion. As value investors, we focus on companies that are best positioned to withstand disruption and innovation.

Strategic Value Investing

Harbor believes that a thoughtful allocation to value can offer significant benefits.

- Despite historical struggles, we see potential opportunities in value. However, there are important nuances to consider.
- We believe investors should always maintain a strategic allocation to value within their portfolio given diversification benefits.
- Given the current market environment, we believe it may be a good time to add value exposure.

JW: What role do interest rates and inflation play in the performance of value versus growth?

JH: Rising interest rates places downward pressure on the prevailing market price-to-earnings multiples. That pressure tends to affect those companies carrying higher than average market multiples to a greater negative extent. With that said, that dynamic only tells a part of the story (the multiple applied to earnings). Higher rates of interest and inflation effect businesses differently. Some (food retailers for example) tend to do better in a higher inflationary environment, others not so much. In our view, there is no substitute for understanding each company's business model at a very granular level.

BS: Since 2007, value has underperformed growth when the slope of the yield curve (long minus short) has narrowed or inverted and outperformed growth when the slope has widened. This is also a period of extraordinary monetary stimulus. Whether these patterns will persist in the future when we return to a more normal monetary policy is an open question.

JW: Value performance has been strong over the recent months. Do you think there is more room to run?

JH: A rising tide does tend to lift all boats, but not always. Looking solely at the indices one might conclude that the ship has indeed sailed. That is, however, rarely the case. Markets are not monolithic; industries are not monolithic. We believe that by applying a disciplined approach to valuing great businesses, businesses that are changing that are the disruptors, one is not dependent on a rising market to do well.

BS: Macro conditions (large fiscal stimulus, beginning of the end of the pandemic, rising interest rates) all point to a more sustainable and longer-term value recovery.

JW: Typically, it is growth managers that are focused on earnings growth. However, given the uptick in earnings revisions within the value universe, how do you feel about the earnings per share (EPS) growth of your portfolio going forward?

JH: To repeat a phrase attributed to Warren Buffett, growth managers are not anti-value. Value managers are not anti-growth. At Aristotle we move back up the income statement, discount reported EPS and focus on the generation of free cash flow and the productive redeployment of the same. Financial accounting standards afford companies a great deal of wiggle room in reporting EPS, hence the frequent revisions. Cash reporting while not absolute, is a bit more discrete. As has been our practice for decades now, if we can identify a company with a clear competitive advantage, generating free cash flow, we feel confident about their respective futures.

BS: The EPS growth of value companies is likely to pick up as economic growth picks up and sell-side analysts start revising their expectations of future growth rates for value companies. Because of the this, value companies are likely to maintain their attractive valuations in spite of their outperformance.

JW: 10 years ago, Energy was nearly 13% and the second highest weighting within the Russell 3000® Value Index. As of the end of 2020, it is a 4.4% weighting and the smallest sector in the index. How do you view the opportunity in this sector?

JH: As mentioned above, the Energy sector is currently undergoing a meaningful disruption as we move toward more sustainable sources of energy. This disruption may take several decades to play out. That does not mean there isn't now or will in the future be opportunities in that sector. We tend to avoid companies that compete solely on price (commodity price takers), as such, we have been underweight that sector for some time.

BS: Until earnings prospects start improving significantly for energy companies, they are not likely to lead the value renaissance.

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