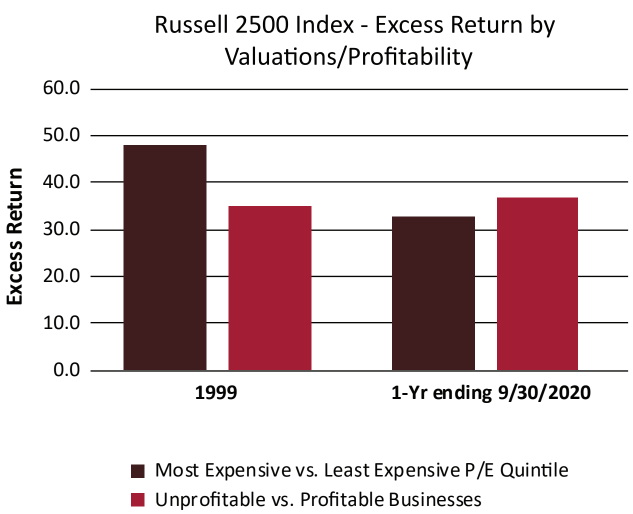
Aristotle Capital Boston December 31, 2020

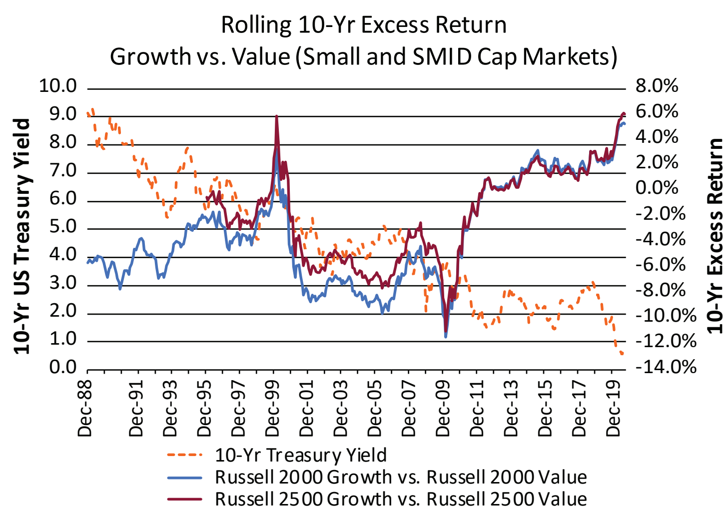
Growth vs. Value: Is Today Really Different?

"This time is different." It's an argument we've heard many times before about various asset bubbles and economic environments. Used by experts and laymen alike, it's an argument that has been used to justify periods of extreme market dislocations by focusing on the "fundamental changes" that have occurred between two various points in time. In fact, it's an argument that has been so commonplace over our financial history that an entire book was devoted to the topic after the Great Recession ended in 2009. The main takeaway from that book, "This Time is Different: Eight Centuries of Financial Folly," written by economists Carmen M. Reinhart and Kenneth S. Rogoff, is that history is riddled with examples of investors, central bankers and policy makers convincing themselves and others "*that the old rules of valuation no longer apply*" before dealing with the fallout that eventually occurs.

It's an argument that many are making today regarding the relative performance relationship between growth and value stocks. Of course, there are legitimate differences between today's environment and previous periods such as the dot-com bubble in the late 90s—actions of the Federal Reserve, liquidity, the rise of algorithmic trading, etc. But is this time actually different? Is it rational to expect value investing be dead in the water forever? Do profits and fundamentals no longer matter? Has Economics 101 suddenly changed?

Despite their differences, both today's environment and the dot-com bubble have exhibited similar investor behavior, namely that many are willing to bid up the most expensive securities and unprofitable businesses while discounting the risks inherent in those investments. This can be seen on a short-term basis when looking at the charts below, which compares the market's preference for speculatively valued/money-losing businesses over the trailing 12-month period vs. the latter stages of the dot-com bubble in 1999. This short-term dynamic by itself does not indicate we are approaching a growth bubble; however, on a long-term basis, we can see that the relative return relationship between growth and value either exceeds or is bested only (depending on the benchmark) by what was experienced at the heights of the dot-com bubble. In a world of market cycles and mean-reversion, we would argue that this dynamic is not sustainable.





Sources: FactSet, Russell Investments

We believe a major contributor to the current divergence between growth and value is the significant decline in interest rates since the end of 2018, which has provided multiple valuation boosts to longer-duration, expensively valued/money-losing businesses. As lower discount rates enhance the value of future cash flows, an immediate boost to some of these businesses may be economically justified; however, we have seen cautionary tales of paying too much for growth in the past and would encourage investors to not forget those lessons, especially given the already speculative nature of the market in recent years.

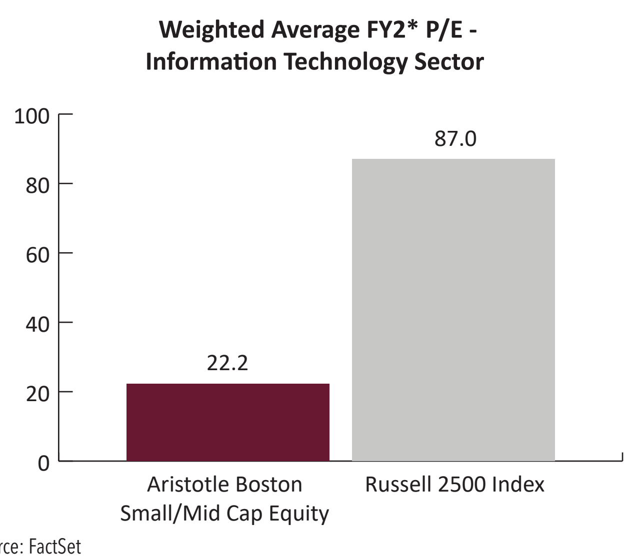
Ignoring Valuations: A Cautionary Tale

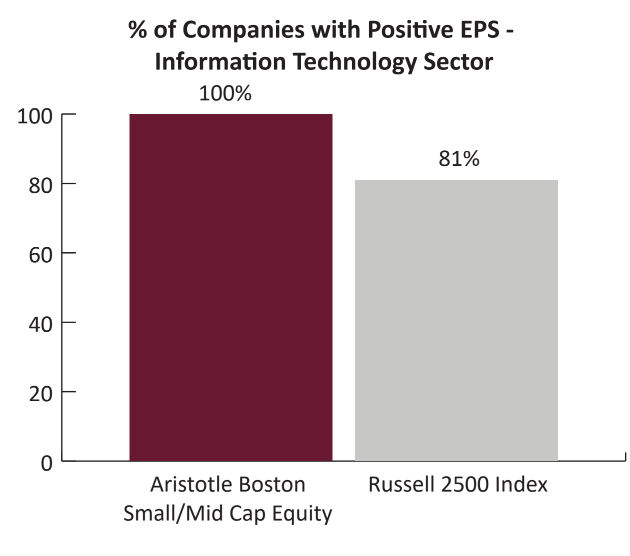
Driven by adoption of its enterprise switches and various networking solutions, Cisco Systems experienced incredible success in the 1990s, growing to become the most valuable company in the world with a market capitalization greater than $500 billion by early 2000. Shares of the company had traded between 10x-20x sales for most of the 1990s, before reaching 25x sales, then nearly 40x sales at their peak. When the dot-com bubble burst, shares of the company collapsed and its market value sank below $100 billion. Much has happened since then. Cisco's annual revenue increased from roughly $12 billion in 1999 to more than $50 billion in 2019. Over the same period, EBITDA increased from roughly $4 billion to $16 billion, net income increased from roughly $2 billion to nearly $12 billion, and free cash flow increased from $4 billion to $15 billion. While the company has arguably been successful over the last two decades, including ventures into additional end markets such as videoconferencing and Internet of Things, its market value has never surpassed 50% of its previous peak and currently sits below $200 billion.

Many lessons can be taken from Cisco's story and applied to today's environment. Continuing with Information Technology as an example, the average forward P/E for the sector (Russell 2500 Index) has risen from roughly 45x at the end of 2018 to 87x at the end of 3Q 2020. The average P/S for the sector has risen from roughly 5x to more than 12x. Much of this has been driven by multiple expansion within the software industry, which consists of many companies trading above these ranges. In our search for long-term investment opportunities, one of the many questions we ask ourselves is not just whether or not an individual company can be successful in the future, but how much of that expected success is already priced into the share price. As we've seen from Cisco and countless others, ignoring valuations to chase an exciting story can lead to poor investment decisions.

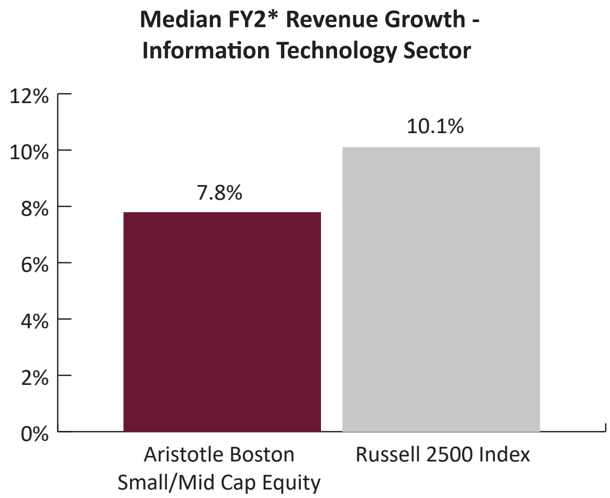
Adhering to a Long-Term Discipline

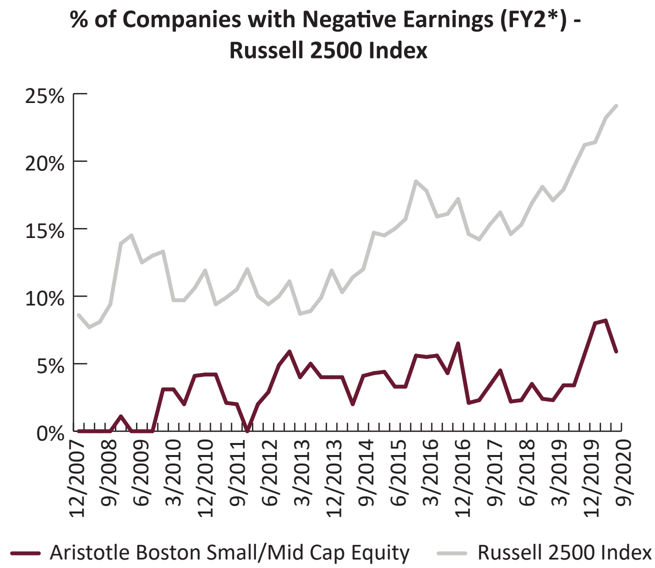
Despite the frustrations of the current market environment, we have remained true to our long-term approach, quality-orientation, and valuation discipline. Within the Information Technology sector, we believe our portfolio has a meaningful valuation discount and greater exposure to companies with positive earnings (with an investment focus on companies with strong recurring revenue opportunities), while still maintaining attractive growth potential as shown in the charts below. Within Health Care, our risk discipline and avoidance of companies with binary fundamentals have led to a lack of exposure to the biotechnology industry, where more than 90% of companies in the benchmark are unprofitable. At the overall portfolio level, we believe our strategy maintains a strong quality orientation relative to its benchmark as evidenced by the higher relative exposure to companies with positive earnings.





Source: FactSet
*Next fiscal year.
The charts shown above are based on a representative portfolio within the Aristotle Small/MidCap Equity Composite.





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We have also been active in initiating new positions this year, as the current environment has presented many investment opportunities that are in line with our long-term investment philosophy. Overall, we believe the combination of the portfolio's existing holdings and recent investments position our strategy well going forward, and believe our continued focus on businesses with strong fundamentals and attractive valuations will be rewarded as the relative performance relationships highlighted above return to more normalized and rational levels.

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