A Momentous Shift

Samir Sikka, CIO
November 2, 2021

Given the decade-long performance leadership of large, growth-oriented companies, Sapience like many others in the investment world, are expecting better relative returns for value stocks in the near to medium term. While value managers are combining various levels of sincere investment conviction with wishful thinking, institutional asset owners and consultants are actively considering modifications to the style structure of their equity exposures to capture the shift.

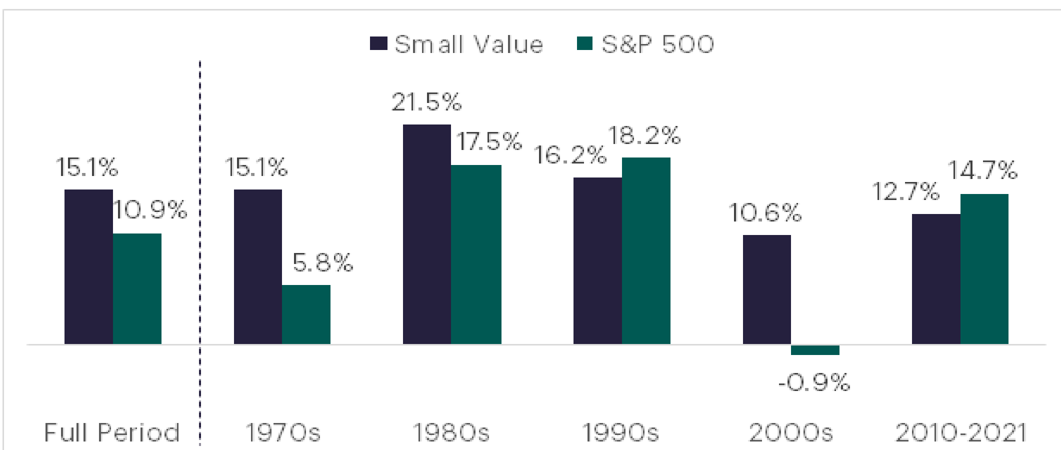
We are ardent believers in David Swensen's quote from his epic book, Pioneering Portfolio Management:

> *"Casual commitments invite casual reversal, exposing portfolio managers to the damaging whipsaw of buying high and selling low. Only with the confidence created by a strong decision-making process can investors sell mania-induced excess and buy despair-driven value."*

Mr. Swensen targeted his comment at two audiences—investment managers who may be tempted to deviate from their disciplines based on current poor relative results, and Investment Committee members who may jettison effective long-term asset categories and manager talent based on recent shortfalls.

The investors at Sapience have focused on small- and mid-cap value stocks throughout their careers for two primary reasons: they are less efficient—thus providing superior alpha potential, and the betas of these stocks have shown historic superiority. On the latter point, small cap value stocks have generated double-digit returns in every decade since 1970, which would suggest a perpetual exposure to this segment is a wise strategy.

U.S. Small Cap Value and S&P 500 Returns by Period (1/1970 – 6/2021)



Source: Capital IQ. Ken French Data Library. Verdad. A Macro View of Factors (September 20, 2021).

Inertia has been a powerful force since the global financial crisis (GFC) and especially in the last five years in the U.S. equity markets. The tepid economic recovery, low rates, and late cycle fear were drivers for multiple expansion in mega-cap growth stocks as well as in quality/defensive businesses. The markets over the last five years can be characterized by an increasingly fervent zeal to invest in growth stocks with minimal regard for prices paid and downside risk. Many investment firms have actually begun to take pride in deemphasizing valuation—read their letters or listen to their podcasts. As multiples have risen, many such investors are now using non-objective measures of quality to defend their holdings at lofty valuations. We believe many mistakes are being made based on investors' desire to expand exposure to growth/quality—while these attributes are desirable in any business, it doesn't protect against downside risks when you have overpaid. The environment is shifting but these investors and their allocators are caught in a cognitive trap of rear-view framing. As Buffett has said, "only when the tide goes out, do you discover who's been swimming naked".

We believe there are three concepts that are particularly relevant in the growth-value debate:

1. There is an increasing dichotomy in how "value" is defined. In the early days of value investing, value was "in the eye of the beholder"—a subjective determination on a stock-by-stock basis. An asset worth $1 that can be purchased for 65 cents is a value. This perspective was forever altered when style indices were created and later embraced by the academics and factor folks. They did not have the time (or maybe just the inclination) to do individual company research, so they needed to identify purely objective metrics to define value. For these applications, *subjective value became absolute cheapness*, and there is an immense difference between these two interpretations of value because investing based purely on cheapness relies solely on regression to the mean for returns.

2. Recognize that value can regain leadership in three ways:

   i. Growth multiples can come under attack as the rose-colored glasses come off allowing value to lead by default, which would result in a somewhat muted victory.
   ii. The marketplace begins to recognize the merits of some neglected or out of favor value-oriented companies and sectors, leading to re-rating and increases in prices.
   iii. Both of the above scenarios occur simultaneously. Recall the three years following the Dot Com correction:

	2000	2001	2002
Russell 2000 Value	22.8%	14.0%	-11.4%
Russell 2000 Growth	-22.4%	-9.2%	-30.3%

Source: Russell Investments.

   Intuitively, the simultaneous scenario seems the most likely. Investors are usually more policy driven, meaning they remain in stocks and choose to make intra-market shifts between styles, sectors, and geographies.

3. Closely related to the point above, there are macro and valuation drivers that are causal factors of cyclical shifts in style leadership. A strong economy can even buoy the operating results of companies with suspect fundamentals, and lead to a multiple rerating. Similarly, an increase in interest rates can have a dual impact. Increasing rates negatively impact long-duration growth stocks, while, the Financials sector, which is the largest component of the value universe, benefits from improving lending spreads.

   In regards to valuation spreads: dramatic precedents exist. The first example is the ten-year run of the Nifty Fifty theme, which ended ugly in the early 1980s. A second example is the technology-media-telecoms (TMT) bubble in the late 1990s. This was a period where the spread between growth and value reached a record. In March of 2020, the same spread reached close to that all-time record and we are not far from these valuation differentials today. The following tables illustrate the dramatically divergent performance for value and growth styles over three (almost equal) time periods during the last 31 years:

1990-1999

	Value	Growth
Large Cap	325.00%	535.71%
Small Cap	223.32%	255.08%

2000-2009

	Value	Growth
Large Cap	27.67%	-33.42%
Small Cap	121.38%	-12.92%

2010-9/30/2021

	Value	Growth
Large Cap	264.17%	552.69%
Small Cap	251.10%	370.19%

Source: Russell Investments.
Returns are cumulative. Large Cap: Russell 1000 Value Index, Russell 1000 Growth Index. Small Cap: Russell 2000 Value Index, Russell 2000 Growth Index.

Our contention based on the three points above is that the probability of a return to value, in whatever form, is likely enough for investors to re-position their equity structure, and that firms like Sapience are in the best position to capture this reversal in leadership. Our confidence comes from our investment approach. As mentioned above, value investing is not a homogenous endeavor. This is why we prefer the label of being a price-driven investor. We never own a stock based on absolute cheapness—generating client performance through reversion to the mean alone is a low-probability strategy in our opinion. We only consider companies that we can value with confidence, and then own them when they are available at a discount. In our view, this is the best defense against a permanent loss of capital.

As the economic environment becomes more volatile, we believe Sapience will add value through our qualitative, fundamentals focused process, which avoids being beholden to a single macroeconomic view or being dogmatic about an investment style box. We have always believed, and maintain, that quality, valuation, and growth are all important criteria in evaluating any business. We remain disciplined—investing in durable and undervalued businesses when they might be out of favor and, at times, trade at a significant discount. This includes owning healthy franchises that are misperceived by the markets and investing in select troubled businesses where we are confident in our underwriting assumptions of improving, rather than static, operating results. We believe our version of value investing works because its core principles are logical and timeless. We frequently refer to having a private equity orientation. The distinctions between this mindset and more common forms of value investing are our emphasis on the recognition of franchise value, a longer time horizon, and modeling our return assumptions based on fundamental drivers rather than a mean reversion approach.

No “category” of investor is free from periodic guilt. Those of us in the value camp might be quick to suggest that since the growth managers failed to recognize the massive bubble in 2000, we should not count on them to recognize the current vulnerabilities. If we do that, then we must acknowledge that when facing the greatest credit excess in history, many value managers maintained their substantial exposure to Financials (in keeping with their benchmarks), which were decimated in the GFC. However, the notion that most value investors only care about one variable—a cheap multiple—is simplistic and nonsensical. There is usually a healthy rivalry between value and growth investors, but today it seems more like a crusade. It is seldom black and white in the markets; we are always grappling among varying shades of gray. However, the growth dynamic is currently stretched to an extreme.

Our number one challenge today is to focus on how to do value investing better. We believe the times call for it. To think hard about what has changed in businesses and the economy and what remains intact. The search for discounted businesses can easily lead the investor to accept catalysts that are mirages. In our opinion, value traps are more prevalent today than at any point in our 25-year careers. Our method of doing value better centers on being increasingly more forward looking, placing an even greater emphasis on assessing the competitive landscape, the threat from future innovation, and evaluating the managements who steward the businesses we own. We think like owners of real businesses, not just traders of securities who are reacting to every tick in the yield curve or a penny miss in quarterly earnings.

Looking out over the near to medium term, we remain constructive but more cautious, as the reduction of fiscal and monetary stimulus should lead to a less favorable backdrop for equities. On the other hand, consumer balance sheets remain sturdy and transitory supply shocks should abate over the next few quarters. The economy should post a strong recovery over the next 12-18 months. A significant turning point in U.S. monetary policy is at hand. However, the consensus view among market participants is still that the FOMC won't be able to lift rates as postulated and if they do, it would be a policy mistake. In last few weeks, the elevated inflation levels is causing a rethink of this consensus view.

In the last five years, riding the popular stocks upward has been a winning game plan. Simple strategies—passive or momentum based—relying on multiple expansion in the name of growth/quality, have all led to unprecedented gains. The fear of missing out on further gains, and the institutional imperative of keeping up with the benchmarks and peer groups has led to an adjournment of healthy skepticism and a dissipation of discipline. Trends usually go too far, and speculation always leads to rational thinking—the voting machine cedes to the weighing machine. Regime shifts in the markets, after long periods of speculative excesses, are seldom orderly and often violent. In the aftermath of the TMT bubble, retail investors swore off hot IPOs and several growth firms shriveled or were shuttered. In our view, the odds now point towards a shift in the equity markets toward the favoring of skill-based investing or alpha over beta. This shift would support modifying equity structures towards active management by investors who do deep fundamental research, focus on valuations based on realistic projections of a company's earnings power, and own stocks at prices that provide a margin of safety.