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Value, Growth and Interest Rates - a complicated relationship

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- The Value factor is one of the most commonly accepted risk premia factors in equity investing. Still, its returns over the past decade have been disappointing even after its more robust performance.
- The poor results of Value investing have frequently been blamed on the low-interest rate environment favouring long-duration assets.
- We have investigated the relationship between Value vs Growth and rates and inflation and found some correlation but generally a relatively weak link.
- Aside from that, we have decomposed the relative return of the Value factor into its drivers, namely Dividends, EPS Growth and Multiple Expansion and argue that Growth likely benefited from being slightly undervalued following the Great Financial Crisis.

October 25, 2022

Is Value vs Growth just a play on interest rates? As Value stocks derive a greater share of their valuation from near-term cashflows, they, in principle, have a shorter duration than Growth stocks. It is, therefore, often argued that the low-interest rate environment mechanically benefited Growth investing as market participants discounted earnings expected to be generated far in the future at lower rates. This article studies the relative performance of Value over Growth over the past two decades - with mixed results.

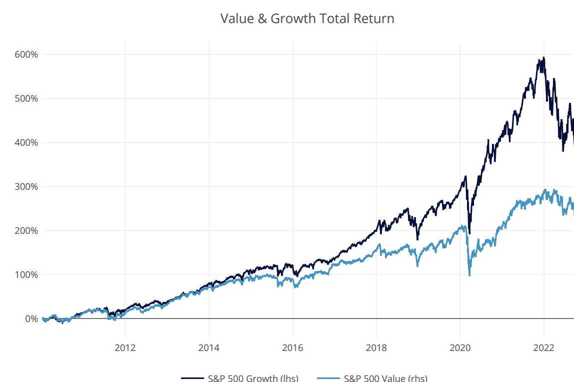

Figure 1: *Growth has massively outperformed Value over the past decade, and although, Value fared better recently on the back of surging energy stocks, the most popular investment factor still has a long way to go.*

1 Will Value finally catch up with Growth again?

The massive underperformance of the Value factor since the early 2010s has been widely discussed for years and frequently blamed on monetary policy. The popular narrative sounds compelling. The value of fast-growing firms is driven by cash flows expected to be generated far in the future, while companies that are predicted to grow slowly or shrink derive their value from contemporary and near-term cashflows.

This, in turn, should make the valuation of growing corporations more sensitive to the interest rate used to discount future cash flows. Growth stocks, so the argument, are, by definition, assets with a much longer duration than Value stocks. Value investors have, therefore, frequently lamented that the low-interest rate environment has favoured Growth and inflated the valuation of companies with high valuation multiples to the detriment of market efficiency. Indeed, over the past two years, there has been a close relationship between the relative performance of Growth and 10-year Treasuries. However, as the chart below indicates, there is little correlation in the longer run. We have outlined before, why we find the duration argument a rather problematic way of looking at the drivers of Values vs Growth - most importantly, commentators frequently fail to distinguish between real and nominal interest rates and overlook the role of aggregate sales and profit growth. To further investigate the outperformance of Growth over the past decade, we have decomposed the relative performance of the S&P 500

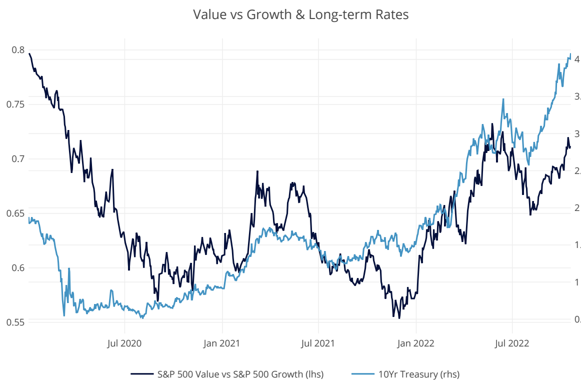

Figure 2: *In the short run, it looks like Value vs Growth and 10-year Treasury yields move in tandem.*

Growth Index against the S&P 500 Value Index. By definition, total return is a function of dividends, Earnings per Share (EPS) growth (which includes share buybacks) and P/E multiple expansion or contraction. Value stocks tend to be the shares of more mature and highly cash-generative businesses that often return the bulk of their profits to shareholders. We would thus expect a higher percentage of the total return of the Value factor to stem from dividends. EPS, in turn, are driven by the progression of sales and profit margins, but, particularly in the U.S., share buybacks have a significant impact too. In principle, by buying back

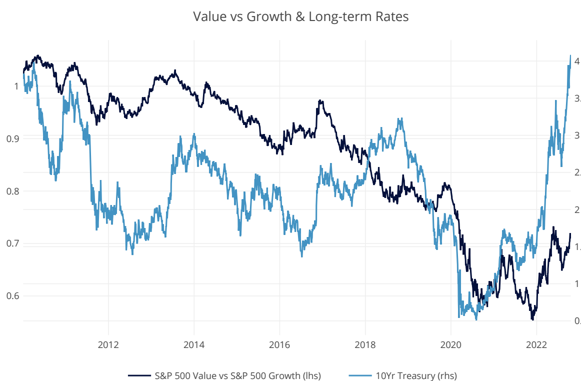

Figure 3: *The longer-term link between Value vs Growth and interest rates has been much weaker*

shares, a mature, shrinking firm with a low valuation multiple could achieve the same EPS growth as a young company with fast sales growth and margin expansion. However, on aggregate, we would expect EPS to expand faster among Growth stocks.

Indeed, we find that between 2010 and today, Value has generated 26% higher dividend income than growth, while EPS expansion has been 36% higher for Growth stocks. Ceteris paribus, this would support a pretty negligible outperformance of Growth. However, while the S&P 500 Value trades at an 15% lower P/E multiple than in 2010 (from 18.6x to 15.8x), the aggregate P/E for the S&P 500 Growth has expanded by 18% (from 18.5x to 21.8x). It is surprising that both indices traded around the same P/E, an observation we attribute to

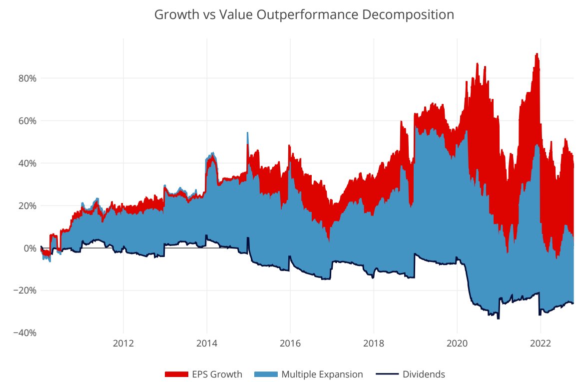

Figure 4: *Over the past decade, differences in EPS growth and dividend yield between Value and Growth have cancelled out each other. Most of the outperformance of Growth stocks has thus been driven by multiple expansions. However, if not for that, returns from buybacks and dividends would also have been higher in Growth stocks, indicating that Growth was undervalued at the onset of the past decade.*

the fact that S&P also uses Price/Sales and Price/Book when constructing the index. In other words, we find that the outperformance of Growth against Value in the U.S. has been driven primarily by divergence in valuation multiples. At first sight, this could be seen as supporting the interest rate hypothesis. As the chart below illustrates, there seems to have been some correlation between the spread in valuation multiples and interest rates over the past two years, but overall, the link remains weak.

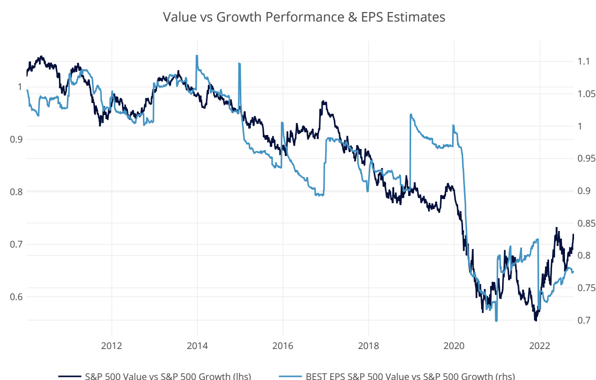

Figure 5: *The massive rally in Growth stocks in 2021 is often attributed to monetary policy but is also tracked by a substantial divergence in EPS as a consequence of Covid.*

More importantly, the observation that higher dividend yields generated by Value stocks more or less compensated for higher EPS growth among Growth stocks is in-line with a priori rational expectations. However, the gap between EPS expansion and dividend income would have likely been more pronounced if not for the multiple expansion in Growth stocks (lower market capitalisation ceteris paribus equates to higher dividend yield and faster share-buyback induced EPS growth).

In other words, the numbers indicate that Growth

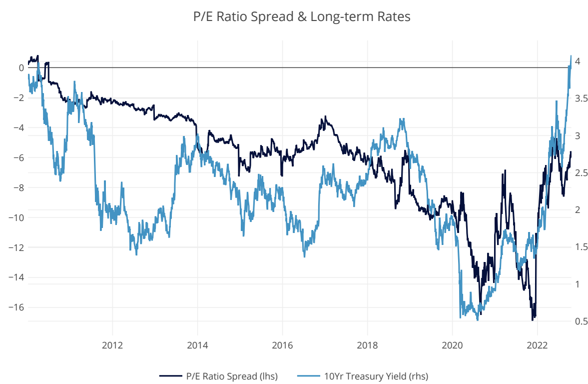

Figure 6: *Over the past years, the P/E spread between Value and Growth stocks has been correlated with 10-year Treasury yields, but overall, there is only a weak link.*

stocks were underpriced. Whether they can support the current, significantly higher valuation premium is a different question, and we believe that the odds are still somewhat in favour of Value now. However, the role of interest rates in this context has likely been exaggerated. While rates may have some explanatory power in the short term and particularly in 2021, the longer-term multiple expansion in Growth stocks was probably a reaction to the better-than-expected operative performance.

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