Elston

Insights

4th November 2021

Value investing makes a come back

- The relationship between equity income, equity duration and value bias
- Income focus, with inherent value bias, acts as potential inflation hedge
- Negative real yields, and yield premium to gilts makes equity income investing attractive

The era of quantitative easing programmes have had a distorting effect on markets since the 2008 financial crisis has given value investors a torrid time in the past decade. The near-constant sugar-rush of liquidity has served to de-link valuations from underlying fundamentals prompting a huge bias towards growth. While pockets of investors have been braced for a long-expected correction that has never really materialised, the recent sharp increase in inflation may constitute an inflection point of sorts. In inflationary periods and when interest rates rise, the time horizon for future discounting shrinks, leaving equities exposed.

Income-yielding shares have an inherent value-bias, owing to the types of company that pay steady dependable dividend). This provides a measure of inflation protection both in absolute terms and relative to nominal bonds.

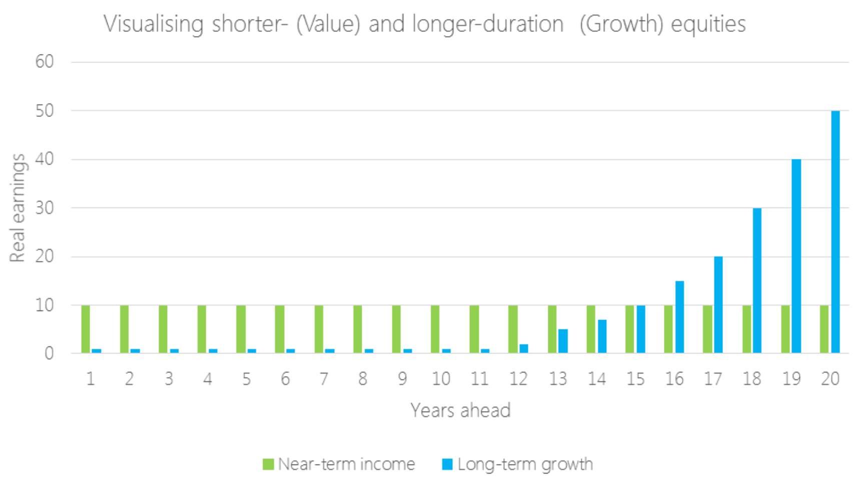
The relationship between equity income, equity duration and value-bias

Mature companies whose valuation is a function of near-term earnings and dividend payments are known as "shorter duration equities" and typically have a value-bias. Valuations and growth rates may not be high, but the company's market value is underpinned by fundamentals of near-term earnings and dividends.

Less mature companies whose valuation is a function of future long-term growth – with or without dividends – are known as "longer duration equities" and typically have a growth bias. Valuations and growth rates may be high, and the company's market value is therefore highly sensitive to changes in assumption around growth rates, and also the discount rate at which future earnings (and potentially dividends) are discounted back. It is this sensitivity to discount rates that make growth-oriented stocks sensitive to inflation. The higher the discount rate, the less valuable in today's terms all that future growth looks.

This concept of duration and equities is illustrated in the chart below.

Fig.1. Illustration of short- and long-term equity duration



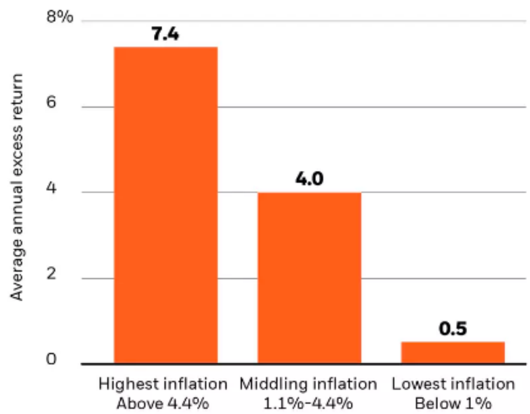
Source: Elston research, for illustration only

The relationship between value and inflation

In addition to the conceptual framework that explains the potential for relative outperformance of value stocks during inflationary regimes, there is also empirical evidence.

In a study of the US market, BlackRock found that from 1927 to 2020, during inflationary regimes (inflation above 4.4%), Value outperformed Growth by an annualised 7.4%p.a. on average. During periods of middling inflation (1.1% to 4.4%p.a, relative to today's 2% target), Value outperformed Growth by an annualised 4.0%p.a on average. During periods of low inflation (<0.5% pa), Value outperformed Growth by just 0.5%p.a. on average.

Fig.2. Value's relative performance under different inflationary regimes 1927-2020

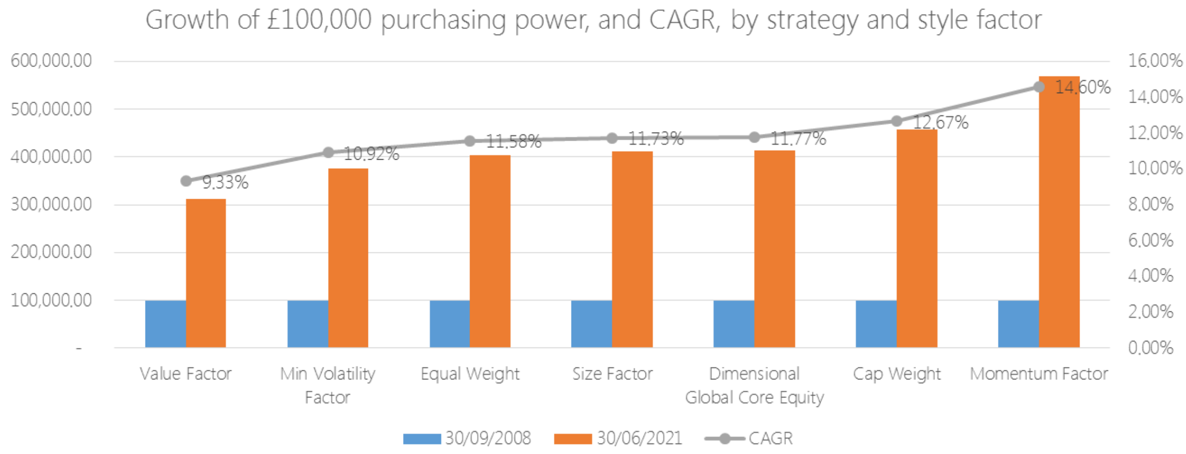


Source: BlackRock, with data from the Kenneth R. French Data Library and from Robert J. Shiller. Fama/French data utilizes the CRSP universe, which includes all companies incorporated in the U.S. and listed on the NYSE, AMEX or NASDAQ exchanges. The level of annual inflation is defined as the year-over-year change in the Consumer Price Index (CPI). "Lowest inflation" represents the bottom 20 years of inflation readings; "highest inflation" represents the top 20 years; and "middling inflation" represents the remainder. The numbers below represent the high-low range in inflation readings for each regime. Value outperformance is annualized and calculated across various inflation regimes using annual data from 1927 to 2020. Value outperformance represents the performance of value stocks minus growth stocks, as defined by the Fama/French HML research factor (i.e., "high valuation minus low valuation" using book to price).

Since the Global Financial Crisis, Value has structurally underperformed all other factors. Since September 2008, World equities Value factor has delivered an annualised return of 9.33% in GBP terms. This contrasts with 12.67% for traditional cap-weighted World equities and 14.60% for

Momentum factor. Put differently Momentum has enjoyed a +5.37%pa premium to Value since the financial crisis in GBP terms (see chart).

Fig.3. Value's relative performance under different inflationary regimes 1927-2020



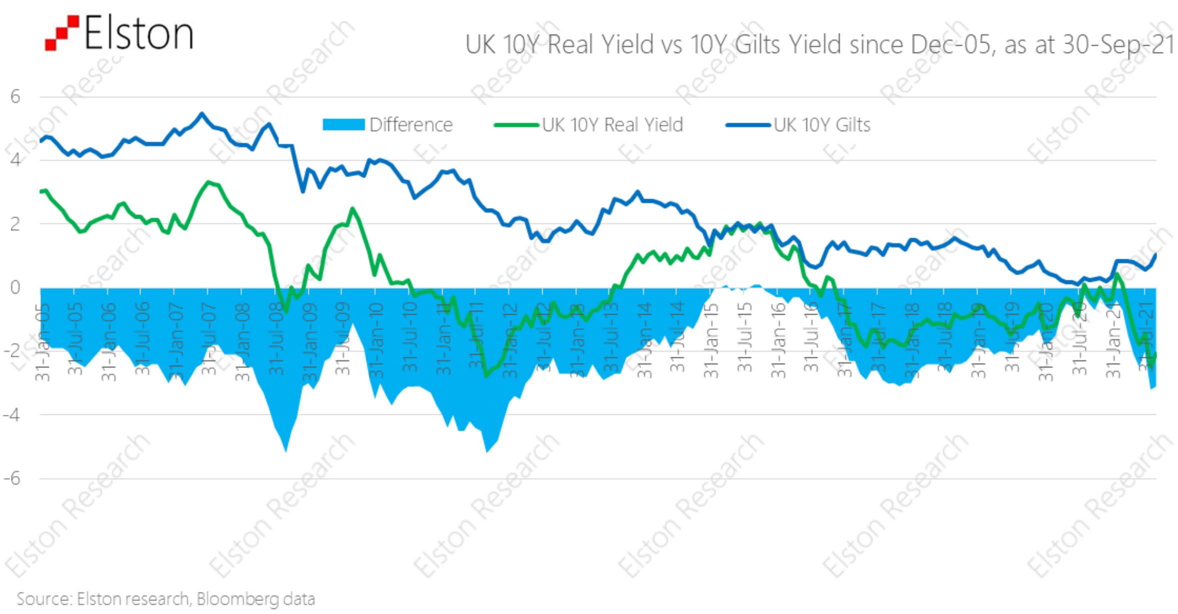
The return to higher-inflationary regime is triggering a "great rotation" into Value-biased stocks.

The case for income investing

The following charts illustrate why we feel the current market environment is a favourable one for income investing.

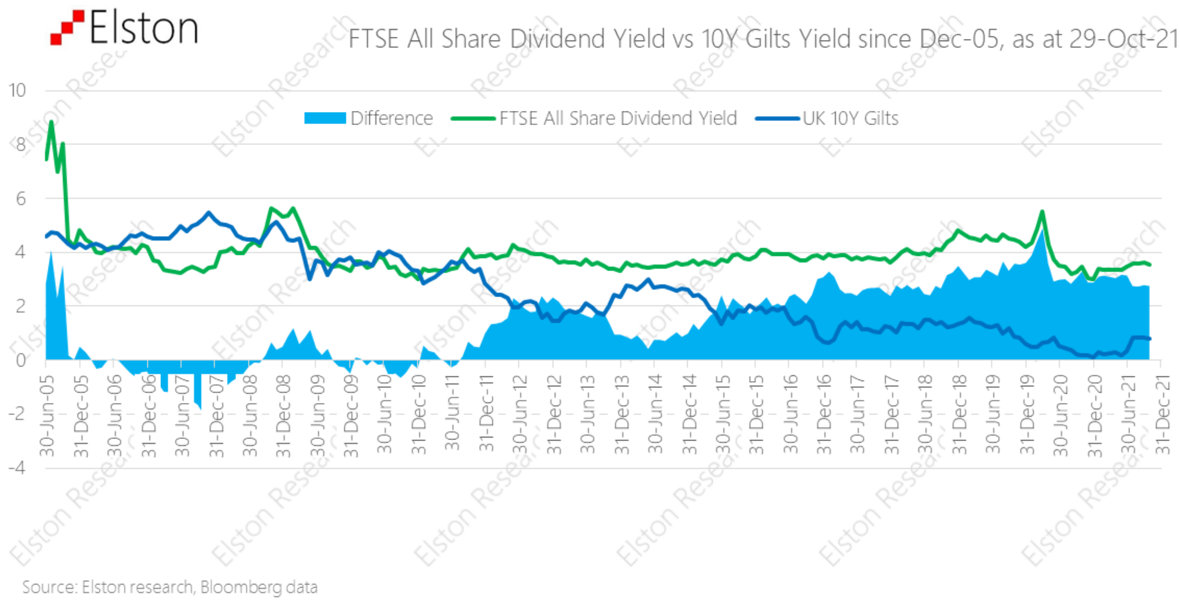
Firstly, real yields are in negative territory, increasing the appeal of risk assets such as equities.

Fig.4. UK Real Yields



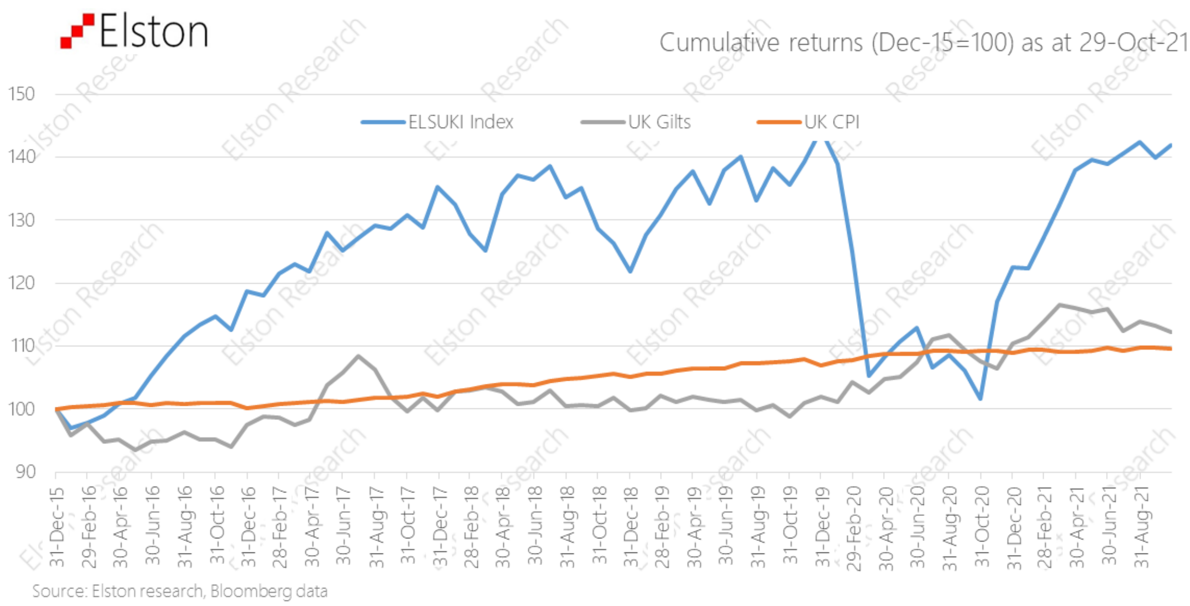
Secondly, spread of returns from dividend-yielding shares over Gilts remains high. For income-oriented investors, it's equities, not bonds, that can provide.

Fig.5. Dividend yield relative to gilts



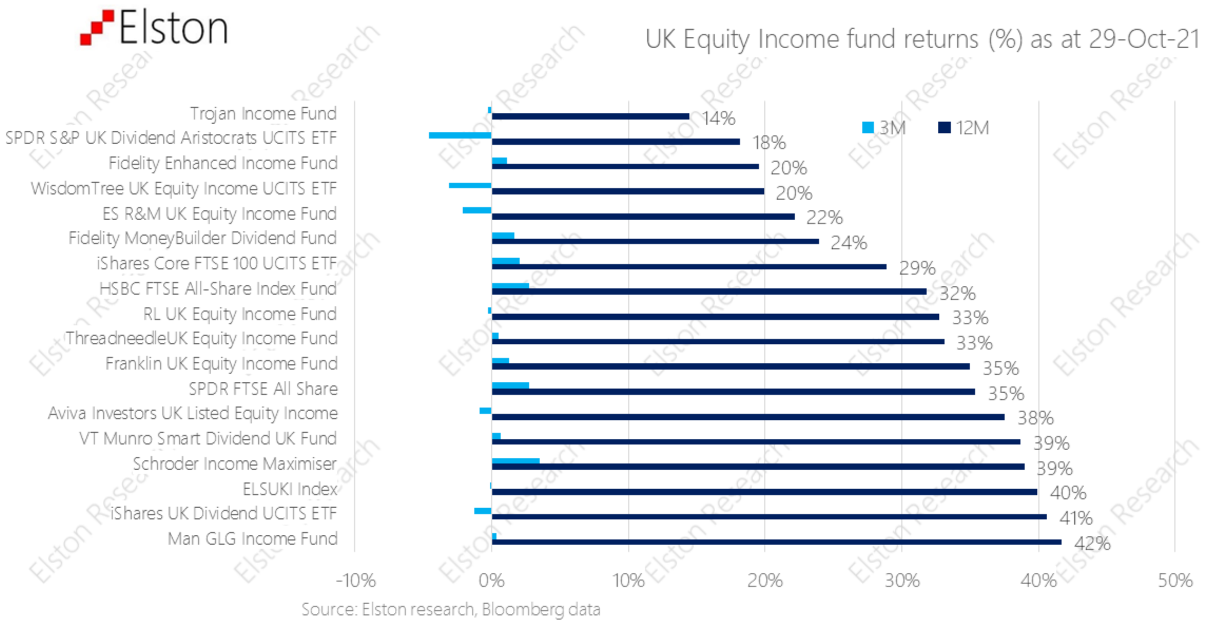
Finally, equities provide a long-term inflation hedge. A look at the Freedom Smart Beta UK Dividend Index (Ticker: ELSUKI Index), whose methodology based on forward-looking dividend estimates, shows that while not immune to short-run volatility, returns still far outpace medium-to long-term inflation.

Fig.6. Equity Income returns, relative to Inflation



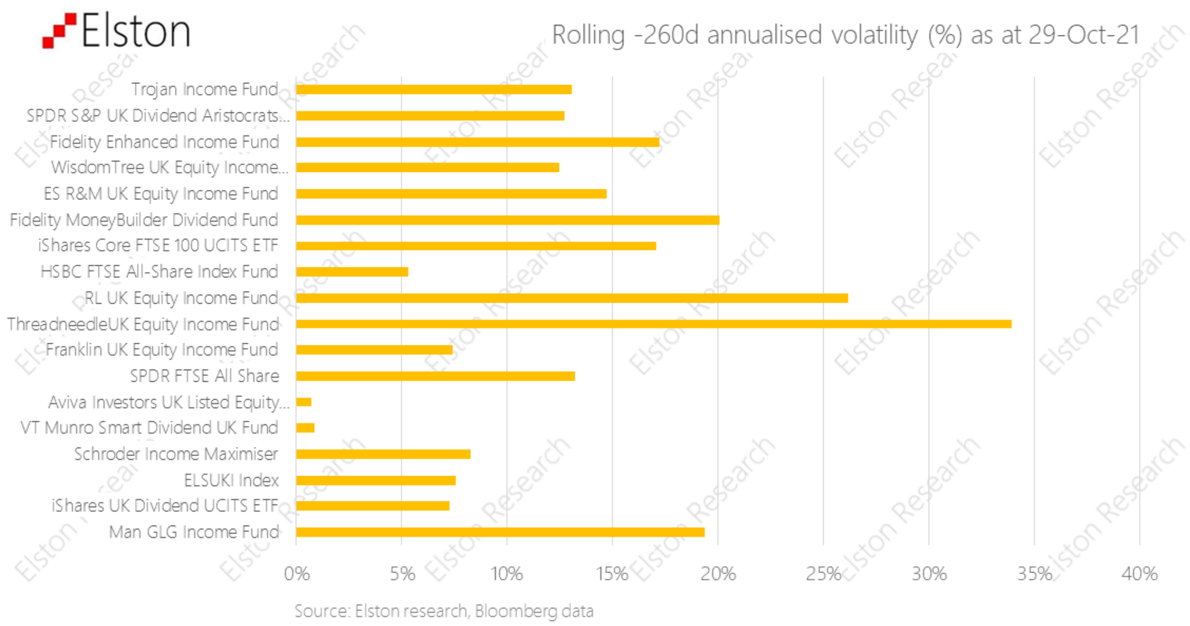
The chart below illustrates the outsized returns generated by income funds in the year to October 2021 as the pace of inflation picked up in the wake of the pandemic.

Fig.7. Equity Income funds 3 month and 12 month total return



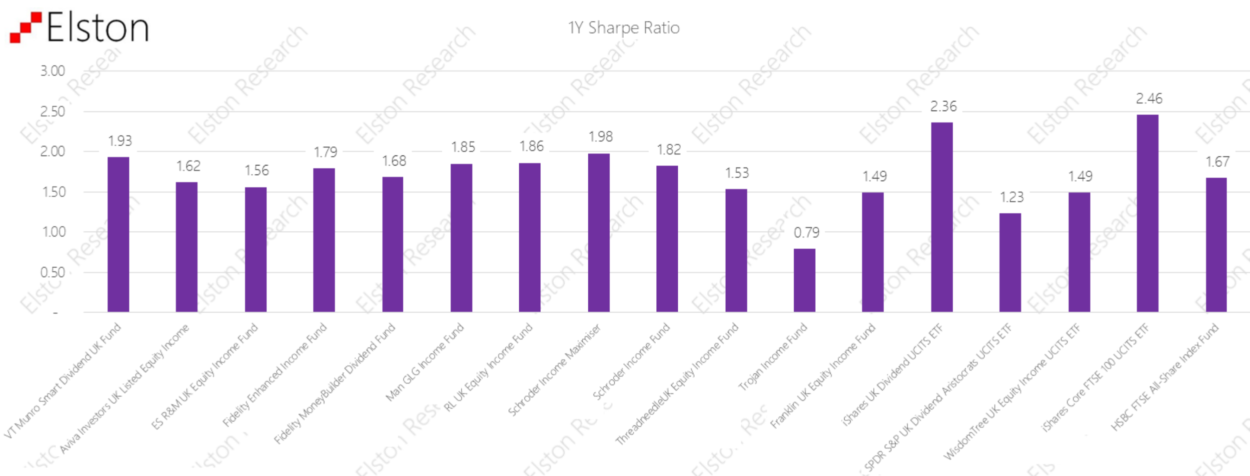
Volatility across income funds varies, so it is vital to take risk into account when looking at returns.

Fig.8 Equity Income funds 260 day annualised volatility



The neatest way to combine these metrics is to look at risk-adjusted returns, as defined by the Sharpe ratio – the unit of return over the risk-free rate (e.g. Bank of England base rate) per each unit of risk

Fig.9 Equity Income funds 1 year Sharpe ratio



Source: Elston research, Bloomberg data

Investment rationale

When considering selection of equity income funds it is worth considering the strength not only of past dividend track record but forward-looking dividend growth too.

Quality income funds exhibit persistency, whereby they pay a regular, stable and ideally increasing dividend over the long-term while at the same time endeavouring to mitigate concentration risk. The emergence of inflationary pressure in the market is putting companies and funds with a value bias and a high-quality income stream back in the spotlight and deservedly so. Research suggests that dividends are a key anchor of total returns and there is therefore a strong rationale for currently allocating to value.

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Note: All chart data as at 29-Oct-21, unless otherwise stated

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