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The rotation to value...but which value?

The rotation from "growth" into "value" has been one of the leading stories in financial markets since the fourth quarter of 2020. The topic has connections to nearly every aspect of equities right now — stocks that benefit from a cyclical recovery, the comeuppance of select headline tech stocks, inflation fears and higher interest rates. Covering all of those different areas would be difficult (and a long read), so I want to focus understanding the rotation in terms of "value" as a sector as opposed to "value" as a factor.

The sector story is based on the idea that a given sector within a benchmark can be classified as a growth sector or a value sector; a growth sector will have a higher-than-average earnings growth rate compared with other sectors or the economy generally. In this taxonomy, a sector like technology is considered "growth" because its future earnings are higher than, say, a sector such as financials. And in the current market, we are seeing a rotation from technology.

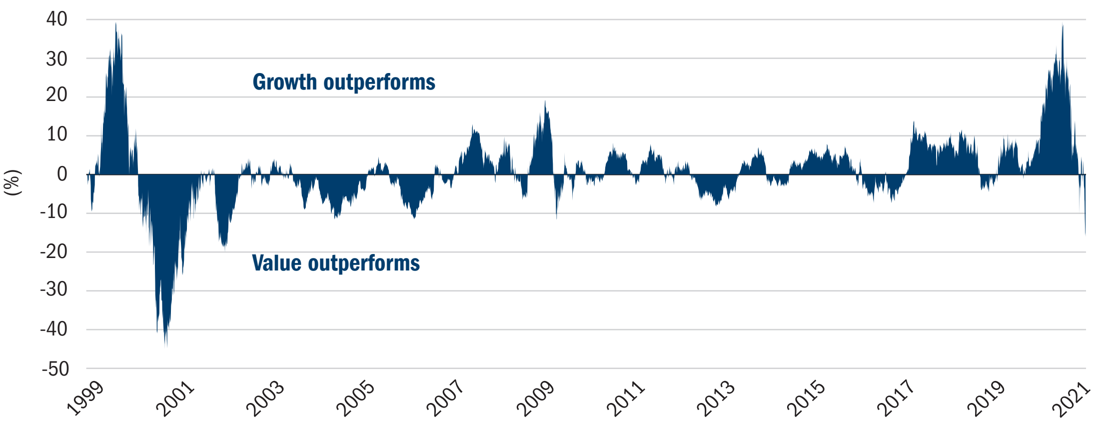
The factor approach tosses out the notion that a given sector may be inclined toward growth or value, and instead considers the stocks themselves. The value factor considers companies sharing a fundamental metric, for example, low price earnings multiples. This does not have to be connected to a value sector manager, and the approach applies to a core or even sometimes a "growth" portfolio. Is it confusing to have the same terminology apply to both approaches? Absolutely. But does it matter whether we get this terminology straight? It does, because the value sector and the value factor are not always aligned, and if you are going to make portfolio decisions based on a rotation, it helps to know what you are buying when you buy value.

Some key historical observations that we will explore:

- The sector-based performance differential between growth and value is a phenomenon that has been strongly linked across market cap, and to a lesser extent, across geographies.
- The sector-based performance differential between growth and value, has also behaved in a similar way to the factor-based approach, but the sector-based and factor-based relationship varies. This is why it's so critical to focus on the definitions.
- The outperformance of both sector-based and factor-based value has been linked recently to the direction of U.S. Treasuries, but that has not always been the case historically nor does it have to be.

To help clarify things, let's start by focusing on the sector-based approach to understanding the rotation. We will look at a rolling six-month comparison of the Russell 1000 Growth and Russell 1000 Value total return indices, ending at the end of February 2021:

Six-month rolling return: Russell 1000 Growth vs Russell 1000 Value

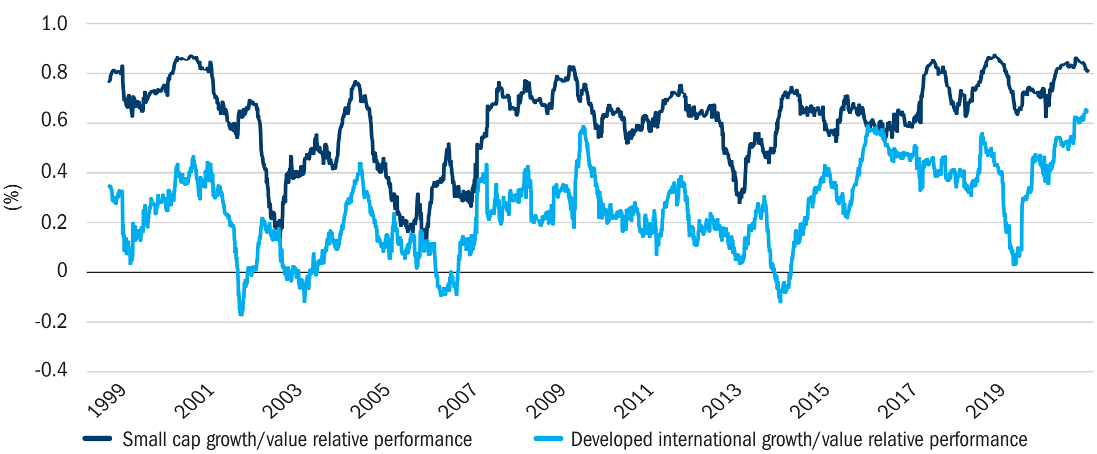


Source: Columbia Threadneedle Investments as of 03/09/21.
Past performance is not a guarantee of future results. It is not possible to invest directly in an index.

It has been quite a long time since we saw such a large outperformance of value relative to growth. The February 2021 month-end differential of -15% is more extreme than anything seen since the tech crisis of March 2000. The relative outperformance of growth (35%) seen in August 2020 is comparable to the levels we saw prior to the tech bubble bursting. And while past performance is of course not an indicator of future results, investors can't help but look at the deeper performance gaps favoring value that developed after the tech crisis and wonder if this rotation could go quite a bit further.

If this pattern is happening across the large/midcap domestic space as measured by Russell 1000 Growth and Russell 1000 Value, can we expect to see similar patterns in other key indices such as small cap or internationally?

Do the patterns hold across equities?
Six-month correlation of U.S. large-cap growth/value relative performance to U.S. small-cap and to international growth/value



Source: Columbia Threadneedle Investments as of 03/09/21.
Large-cap stocks are represented by the Russell 1000 Growth and Russell 1000 Value. Small-cap stocks are represented by the Russell 2000 Growth and Russell 2000 Value. Developed international stocks are represented by the MSCI EAFE.
Please see disclosures for index definitions.

By looking at correlations, we can examine the degree to which these sector-based growth/value premia are moving in tandem with one another. The dark blue line measures the degree to which the relationship between growth and value in small cap is aligned with the relative out/underperformance in large cap. As we can see, the relationship has been positive throughout this period, and has spent quite a bit of time higher than zero, suggesting a relatively strong connection of growth/value trends in small-cap stocks when compared to large/mid. That said, there have been times such as 2006 when this relationship has become less significant. So, if an investor wants to make portfolio changes due to a rotation to value, it's important to understand whether that rotation is playing out across all market caps or is specific to a subset.

The light blue line in our chart measures the degree to which the relationship between growth and value in international stocks is aligned with the relative out/underperformance of growth and value in U.S. stocks. We are currently at a high for this relationship, indicating a strong correlation, but historically it has also been much lower, and occasionally even negative.[1] In the current environment, the pandemic has impacted every developed nation and we have seen a synchronized global downturn and recovery. But we can easily imagine a different scenario when country and regional differences dominate. For investors, a key takeaway, again, is that trying to take advantage of a rotation that may be taking place in equities requires a nuanced approach and understanding the degree to which it is universal, as opposed to regionally specific.

Now, let's turn to the question of comparing sector-based and factor-based value approaches. How aligned are they now, and what should the investor takeaway be?

Do the value sectors and the value factor perform in sync?

Six-month correlation of Russell 1000 growth/value relative performance to value factor performance

Source: Columbia Threadneedle Investments as of 03/09/21.

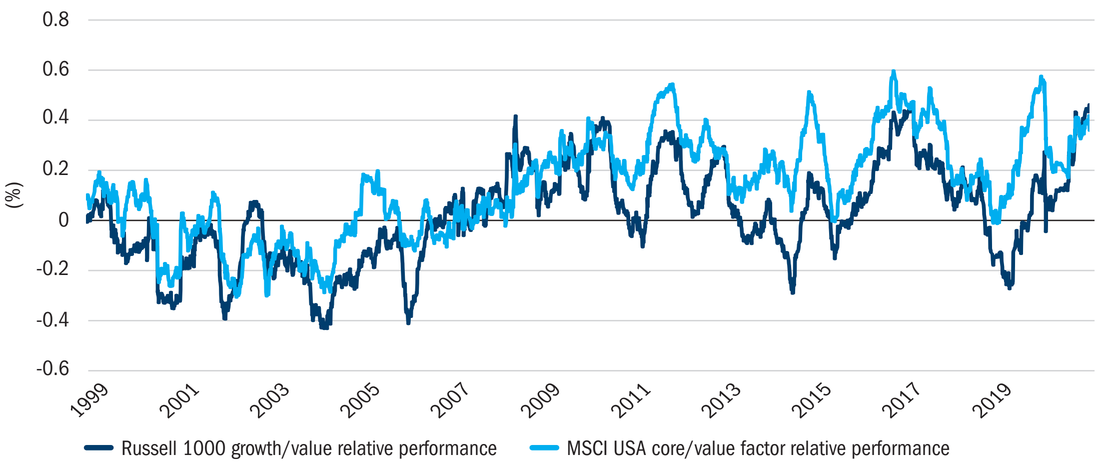
The answer is that, while the sector and factor approaches have generally been positively correlated, the recent connections have been unprecedented. However, the variation in the chart makes it clear that when value as an investment factor outperforms, value sectors do not always follow. In the current environment, the sector and factor approaches to value are exhibiting a meaningful reversion compared with 2020 market dynamics. Investors pricing a cyclical recovery in a post-COVID-19 world are expressing this both in factor- and sector-based value approaches.

2020 saw big moves in one direction, and investors are taking the other side of those trades. But we would caution against assuming that this relationship between factor and sector has to hold, quite as strongly, going forward.

One final topical comparison is the linkage between U.S. Treasury returns and the value rotation. Below, we compare the correlations of the Bloomberg Barclays U.S. Treasury Aggregate index with both the sector-based measure (the dark blue line) and the factor-based measure (the light blue line). Note the changing level of correlation for both since 1999; it has been both negative and positive for both measures over time.

Looking at the correlation of value performance and U.S. Treasuries

Six-month correlation of Bloomberg Barclays U.S. Treasury Aggregate with value sector and factor-based approaches



Source: Columbia Threadneedle Investments as of 03/09/21.

The relationships have spiked recently and have seen high levels at several points since the Great Recession. But we can also see that they were uncorrelated with Treasuries in the period from the tech crisis to the Great Recession. Why such an unstable relationship here, more so than any of the previous charts? We know that inflation itself has a complicated relationship with risky assets, which are more directly tied to growth expectation. Too much or too little inflation can be a bad thing for financial markets. Interest rates, which drive the Treasury returns used above, are linked to investors' expectations for future inflation. In the current environment, investors are linking the idea of a cyclical recovery with expectations for higher interest rates and fears of inflation. But interest rates do not always have the same linkage to value-oriented stocks as defined by either sector or factor approaches.

We have covered a number of different dynamics, but what are some tangible implications for investors?

- Active management has become more relevant. Should the value factor rotation continue, the best way to harness that return is through value-oriented investment approaches. This is an area that has strong links to active management, ranging from the value or contrarian approach of fundamental investors to the value factor that features prominently in quantitative portfolios.

- Asset allocation is particularly important in this environment. The chart showing the connection between growth vs. value and the direction of Treasuries is critical. Imagine a portfolio that is long growth stocks and has a large exposure to long-dated Treasuries — these sorts of connected risks can have disastrous implications for an investor. Cross asset risks need to be considered carefully.
- Diversification is back in vogue. While we believe the rotation toward value could continue, we have already seen several recent days when growth stocks have performed very well. Exposures to all of these sectors and styles can provide balance to a portfolio. And should the value rotation continue, investors will no longer benefit from the concentrated exposures in a few headline technology names.

Index descriptions

The **Russell 2000 Growth Index** measures the performance of those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values.

The **Russell 2000 Value Index** tracks the performance of those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The **MSCI Europe, Australasia, Far East (EAFE) Index** is a capitalization-weighted index that tracks the total return of common stocks in 21 developed-market countries within Europe, Australasia and the Far East.

The **MSCI USA Index** measures the performance of the large and mid cap segments of the US market.

The **MSCI factor indexes** are rules-based indexes that capture the returns of systematic factors that have historically earned a persistent premium over long periods of time.

The **Russell 1000 Growth Index** measures the performance of those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.

The **Russell 1000 Value Index** measures the performance of those Russell 1000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The **Bloomberg Barclays U.S. Treasury Index** (“U.S. Treasuries”) measures U.S. dollar-denominated, fixed-rate, nominal debt is sued by the U.S. Treasury.

[1] One potential explanation for this is that regional breakdowns are not always comparable in international indices such as MSCI Growth and Value. For example, as of 02/28/21 the weight of UK equities in the growth index was 10% but the UK’s weight in the value index was 19%, almost twice as high.

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