COLUMBIA THREADNEEDLE INVESTMENTS

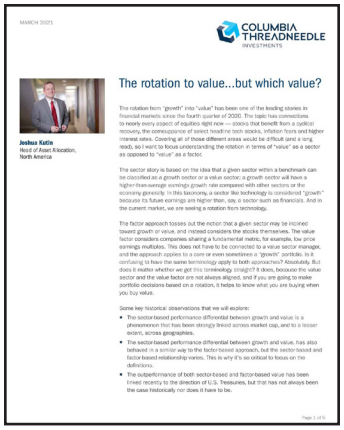
Thinking of riding the rotation to value stocks? There's more than one approach.

April 27, 2021

In a cyclical rotation, there are several ways to gain exposure to value. Here's what investors should know.

The rotation from growth into value has been one of the leading stories in financial markets since the end of 2020. This trending topic connects to nearly every aspect of equities right now: which stocks will benefit from a cyclical recovery, the fate of flashy headline tech stocks, inflation fears and higher interest rates. But it's critical for investors to make the distinction between *value as a sector* and *value as a factor.*

THE ROTATION TO VALUE
AN IN-DEPTH LOOK



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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 timed recently to the direction of U.S. Treasuries, but that has not always been the case historically, nor does it have to be.

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Value as a sector

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 in general. A sector like technology is considered growth because its future earnings are higher than, say, a financial sector. And in the current market, we're seeing a rotation away from technology.

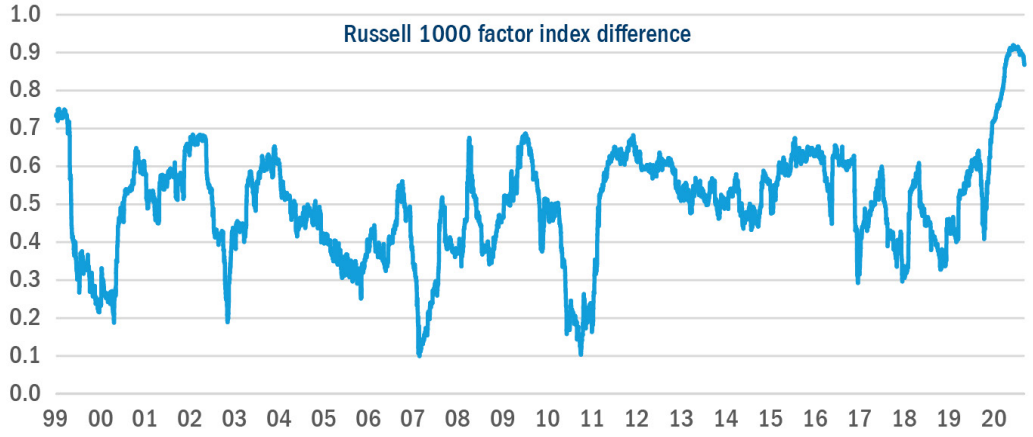
Value as a factor

This simply means considering the stocks themselves, not necessarily the sector as a whole. Value factors look at companies sharing a fundamental metric like low price-to-earnings ratios. The approach can apply to a core or even a growth portfolio and is not necessarily connected to a value sector manager.

Is it confusing to have the same terminology apply to both? Absolutely. But it does matter whether we get this terminology right because the value sector and the value factor are not always aligned. And if you're going to make portfolio decisions based on a rotation, it certainly helps to know what you're getting when you buy value. While sector and factor approaches have performed in a similar manner in the past year, don't assume that adding value sector stocks to a portfolio will return the same result as adding value factor stocks — and vice versa.

When value factors outperform, value sectors don't always follow

Six-month rolling snapshot of the correlation between value sector and value factor



Source: Columbia Threadneedle Investments as of 03/07/21. Correlation (indicated by the blue line in the chart) measures the relationship between two variables on a scale of -1 to +1, with a value of +1 indicating perfect correlation (i.e., the variables move in tandem). The sector approach to value is represented by the relative difference of the Russell 1000 Growth and Russell 1000 Value indices, measures of the U.S. large cap growth and value styles, respectively. The factor approach is represented by the MSCI USA Enhanced Value Factor Index.

Should the value rotation continue, the best way to harness that return is through value-oriented investment approaches. Both value sector and value factor approaches have 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.

It's important not to abandon diversification. There are days when growth stocks perform very well and exposures to multiple sectors and styles can help balance a portfolio. At the same time, assuming the value rotation continues, investors will no longer benefit from concentrated exposures in a few headline technology names.

Bottom line

It's a strong possibility that the stock market's rotation to value will continue — at least in the near term. Investors can position their portfolios to take advantage of these opportunities but should keep in mind that there are different ways to identify value stocks: based on market sector or as a factor based on company fundamentals. *Value sector* and *value factor* don't always perform the same way, so it's important for advisors and their clients to work together and discuss what makes the most sense on a case-by-case basis.

DISCLOSURES:

Value securities may be unprofitable if the market fails to recognize their intrinsic worth or the portfolio manager misgauged that worth.

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