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VIEWS FROM CAMELBACK MOUNTAIN

Will Value Stocks Ever Come Back?

There are many styles of investments that come into and go out of favor over time. Throughout the years, there has been a great debate between growth and value stocks as to which will produce the best returns over the long term.

Growth stocks, as the name implies, are companies where revenues or earnings are expected to increase at a rate faster than an average company. Some investors, like our firm, favor companies that can grow earnings pretty consistently year in and year out. Others favor companies that are able to grow revenues even faster, possibly because of a new technology or idea, regardless of current or near-term profitability. Sometimes these are referred to as hyper-growth, market darling, or momentum stocks. Growth companies tend to be newer or young, pay low or no dividends, and typically have low debt burdens.

Value stocks are less expensive in terms of price to earnings ratio, price to book value and across many other metrics. Value stocks tend to be older, established companies. They also tend to have more debt and, in many cases, higher dividend levels. Over the years growth or value stocks may be in favor (and perform better) for 3, 5, or even 8 or 10 years.

Over the past dozen years, growth stocks have been strongly in favor, while value stocks have not. Some investors believe that this means value stocks are now very cheap on a relative basis and investors would do well to consider selling growth stocks to invest in beaten down value stocks.

We think there are three issues that need to be considered when trying to judge relative valuation levels.

- First, when either growth or value stocks were strongly in favor for a long time, relative performance eventually changed, and the other style came back into favor. Many refer to this as regression to the mean. We think this phenomenon will occur relative to many of the hyper-growth companies that have become market darlings. There are currently several hundred of these very high-priced stocks. Valuations are exceptionally high for Amazon, Facebook, Netflix, Nvidia, Uber, and many others. Many of these companies trade for 50, 75, 100 or even 150 times earnings. Some of these companies don't even have any earnings. We think valuations for hyper-growth companies are stretched and

eventually are likely to decline, even though some of these may become wonderful businesses.

This last dramatically occurred when the tech bubble burst in 1999 and 2000. If you purchased Microsoft in 1999 at $120 per share (before their eventual 2 for 1 split), you would have waited until 2016 just to break even on a share price basis. The unfortunate investor that paid way too much back in 1999 earned nothing for 15 years, even though Bill Gates would probably tell you that Microsoft has been a reasonably successful company. Timing and valuation matter.

There are many hundreds of other growth stocks that are less expensive than the market darlings, but still more expensive than the average company (maybe 25% - 50% more expensive). Undoubtedly their valuations have been pulled up by the hyper-growth market darlings. If and when sentiment changes, investors may no longer pay astronomical valuations for what are perceived to be the very best companies. If that happens, other growth stock valuations (including some of our holdings) may decline somewhat. Investors pulling money out of hyper-growth companies and to a degree, out of other growth companies, would likely shift to value stocks as the money has to go somewhere.

- Second, there are undoubtedly some value-oriented companies trading at beaten down prices that are probably attractive for some investors based on current low relative valuations. We are not convinced, however, that many value-oriented companies will overcome the serious problems they face.

  The pace of change in world economies today has picked up substantially as compared to 30-50 years ago. Much of this has been driven by technology. You can imagine that Eastman Kodak and Fuji Film may have made the best photographic materials available, but the iPhone and others have rendered the photographic material industry extinct. Pitney Bowes still makes fine postal meters and we expect the company to thrive as soon as the internet goes away.

  Investors chasing value companies based on their seemingly very low relative valuations compared to growth stocks, or even the average stock, may be getting exactly what they're paying for based on the much more rapid rate of change that is now occurring.

- A third factor that has to be considered, is the impact of COVID-19. COVID has been kind to many growth stocks, but bordering on catastrophic to many value companies. At our firm, we characterize the COVID impact on companies from 30,000 feet, between win, lose, or draw. Here are a few COVID winners: Amazon, Netflix, Google, Apple, and Home Depot. Next, we have some COVID losers: airlines, cruise ships, hotels,

anyone in the hospitality industry, many old-line brick and mortar retailers, automobile manufacturers, and many real estate strategies including traditional retail and even office space.

Another important but less obvious industry negatively impacted is banks. Because of COVID, we now know that the Federal Reserve plans to keep interest rates at zero for at least two and a half years. This will hurt bank profitability a lot and it comes at a time when some credit card and other borrowers may not be able to pay their obligations to banks.

There are also many companies where COVID hasn't helped their business, but beyond the general economic impact, they haven't been particularly hard hit by the virus. It should be clear that most of the COVID winners are growth stocks and almost all of the COVID losers are value stocks.

Valuation and timing matter to us. We evaluate each individual company carefully based on future business, earnings and cash flow prospects. Risks and opportunities are also considered. We do expect some reversion to the mean when the market cools, at least to a degree, for some of the very high valuations on the market darling stocks. We are less sure that out of favor, value stocks will benefit significantly. Many of these companies deserve to trade at significant discounts based on the numerous threats to their business.

Best Regards,

Harry Papp
Managing Partner
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