PORTFOLIO INSIGHTS

Multi-Asset Solutions Weekly Strategy Report

Global markets and multi-asset portfolios

August 20, 2018

IN BRIEF

- Among factors, value has significantly underperformed in this market cycle. Its recent bounce appears driven by some poor company guidance in key growth stocks and a short-lived steepening in the yield curve that supported the financial sector.
- The risk of picking a cheap stock that turns out to be a value trap has only been greater during the depths of the global financial crisis– a cautionary note for value investors.
- In our multi-asset portfolios, which reflect a modestly pro-risk tilt, we continue to place more of an emphasis on quality and growth, as expressed through our preference for U.S. equities relative to other regions.

FACTORING IN VALUE TRAPS

Investors often overlook the benefits of portfolio diversification. But capturing these benefits can be just as important as getting directional views correct. Factors, or risk premia, provide one potential source of diversification. In the following pages we look at recent trends in factor performance, seek to establish any consistent patterns in the behavior of factors through different phases of the business cycle, and take a closer look at the value factor.

The key factor theme in this market cycle has been the underperformance of value. Since 2009, the MSCI ACWI value index has trailed the broad market by 18%, far surpassed by momentum (47% outperformance), quality (26% outperformance) and growth (21% outperformance). There have been occasional blips in value's underperformance. For example, the performance of value relative to growth experienced a two standard deviation rise at the start of August. We see a few possible reasons for this move. Value itself had become abnormally cheap. In addition, investors reacted to disappointing forward guidance in some key growth stocks and a temporary pause in the flattening of the U.S. yield curve, which provided some support to financials, a heavily weighted sector in widely-used value benchmarks.

From a theoretical perspective, one can posit that value should outperform growth stocks when interest rates rise. There are three elements to this argument: A rising discount rate incurs a bigger net present value reduction for growth stocks; rising rates also suggest that economic growth is more abundant, thereby reducing the scarcity premium that may be attached to growth stocks; and, finally, rising rates may indicate a changing economic environment that can provide the catalyst for a re-rating of value stocks.

AUTHOR

Mark Richards
Executive Director
Global Strategist
Multi-Asset Solutions

However, little empirical evidence supports this theoretical argument. The correlation of the performance of value relative to growth with bond yields is unstable through the cycle. Similarly, phases of equity bull markets do not exhibit consistency in terms of factor performance. The run up to the peaks of the late 1980s and mid-2000s bull markets were value-driven, while the late 1990s and current bull markets were growth-driven.

Further, the ability to identify trends related to single factors is heavily dependent on the methodology of the index construction. Many of the major providers fail to properly allow for sector and regional biases. For example, the financial sector is more heavily weighted in the MSCI and Russell value indices than it is in the broad benchmark; similarly, growth indices are skewed toward the technology sector. From a regional perspective, global factor benchmarks reveal a UK and emerging market bias within value relative to growth, while U.S. and euro area stocks have higher weighting in growth relative to value. J.P. Morgan Asset Management's Quantitative Beta Strategies (QBS) team has its own single factor indices that correct for such biases. We find it reassuring that the value factor's secular struggle and recent bounce are echoed in the QBS indices (**Exhibit 1**). An analysis of similarly-constructed baskets reveals that the recession phase of the business cycle tends to deliver the best returns for a long-short value strategy, also outperforming other factors. The rationale for this is that value stocks will likely begin to re-rate ahead of the start of the economic recovery. Through the business cycle the most consistent factor tends to be momentum.

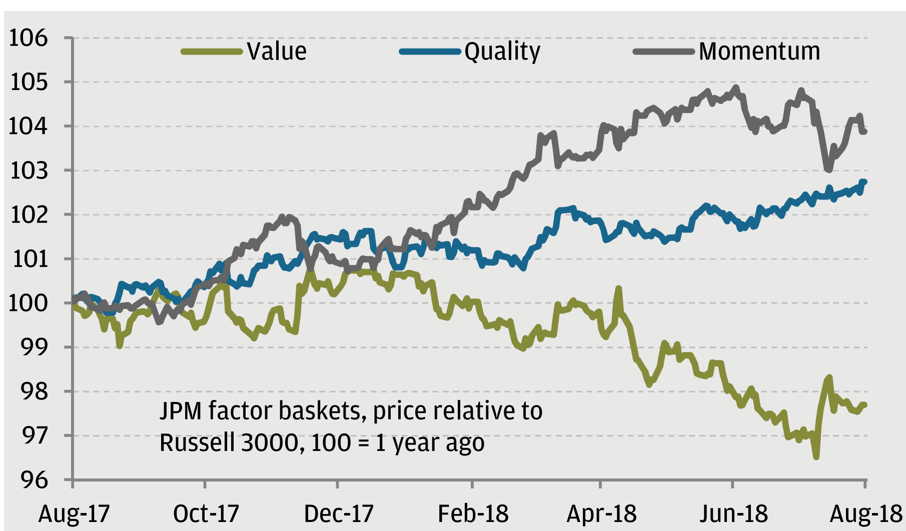
Cheap for a reason

What else can we say about value? Moving away from the technical and empirical aspect of analyzing factors, it is important to ask one of the key questions that informs an investment framework: How sustainable is a company's competitive advantage? Or as Warren Buffet would put it, How deep and well-protected is a firm's economic moat?

This issue is especially relevant as so many areas of the global economy are being disrupted by the adoption of new technology. (This is a central investment theme in our multi-asset portfolios.) Examples of that disruptive power range from the impact of internet retailing on traditional bricks and mortar stores, easy price comparison that limits firms' ability to raise prices, and rising competitive pressures as technology helps to lower barriers to entry. Value investing demands close attention to these economic forces, as a low earnings or book value multiple will not necessarily signal that a company's share price represents good value.

EXHIBIT 1: PERFORMANCE OF FACTORS RELATIVE TO THE RUSSELL 3000 INDEX

The value factor has underperformed the broad market and quality and momentum in the last 12 months. The bounce in value appears to be short-lived driven by some poor company guidance in key growth stocks and a short-lived steepening in the yield curve that supported the financial sector.



Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions and Quantitative Beta Strategies; data as of August 16, 2018.

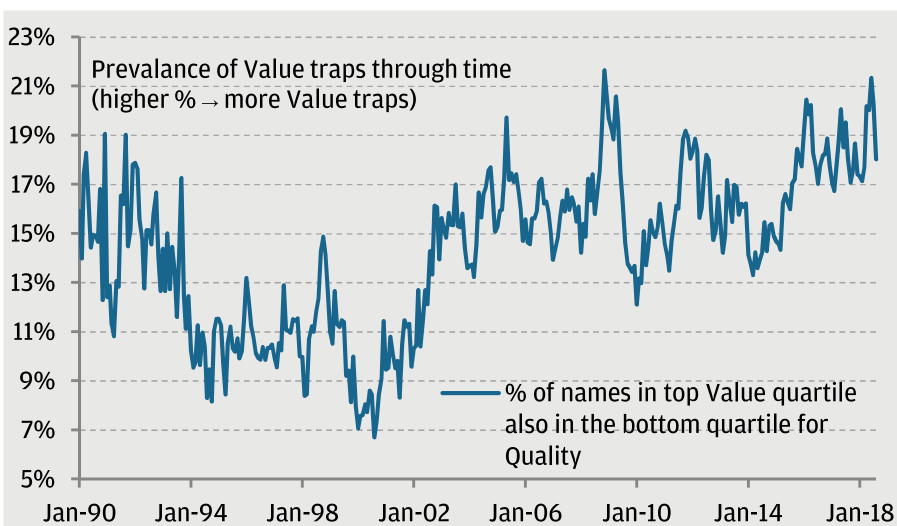
To determine the extent to which disruption is occurring, we look at the degree of overlap between the constituents of value and low quality stocks. **Exhibit 2** shows that the proportion of the cheapest segment of the equity market that also features in the lowest quality bucket is close to the highest on record. The risk of picking a cheap stock that turns out to be a value trap has only been greater during the depths of the global financial crisis—surely a cautionary note for value investors.

ASSET CLASS IMPLICATIONS

Our multi-asset portfolios invest in a number of underlying managers with varying style tilts; we also leverage our Equity team's behavioral finance funds that combine value, quality and growth to generate alpha. Overall our portfolios reflect a modestly pro-risk tilt. Taking into account both a factor perspective and our broader regional equity views, we continue to place more of an emphasis on quality and growth, as expressed through our preference for U.S. equities relative to other regions. The U.S. has been a funding market for some investors in recent years, but we have taken the view that valuations have been justified by the superior return on equity and earnings growth. However, relative growth differentials have seen sentiment towards the U.S. improve in recent months. Indeed, according to the Bank of America Merrill Lynch Fund Manager Survey, the U.S. is now the most preferred region for the first time in five years. While this diminishes the contrarian appeal of our position, it is as yet insufficient for us to alter our preference. Key catalysts to alter our view would be an improvement in non-U.S. economic momentum and an abatement in trade tensions.

EXHIBIT 2: THE PREVALENCE OF LOW QUALITY STOCKS WITHIN GLOBAL VALUE IS CLOSE TO AN ALL-TIME HIGH

One reason for the secular under-performance of value is that the proportion of value stocks that also feature in the lowest quality section of the market is close to a 30-year high. Typically, the concentration of so-called value traps within the value factor only rises during recessions, but with economic growth close to trend we believe that widespread disruption, largely a result of technological innovation and globalization, is leading to more value traps than usual.



Source: Factset, J.P. Morgan Asset Management Multi-Asset Solutions and Quantitative Beta Strategies; data as of July 31, 2018.

Global Multi-Asset Strategy:

John Bilton
Head of Global Multi-Asset Strategy
London

Patrik Schöwitz
Global Strategist, Editor
Hong Kong

Michael Hood
Global Strategist
New York

Thushka Maharaj
Global Strategist
London

Benjamin Mandel
Global Strategist
New York

Mark Richards
Global Strategist
London

Michael Albrecht
Global Strategist
New York

Diego Gilsanz
Global Strategist
New York

Tim Lintern
Global Strategist
London

NEXT STEPS

For more information, contact your J.P. Morgan representative.

PI-AA-WEEKLY-082018 | 0903c02a81f59f1d