FRANKLIN TEMPLETON
INVESTMENTS

Topic Paper

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Value stocks - time to shine

PERSPECTIVE FROM THE TEMPLETON GLOBAL EQUITY GROUP

SUMMARY

- Since 2008, US growth stocks (particularly in faster-growing sectors such as technology) have tended to perform better than US value stocks.
- As the performance gap between growth and value widens, more investors may be wondering when this dynamic between growth and value might change.
- Rising inflation and interest rates will likely see value stocks outperform growth and investors should look closely at the many opportunities that exist in Europe and Asia for value-style investing.

CHARACTERISTICS OF GROWTH AND VALUE INVESTING

Growth *investing focuses on companies that are growing at a faster-than-average rate. These companies often have accelerating revenues, earnings and cash flows, but also typically have relatively high price-to-earnings (P/E) metrics. Often these companies have dividend payouts that are low or non-existent, since profits are used to expand the business.*

Value *investing focuses on companies whose stock prices don't reflect their intrinsic or fundamental value. These companies are often mature, and their stocks may have suffered due to a temporary earnings setback or an economic or political event hampering their industry. They are often characterised by low P/E or price-to-book ratios and sometimes by higher-than-average dividend yields.*

Just as bubbles burst, rates rise…

In the US, at the peak of the tech bubble at the turn of the century, growth stocks had significantly outperformed value stocks for a number of years. By February 2000, the 10-year average annual return differential had reached 6.49% in favour of growth.[1]

Only months later in December 2000, that 10-year differential had been wiped out.

Investors might recall some of the prominent tech names that were leaders during the boom and bust – companies like Yahoo, CompuServe, Alta Vista, Compaq and Netscape. All multi-billion dollar companies that had a big impact on the market indices and many of which are now gone or have been bought out.

Since 2008, growth has again outperformed value due to monetary policy that has kept global interest rates low.

All things being equal, when you have artificially low interest rates, growth companies are worth more than value companies because earnings in 10 years become more valuable than earnings in one year. The lower an interest rate is, the greater the value of future earnings.

However, with the advent of rising inflation and higher interest rates, potential headwinds for growth stocks are developing.

Growth Has Outperformed Since 2008

Growth of $10,000 Investment (USD)

31 December 2007 - 31 December 2017

Source: Russell Indices

According to Templeton Global Equity Group's analysis of companies in the MSCI All Country World Index universe, at the end of the second quarter 2018, global valuation spreads (the gap between the market's cheapest and most expensive stocks) were the widest they have been in at least 30 years.[2]

Put another way; value stocks globally have only been this cheap 1% of the time in the past three decades.

As value investors, we believe we are at a unique point in the market cycle where many global equities, particularly outside the US, look exceedingly attractive.

Value Stocks Outperform in July

Monthly Index Returns (%)

January 2018 – July 2018

Source: Russell Indices

Europe and Asia - the value hubs

The improving global economy should help bolster corporate fundamentals outside the US. Tightening US policy conditions may represent a headwind for a maturing US bull market, while helping recovery gain pace in other regions.

In the US, corporate margins and earnings per share are well above the levels reached in the 2007 cyclical peak. Company valuations may inadequately reflect rising political uncertainty, tightening monetary policy and a more mature profit cycle.

On the other hand, European equities are experiencing their most extreme and sustained underperformance against the US in at least half a century, and the region is trading near its cheapest levels on record relative to the US.

We have been identifying value opportunities in Europe since post the Global Financial Crisis (GFC), particularly in financial and energy stocks, and both the equity market rally and the economic recovery in Europe remain less mature than in the US, and we believe it has much more room to run.

Beyond Europe, there is also opportunity. For example, South Korea has been one of the world's cheapest markets for some years and continues to offer compelling investment opportunities. Other Asian markets such as China and Japan should also be considered, with the telecommunications and utilities sectors in these countries two standouts.

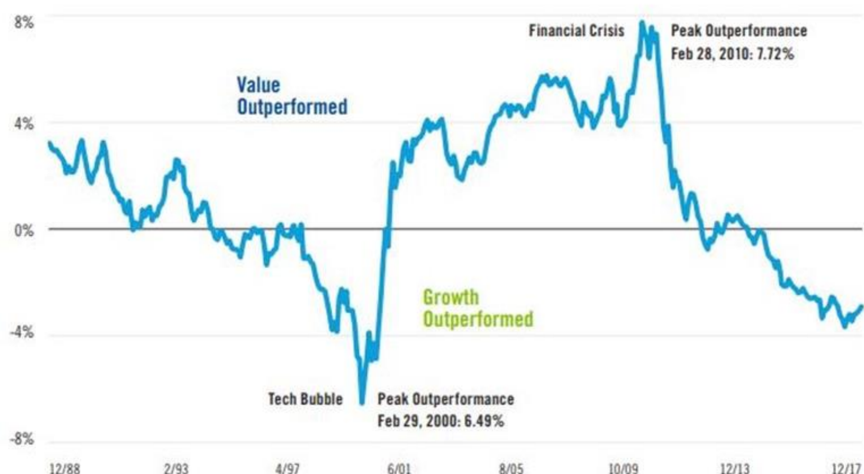
While there are obviously very different levels of economic development across these markets, they should have a place in a well-diversified portfolio.

Conditions are increasingly pointing to an imminent value revival. Investors can find some of the cheapest and most attractive opportunities outside the US, with European financials and energy stocks, as well as Asian telecommunications and utilities, offering some of the best value buys.

Growth Versus Value over 30 Years

Rolling 10 Year Annualised Excess Return

31 December 1988 - 31 December 2017



Source: Russell Indices

1. Source: Russell Indices. Growth stocks represented by the Russell 1000 Growth Index. Value stocks represented by the Russell 1000 Value Index.
2. Source: MSCI Indices, as at June 2018.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Value securities may not increase in price as anticipated or may decline further in value. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors.

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