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Questions of Value — What Do You Have to Believe for Growth to Outperform Value?



Questions of Value is a series of memos in which we address common questions from our clients about the Partners Fund and Value investing. We welcome your feedback and suggestions for future memos.

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Stephen A. Burlingame, CFA, Partner

Over the last 10 years, the performance of Value styles, as represented by the S&P 500 Value Index, has significantly lagged Growth styles, as represented by the S&P 500 Growth Index. Our analysis suggests the majority of this performance gap is due to a widening spread in valuations between the two investing styles. Based on price to next twelve-month earnings (NTM P/E) ratios, the difference in relative valuations between Growth and Value investing styles expanded to historically extreme levels in 2021. Many of our clients have benefitted from Growth's historic run of outperformance and are now questioning whether it makes sense to rebalance some of their Growth-related profits into Value-oriented portfolios like the Poplar Forest Partners Fund. This strikes us as an important question for all equity market participants to consider. When exploring difficult questions, inverting or reframing the debate can be helpful. For instance, the merits of increasing allocations to Value portfolios can be clarified by asking: "What do you have to believe for Growth to outperform Value from here?" In this memo, we explore this question by analyzing the past and future drivers of index performance.

Excluding rebalancing effects, the future performance of Growth and Value styles can be distilled into three key variables: (1) profits, or EPS Growth; (2) income, or dividends; and (3) valuation, or price-to-earnings (P/E) ratios. Following Growth's outperformance of Value over the last ten years, to believe that Growth will continue to outperform you have to believe that at least one of these three variables will consistently favor Growth, such that the sum of all three enables the total returns of Growth to exceed those of Value.

Total Returns = EPS Growth + Dividend Yield + P/E Ratio Changes

EPS Growth

Before thinking about the future trends of these three variables, it is helpful to analyze historical patterns. Over the last ten years, the S&P 500 Value Index grew earnings per share at a 7% CAGR versus a 10% CAGR for the S&P 500 Growth Index. Longer-term time series also suggest a 2-4 percentage point gap in earnings growth is typical when comparing Growth and Value styles since, by definition, Growth indices favor faster growing companies. In 2021, EPS Growth for Value styles exceeded that of Growth styles mostly due to cyclical rebounds in earnings from Financial Services, Basic Materials, and Energy companies -- many of which had experienced meaningful profit declines or losses in 2020. During 2022-23, however, we expect profit growth trends for most companies to trend closer to historical averages.

The last ten years saw an unprecedented amount of innovation and disruption throughout the economy and we wouldn't be surprised for these trends to persist. While disruptive innovations can be problematic for incumbent companies incapable of adaptation, overstated disruption risks can also create opportunities for discerning Value investors. One of the reasons we have allocated significant portions of the portfolio to the Financial Services and Healthcare sectors is because extensive government regulation of these sectors slows the adoption of disruptive technologies. This regulatory buffer on disruption improves the ability of established firms to successfully adapt their business models and potentially convert disruptive innovations into sustaining innovations. When high quality businesses get valued as if they will be imminently disrupted, attractive investment opportunities can emerge for highly selective, contrarian Value investors. For the sake of this general discussion about Value and Growth styles, we assume that disruptive innovations will continue and wouldn't be surprised to see normalized EPS growth for Growth indices exceed Value by about 2-4 percentage points (as shown in the "Normal" column below).

<u>Profits: EPS Growth</u>	<u>10YR</u>	<u>2021E</u>	<u>Normal</u>
S&P 500 Value	6.6%	178.9%	6.0%
S&P 500 Growth	10.1%	66.8%	9.0%
Growth less Value	3.5%	-112.2%	2-4%

Source: S&P Capital IQ data and estimates as of 12/31/2021

Dividend Yields

After profits, or EPS Growth, the second driver of total returns is income, or dividend yields. The dividend yields of Value stocks tend to be higher than Growth stocks since more mature companies don't need to allocate all of their profits to reinvestment opportunities and can consistently return some portion of these profits to shareholders through dividends. The higher dividend yields of Value stocks serves to partially offset their lower EPS growth potential versus Growth stocks. Over the last ten years, dividend yields of both Growth and Value indices declined as stock prices and valuations increased faster than dividends. This has been particularly true for Growth indices where the dividend yield has declined from 1.8% to 0.6%.

While the dividend yield of a stock or index reflects dividends divided by the stock price, the payout ratio reflects dividends as a percentage of net income, or EPS. The payout ratio will vary over time depending on where we are in the economic cycle. History suggests Value indices tend to have a payout ratio that is 8-10 percentage points higher than Growth indices, which makes sense since Growth companies often have more reinvestment opportunities than Value companies. Over the next few years, we would expect dividend yields between Value and Growth indices to be more impacted by changes in stock prices than changes in payout ratios. From current price levels, we would expect the total return of Value indices to benefit from at least a 1 percentage point higher dividend yield than Growth indices.

<u>Income: Dividend Yields</u>	Payout Ratio*		
	<u>2011</u>	<u>2021</u>	<u>2011-21</u>
S&P 500 Value Index	2.4%	1.9%	43.8%
S&P 500 Growth Index	1.8%	0.6%	33.5%
Growth less Value	-0.6%	-1.3%	-10.3%

Source: S&P Capital IQ data and estimates as of 12/31/2021

*10 year median of index Dividends / Net Income.

P/E Ratio Changes

On the basis of normalized business fundamentals, we've suggested that Growth indices could generate EPS growth that is 2-4 percentage points higher than Value while Value indices offer dividend yields that are 1 percentage point higher than Growth. This simple math suggests an aggregate 1-3 percentage point return tailwind in favor of Growth, excluding any changes in valuation. At the end of 2021, however, relative valuations between Growth and Value indices were nearing extreme levels.

Over the last ten years, valuations, as measured by the price to next twelve months earnings (NTM P/E) ratio, increased about 60% for the Value indices but 100% for Growth indices. At year-end 2021, the NTM P/E ratio for the Growth index was around 29x, approximately 10 points higher than the NTM P/E ratio of the Value index. This 10 point excess compares to a median difference in NTM P/E ratios over the last 10 or 20 years of closer to 3-5 points. If the current valuation difference between the two styles were to revert to historical medians, that would create a 20-25% headwind to total returns for Growth indices versus Value. This potential valuation correction dramatically overshadows the 1-3 percentage point performance tailwind in favor of Growth from business fundamentals (EPS Growth + Dividend Yield). It is worth noting that recent indications from the Federal Reserve that they plan to raise interest rates could hasten a valuation correction in Growth stocks. We are less concerned about the impact of rising interest rates on our portfolios since the Poplar Forest Partners Fund trades at an 11x NTM P/E ratio, which represents a significant valuation discount to both the S&P 500 Value and the S&P 500 Growth Indices.

<u>Valuation: NTM P/E Multiple</u>	<u>2011</u>	<u>2021</u>	<u>% Change</u>	<u>Normal</u>
S&P 500 Value Index	11.6x	18.7x	61%	
S&P 500 Growth Index	14.2x	28.8x	103%	
Growth less Value	2.6x	10.1x	42%	3-5x

Source: S&P Capital IQ data and estimates as of 12/31/2021

There's great value in Value

In conclusion, to believe that Growth will continue to outperform Value, you have to believe that: (1) historically extreme valuations between the two investing styles will persist or expand; and/or (2) the relative performance of business fundamentals for Growth indices compared to Value will significantly exceed our estimates of normalized EPS growth and dividend yields. We find neither of these beliefs compelling and think the stage is set for a multi-year period in which Value indices can outperform Growth.

We believe the current environment is particularly well suited to our investment process. The Poplar Forest Partners Fund is a 30 stock, best ideas portfolio of high conviction value investments crafted to outperform our benchmarks over the long run. When compared to the S&P 500 Value Index, we believe the Poplar Forest Partners Fund offers higher potential EPS growth, similar dividend yields, and a lower valuation.

Let's Discuss — We'd Love To Hear From You

Please contact Drew Taylor (dtaylor@poplarforestllc.com) or (626) 304-6030 or your Poplar Forest relationship manager with feedback and suggestions for future Insights. Follow us on LinkedIn where we commonly post useful and informative material.



Index Data Comparisons from S&P Capital IQ:

Index Data Comparisons	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021E*
S&P 500 Value -- EPS	\$43	\$43	\$52	\$51	\$42	\$43	\$55	\$62	\$66	\$29	\$82
NTM P/E	11.6x	12.3x	14.8x	15.3x	15.1x	17.7x	18.1x	12.6x	16.1x	22.4x	18.7x
Dividends	\$14	\$17	\$19	\$22	\$24	\$23	\$27	\$27	\$32	\$30	\$30
Index Price	\$573	\$657	\$847	\$928	\$876	\$1,001	\$1,127	\$1,000	\$1,286	\$1,267	\$1,548
Implied Dividend Yield	2.4%	2.6%	2.3%	2.3%	2.7%	2.3%	2.4%	2.7%	2.5%	2.4%	1.9%
Payout ratio	32.3%	39.0%	37.0%	42.6%	55.8%	54.2%	48.9%	43.8%	49.2%	101.9%	36.4%
S&P 500 Growth -- EPS	\$43	\$44	\$46	\$49	\$44	\$50	\$53	\$67	\$69	\$68	\$114
NTM P/E	14.2x	15.2x	19.5x	20.3x	20.6x	20.5x	23.3x	19.9x	25.0x	32.9x	28.8x
Dividends	\$12	\$14	\$15	\$17	\$18	\$21	\$20	\$25	\$23	\$20	\$20
Index Price	\$678	\$761	\$992	\$1,122	\$1,164	\$1,223	\$1,533	\$1,512	\$1,953	\$2,577	\$3,377
Implied Dividend Yield	1.8%	1.8%	1.5%	1.5%	1.6%	1.7%	1.3%	1.6%	1.2%	0.8%	0.6%
Payout ratio	28.8%	31.0%	32.6%	35.1%	41.6%	42.5%	38.3%	37.2%	33.5%	29.3%	17.2%

* Some EPS and NTM P/E data is estimated as not all companies have reported their 2021 results at this time.

Implied Dividend Yield is calculated by dividing Dividends by Index Price.

Disclosures

Past performance does not guarantee future results. Mutual fund investing involves risk. Principal loss is possible. The Fund may invest in debt securities which typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. The Fund may invest in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. Investing in small and medium sized companies may involve greater risk than investing in larger, more established companies because small and medium capitalization companies can be subject to greater share price volatility. The Fund may invest in options, which may be subject to greater fluctuations in value than an investment in the underlying securities.

Index performance is not indicative of fund performance. To obtain fund performance, visit www.poplarforestfunds.com or call 1-877-522-8860.

The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory prospectus and summary prospectus contain this and other important information and can be obtained by calling 1-877-522-8860 or by visiting www.poplarforestfunds.com. Read it carefully before investing.

Opinions expressed are subject to change at any time, are not guaranteed and should not be considered investment advice. The S&P 500 Growth Index is a stock index that represents the fastest-growing companies in the S&P 500. The S&P 500 Value Index is a stock index comprised of stocks in the S&P 500 with the lowest ratios of book value, earnings, and sales to price. Price-to-earnings (P/E) ratio is the ratio for valuing a company that measures its current share price divided by its earnings-per-share. Basis Point (bps) is a value equaling one one-hundredth of a percent (1/100 of 1%). Dividend Yield represents the trailing 12-month dividend yield aggregating all income distributions per share over the past year, divided by the period ending fund or stock share price. It does not reflect capital gains distributions. Earnings Growth is the annual rate of growth of earnings typically measured as Earnings Per Share Growth. Earnings growth is not a measure of the Fund's future performance. Earnings Per Share (EPS) is the net income of a company divided by the total number of shares it has outstanding. The S&P 500 Index is a market-value weighted index consisting of 500 stocks chosen for market size, liquidity, and industry group representation. One cannot invest directly in an index. Compound Annual Growth Rate (CAGR): The year-over-year growth rate of an investment over a specified period of time. The compound annual growth rate is calculated by taking the nth root of the total percentage growth rate, where n is the number of years in the period being considered.

Poplar Forest Capital, LLC (the "Adviser") is the Investment Adviser to the Fund. Poplar Forest Funds are distributed by Quasar Distributors, LLC.