Value vs Growth - International Small Caps

Time to Overweight Value Stocks

ABOUT RADIN CAPITAL

Radin Capital Partners specializes in international/ global small-capitalization equities with a focus on classic opportunistic deep value investing. We are an independent and employee-owned investment management firm that strives to generate outstanding capital appreciation over the long term. We serve institutional asset allocators, manager-of-managers and other institutional investors who prioritize performance and wish to prudently exploit market inefficiencies.

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80-YEAR LOW FOR VALUE STYLE RELATIVE TO GROWTH

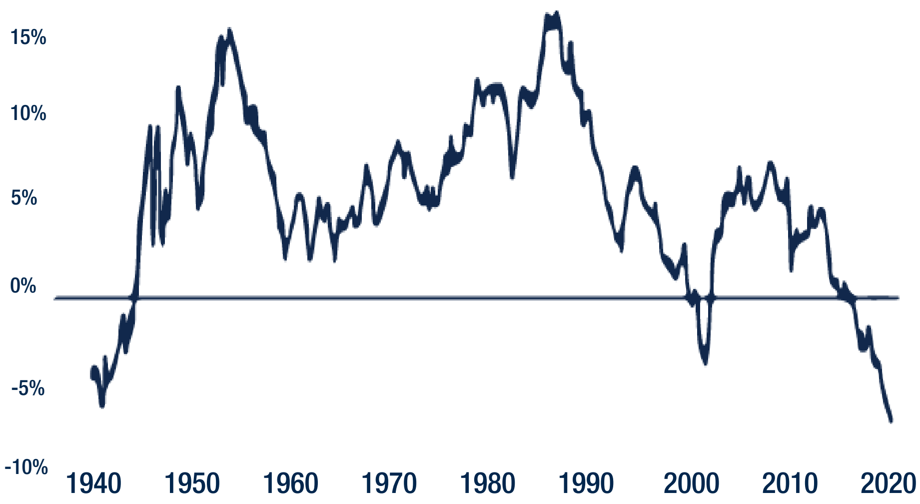
The last few years have been a very challenging period for value stocks relative to growth stocks. In fact, value stocks are even more out of favour today than they were during the technology bubble of the late 1990s. We would have to look back a full 80 years to find another moment in history when equity markets were almost as unfavourable toward value stocks. The chart below shows the performance of a U.S. value portfolio minus a growth portfolio over rolling 12-year periods going back 80 years.

This year has been such a challenge for value investing that by the end of the third quarter, the year had already produced three of the 10 worst months in the last 25 years for value investing: March, May and August.[1] Aside from possibly a few centenarians reading this note, no investors have experienced a time when markets have been more optimistic toward growth stocks and more pessimistic about value stocks.

The chart also illustrates that for roughly 80% of the time over the past 80 years, value investing returns have been better than growth investing returns over rolling 12-year periods. What this all presents is an opportunity for investors to profit from the value/growth imbalance when the pendulum inevitably swings back.

VALUE MINUS GROWTH

Annualized total return on U.S. value portfolio minus growth portfolio



Source: Wall Street Journal, Street Wise, July 15, 2019

[1] QMA, Value vs. Growth: The New Bubble, September 2019, referencing Russell 3000

VALUE STOCKS ARE TRADING AT A SIGNIFICANT DISCOUNT

Investors have come to expect value stocks to be less expensive than growth stocks. Today, however, value stocks are available at extreme bargain levels relative to growth stocks. This should come as no surprise given how out of favour value has been over the last few years. Value stocks relative to growth stocks appear as cheap today as they have been in the last two decades.

S&P 500 GROWTH MINUS VALUE P/E (Forward) SPREAD

Source: Radin Captial, Bloomberg, S&P 500

LONG TERM RETURNS DRIVEN BY STARTING VALUATIONS

Over the long term, returns are mostly driven by the starting valuation point. We know that there is a very strong correlation between the price paid (valuation) for stocks and the subsequent returns generated over the next 10 years.

A Morgan Stanley regression analysis over many decades and many different market conditions illustrates this relationship (R squared of 0.85). When investors buy the equity market at 10x forward earnings, they will most likely generate returns of around 15% annually over the next 10 years. Conversely, if investors buy the market at 25x forward earnings, their returns over the next 10 years will most likely be closer to 0%. Over the long term, valuation is the overwhelming driver of future returns. Investors can significantly improve their chances of long-term success by buying stocks at bargain levels and avoiding stocks that are expensive. Today, however, a stock's valuation level is quite far down the list of factors that most investors care about. The market's excessive noise, coupled with a generally short-term focus, has created an attractive opportunity for investors with a long time horizon who wish to buy low and sell high.

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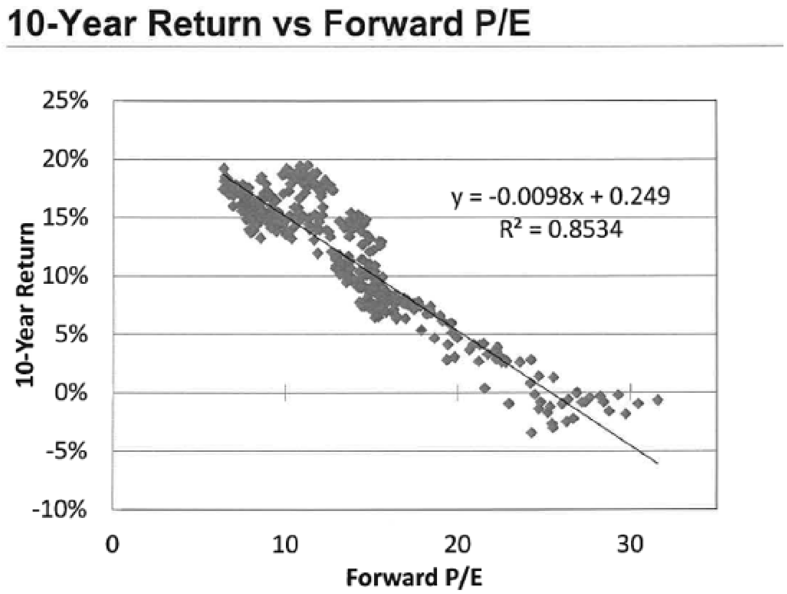

Source: Morgan Stanley, S&P 500

IS THIS TIME DIFFERENT? WHAT ABOUT DISRUPTORS

Disruptors are the most extreme version of growth stocks this cycle. Today's disruptors are companies that generally use technology in a novel way and capitalize on the network effect to grow very quickly by disrupting a mature industry that is dominated by incumbents. Disruptors always have a great story, which is critical since they rarely produce profits. In some cases, these disruptors may never be profitable. This profitless growth has been enabled by the extreme abundance of private venture capital money available during this cycle for pre-initial-public-offering (IPO) disruptors.

For example, Uber raised $26 billion while it was still private (before its IPO). In stark contrast, Google raised less than $50 million and was profitable before its 2004 IPO. During the last calendar year, Uber had net revenues of around $4 billion and expenses of roughly $8 billion, for a loss (before unusual items) of close to $4 billion. Our guess is that, at some point in the not-too-distant future, investors will start to question companies with money-losing business models. But not yet, as over 80% of recent IPOs in the U.S. have been completed by unprofitable companies.[2] The last time unprofitable IPOs were this popular with investors was the peak of the tech bubble almost 20 years ago. Perhaps the WeWork failed IPO debacle will, in the fullness of time, come to be viewed as a watershed moment when investors started to collectively question the wisdom of investing in unprofitable businesses. An old colleague of ours was fond of saying that "they never ring a bell at the top." Maybe WeWork's failed IPO was this cycle's bell.

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[2] Wall Street Journal, Moneybeat referencing Jay Ritter, University of Florida, March 16, 2018

STYLE PURE

At Radin Capital, we are style pure. We are a classic deep value manager – always have been and always will be. We believe our approach to investing offers asset allocators and investors a targeted way to benefit from the great style rotation that should occur over the next decade. We take a long-term, bottom-up approach to investing in solid companies with proven and profitable business models that are at bargain prices. Each stock we purchase has the potential to double over the next five years, regardless of what happens in the broader market. Our International Small Cap Value Strategy is comprised of companies with an average market capitalization of $1.3 billion, a median forward (FY2) PE of 9.7x, a median P/BV of 1.1x and a median dividend yield of 4%.

CONCLUSION

Value stocks have been crushed relative to growth stocks over the last 10 years, and especially over the last few years. Value stocks are at an 80-year performance low when compared to growth stocks. Value stocks today are as cheap as they have been in the past two decades when compared to growth stocks. Over the long term, buying cheap stocks is far more likely to generate stronger returns than buying expensive stocks. The Radin Capital deep value style of investing provides asset allocators with a targeted way to benefit from the 'Great Rotation'.

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