STATE STREET GLOBAL ADVISORS

Active Quantitative Equity

Why It's Critical to Look at Growth Through a Value Lens

- Earnings growth has been a major driver of equity-market performance this year.
- At the same time, it remains important for equity investors to use a value lens when selecting growth companies.
- In various segments of the market, we seek the best opportunities for return—based on a broad set of desirable characteristics—in healthcare, financials, energy, technology hardware, industrial services, and auto manufacturing.

Olivia Engel, CFA
Chief Investment Officer
Active Quantitative Equity

As we discussed in our July commentary, the Value theme on its own has underperformed in recent years—a pattern that accelerated in 2018. As we noted then, the efficacy of the Value premium experiences cyclicality, like any investment.

This does not mean, however, that every downturn in Value is the same. There is something very interesting about Value's current underperformance and, in particular, the recent acceleration of that underperformance: it has largely occurred within high earnings-per-share (EPS) growth stocks. This isn't the first time this has happened. We've observed this phenomenon before, during the global financial crisis, beginning at the end of 2007, and during the dot-com bubble in 1999.

What does this mean to us as investors? Even though earnings growth has been a major driver of equity-market performance this year, our research and experience show that it's important to continue to view growth companies through a Value lens. Overpaying for growth does not pay off in the long run.

Earnings Growth as a Market-Performance Driver

Comparing the performance of the US equities market with the rest of the globe shows that earnings growth has been the main thing propping up the market this year. Although US equities continue to show strength, the world equities market in US dollar terms is flat. Year to date, forward earnings per share have risen about 14% in the United States, while the price to earnings (P/E) multiple in the US has dropped about 11%. Outside the US, EPS growth year to date has only been around 5%. *(See Figure 1.)*

CFA® is a trademark of the CFA Institute

Figure 1. **Earnings growth—primarily in US equities—has propped world equity markets this year.**

Source: Bloomberg Finance, L.P. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

Figure 1.
Year to Date % Change

Percent change in each measurement; January 1, 2018 through July 31, 2018

Legend

MSCI World

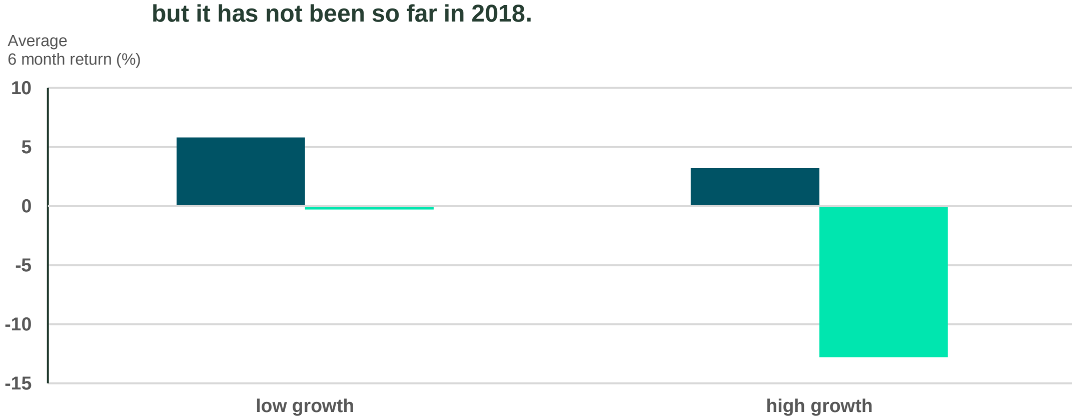
MSCI US

MSCI World ex US

Applying the Value Lens to Growth Stocks

In general, the Value premium is rewarded in both the high- and low-growth pockets of the market. (Put another way, good-value, "cheap" growth stocks generally perform better than bad-value, "expensive" growth stocks, across both high- and low-growth market segments.) This has not been the case so far this year. In 2018, Value has exhibited a near-zero return spread in low-growth stocks, and an extreme negative spread in high-growth stocks, as shown in Figure 2. The near-zero return spread in low-growth stocks is derived from a long portfolio of cheap, low-growth companies and a short portfolio of expensive, low-growth companies. The extreme negative return spread in high-growth stocks is derived from a long portfolio of cheap, high-growth companies and a short portfolio of expensive, high-growth companies.

Figure 2. **Value is usually rewarded in both high- and low-growth segments of the market—but it has not been so far in 2018.**



Source: State Street Global Advisors, MSCI, Factset. Portfolio returns shown above are hypothetical and are based on the returns of the underlying market index. Results are unmanaged and not subject to fees and expenses which would lower returns.

Figure 2.

Average six-month percentage return of portfolios that are long the cheapest quintile and short the most expensive quintile, within high- and low-growth groups in the MSCI World Index.

Legend

1995-2018 average

2018 YTD

Note: Value was determined according to State Street Global Advisors proprietary Value metrics; growth segments were composed according to forecast EPS growth over one year.

Looking back at the most recent periods when Value went unrewarded to this degree among growth stocks provides some additional context. The last time we saw the Value return spread in high-growth stocks as wide as it's been during the first half of 2018 was during the global financial crisis, beginning at the end of 2007. During the dot-com bubble at the end of 1999, the Value spread return in high growth stocks was also as negative as we have seen this year.

In each case, Value's performance bounced back. In the market decline during the global financial crisis, when the MSCI World Index experienced a calendar year return of -42%, Value themes underperformed the declining market, but rebounded strongly when the whole market recovered in 2009. In the market collapse in the years 2001 to 2003—the bursting of the dot-com bubble—the Value theme strongly outperformed while the market fell.

These were, of course, very extreme periods—market conditions such as aggregate valuations, leverage, and other potential sources of market stress were a lot worse during those market crises compared with today. Even so, we believe that it would not be wise to ignore the similarity of the current environment to these extreme periods.

The Bottom Line: Finding Opportunities at the Intersection of Growth and Value

For investors seeking growth opportunities, our research and experience indicate that assessing the value of growth stocks is important.

Particularly during a period when growth is a primary driver of market performance, investors could be tempted to put this idea in action simply by seeking cheap, high-growth stocks. In the long portfolio of cheap, high-growth stocks depicted in Figure 2, for example, financials feature meaningfully; there are many banks trading on attractive valuations that have experienced a strong recovery in earnings after years of soft results in the low-interest-rate environment. By contrast, in the short portfolio of expensive, high-growth stocks, technology companies are heavily represented, and also some consumer discretionary and energy names.

But our goal when choosing stocks is not, in fact, to find the cheapest high-growth companies—it is to uncover the best opportunities for return over the long term, based on a much broader set of desirable characteristics. Among developed large-cap stocks, we see the best opportunities for return in healthcare across all regions. Outside of North America, we see the best return opportunities in banks and insurers, and in energy stocks. In the United States, we believe the best prospects for return lie in technology hardware; in Europe, in industrial services; and in Asia-Pacific, in auto makers. Not all of these are cheap companies, and some of them are in high-growth areas (including energy, insurance, and technology hardware). We feel the important thing for equity investors when selecting growth companies is to use the lens of Value.

Glossary

Earnings per Share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock.

Growth stock A company that in anticipated to grow at a rate above the average for the market, rather than yield high income.

Value stock A company with solid fundamentals (e.g., dividends, earnings and sales) that tends to trade at a lower price than its peers.

Marketing communication

State Street Global Advisors Worldwide Entities

Australia: State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services Licence (AFSL Number 238276). Registered office: Level 17, 420 George Street, Sydney, NSW 2000, Australia T: +612 9240-7600. F: +612 9240-7611. **Belgium**: State Street Global Advisors Belgium, Chaussée de La Hulpe 120, 1000 Brussels, Belgium. T: 32 2 663 2036. F: 32 2 672 2077. SSGA Belgium is a branch office of State Street Global Advisors Limited. State Street Global Advisors Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. **Canada**: State Street Global Advisors, Ltd., 770 Sherbrooke Street West, Suite 1200 Montreal, Quebec, H3A 1G1, T: +514 282 2400 and 30 Adelaide Street East Suite 500, Toronto, Ontario M5C 3G6. T: +647 775 5900. **Dubai**: State Street Bank and Trust Company (Representative Office), Boulevard Plaza 1, 17th Floor, Office 1703 Near Dubai Mall & Burj Khalifa, P.O Box 26838, Dubai, United Arab Emirates. T: +971 (0)4-4372800. F: +971 (0)4-4372818. **France**: State Street Global Advisors Ireland Limited, Paris branch is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Paris Branch, is registered in France with company number RCS Nanterre 832 734 602 and whose office is at Immeuble Défense Plaza, 23-25 rue Delarivière-Lefoullon, 92064 Paris La Défense Cedex, France. T: (+33) 1 44 45 40 00. F: (+33) 1 44 45 41 92. **Germany**: State Street Global Advisors GmbH, Brienner Strasse 59, D-80333 Munich. Authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). Registered with the Register of Commerce Munich HRB 121381. T: +49 (0)89-55878-400. F: +49 (0)89-55878-440. **Hong Kong**: State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288. F: +852 2103-0200. **Ireland**: State Street Global Advisors Ireland Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered Number: 145221. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300. **Italy**: State Street Global Advisors Limited, Milan Branch (Sede Secondaria di Milano) is a branch of State Street Global Advisors Limited, a company registered in the UK, authorised and regulated by the Financial Conduct Authority (FCA), with a capital of GBP 62'350'000.00, and whose registered office is at 20 Churchill Place, London E14 5HJ. State Street Global Advisors Limited, Milan Branch (Sede Secondaria di Milano), is registered in Italy with company number 06353340968 - R.E.A. 1887090 and VAT number 06353340968 and whose office is at Via dei Bossi, 4 - 20121 Milano, Italy. T: 39 02 32066 100. F: 39 02 32066 155. **Japan**: State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan. T: +81-3-4530-7380. Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association. **Netherlands**: State Street Global Advisors Netherlands, Apollo Building, 7th floor Herikerbergweg 29 1101 CN Amsterdam, Netherlands. T: +31 20 7181701. SSGA Netherlands is a branch office of State Street Global Advisors Limited. State Street Global Advisors Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. **Singapore**: State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore). T: +65 6826-7555. F: +65 6826-7501. **Switzerland**: State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16. **United Kingdom**: State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350. **United States**: State Street Global Advisors, 1 Iron Street, Boston, MA 02210-1641.

For use in Australia. Issued by State Street Global Advisors, Australia, Limited (AFSL Number 238276, ABN 42 003 914 225) ("SSGA Australia"). Registered office: Level 17, 420 George Street, Sydney, NSW 2000, Australia T: +612 9240 7600 Web: ssga.com. This communication is directed at institutional and wholesale clients only. The products and services to which this communication relates are only available to such persons and persons of any other description (including retail clients) are not entitled to rely on this communication.

For use in EMEA. The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the European Communities (Markets in Financial Instruments) Regulations 2007. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research. The information provided does not constitute investment advice as such term is defined under the Markets in Financial Instruments Directive (2004/39/EC) and it should not be relied on as such. This communication is directed at professional clients (this includes eligible counterparties) who are deemed both knowledgeable and experienced in matters relating to investments. The products and services to which this communication relates are only available to such persons and persons of any other description (including retail clients) should not rely on this communication.

For use in Switzerland. The information provided does not constitute investment advice as such term is defined under applicable Swiss regulation and it should not be relied on as such.

Disclosure

The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor.

All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information.

The views expressed are the views of Olivia Engel only through July 31, 2018 and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

Investing involves risk including the risk of loss of principal.

Actively managed funds do not seek to replicate the performance of a specified index. Equity securities may fluctuate in value in response to the activities of individual companies and general market and economic conditions.

Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

The MSCI World Index, MSCI World ex US and the MSCI US Index are trademarks of MSCI Inc. MSCI indices are the exclusive property of MSCI Inc. ("MSCI"). MSCI and the MSCI index names are service mark(s) of MSCI or its affiliates and have been licensed for use for certain purposes by State Street Global Advisors ("SSGA"). The financial securities referred to herein are not sponsored, endorsed, or promoted by MSCI, and MSCI bears no liability with respect to any such financial securities. No purchaser, seller or holder of this product, or any other person or entity, should use or refer to any MSCI trade name, trademark or service mark to sponsor, endorse, market or promote this product without first contacting MSCI to determine whether MSCI's permission is required. Under no circumstances may any person or entity claim any affiliation with MSCI without the prior written permission of MSCI.

All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment.

The trademarks and service marks referenced herein are the property of their respective owners. Third party data providers make no warranties or representations of any kind relating to the accuracy, completeness or timeliness of the data and have no liability for damages of any kind relating to the use of such data.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without SSGA's express written consent

www.ssga.com

2204304.1.2.GBL.RTL Exp. Date: 03/31/2019