STATE STREET GLOBAL ADVISORS SPDR

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IS THERE VALUE IN VALUE?

- After years of waiting, could this be the time for Value?
- Our research suggests that there is value in Value
- We now see momentum and the start of inflows into Value funds

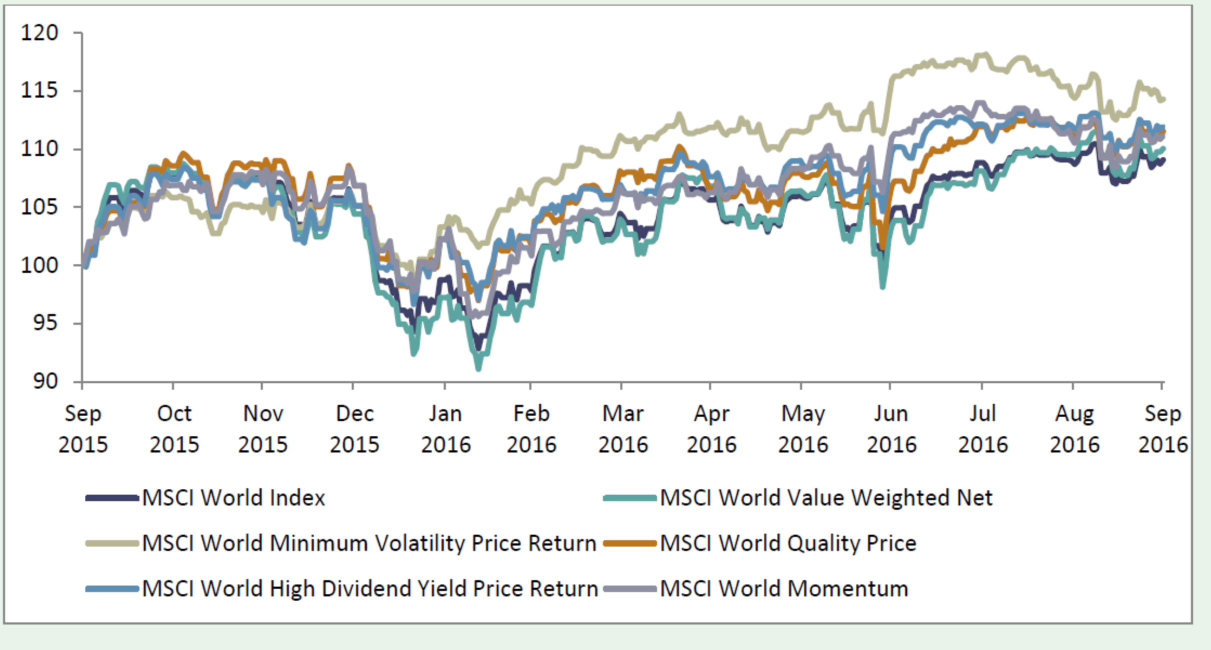
Long-term Popularity of Value

Value-weighted is one of the easiest to define and best known of smart beta factors. There is much academic proof that Value outperforms over the long term and, as such, there are many supporters of this approach to investing. Nevertheless, Value has been out of favour for years, both because of the threat of economic recession globally as China slowed down and Europe struggled – when it was a necessity to look for companies delivering growth – and also because of the demand for other factors such as Low Volatility.

After several years of underperformance, we now believe that the Value factor is ready to outperform the general market, and it is time to consider Value-Weighted funds again. There is convincing value within Value, and at the same time other factors are looking expensive. The economic environment is also right; barring a shock win from Trump in the US Presidential election, which could cause short-term market weakness, investors appear relatively confident about growth and equities in general.

The low, and in some cases negative, correlation of Value to other factors such as Momentum, Quality and Low Volatility means that it has performed differently to other factors. Therefore, even if you don't think about Value for higher returns now, you should consider the portfolio diversification it could provide.

Chart 1: Indexed Returns of Style Factors



Source: Bloomberg Finance L.P as at 30 September 2016.

There is Momentum in Value

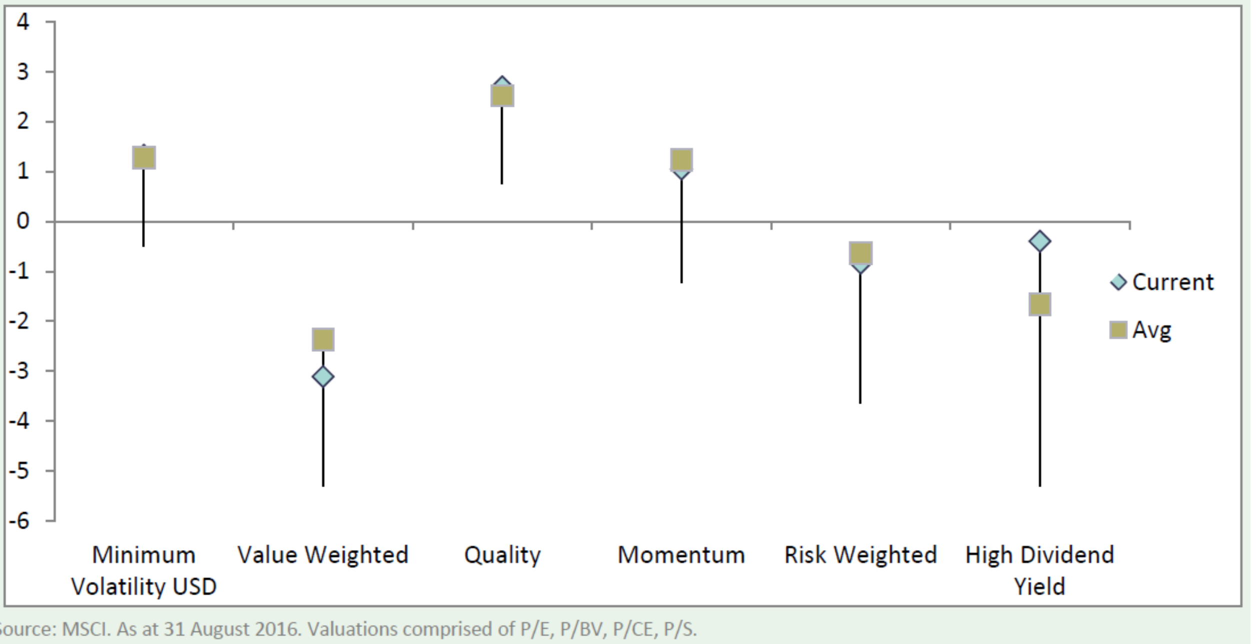
Along with much of the equity market, equities that fit into the Value category fell sharply on the announcement of the UK's vote to leave the EU, which unsettled markets globally; however, since then, these cheaper stocks have recovered more strongly than the rest. Chart 1 shows the sharp increase in prices since 27 June (two trading days after the Brexit announcement). At the same time, returns from Low (or Minimum) Volatility and Momentum styles fell in September after being relatively flat in August. This change in style leadership is quite marked after several years in the opposite direction. Is this reversal in fortune set to continue? To retain this positive momentum, various other factors must also fall into place.

There is Value in Value

There are several ways we can look at valuation, for example historically, relative to the general market, or relative to other factors. The following chart allows us to do this in one glance. Valuation is calculated as a combination of price to earnings (i.e. P/E), price to book value, price to cash earnings and price to sales. Each factor's trading range is shown as a vertical line from its minimum to maximum point relative to the parent index (where the line is below zero it indicates that the factor is cheaper than its parent; for example, Minimum Volatility shares usually trade between a small discount to the market and a modest premium). Currently, Minimum Volatility shares, as a group, are trading right at the top of their historical trading range (calculated since the end of 2001) as indicated by the blue diamond. This is slightly above the average for this factor, as represented by the gold square symbol.

All of the factors on Chart 2, other than Value-Weighted, are trading at the top of their ranges and above their average valuation. Value-Weighted is the only factor that is trading below its average valuation.

Chart 2: Relative Valuation of Style Factors



Source: MSCI. As at 31 August 2016. Valuations comprised of P/E, P/BV, P/CE, P/S.

There are Flows into Value

It is early days, but after years of outflows, investors are now starting to dip their toes back into Value funds. There are particularly strong signs that smart beta investors are switching their preferences. Amongst our SPDR sector funds we have seen inflows into Energy over recent months, which features highly as a Value sector. Together with Materials, which also demonstrates Value, the sector is enjoying earnings forecast upgrades. Meanwhile, there have been recent forecast cuts and outflows from more expensive sectors such as Healthcare.

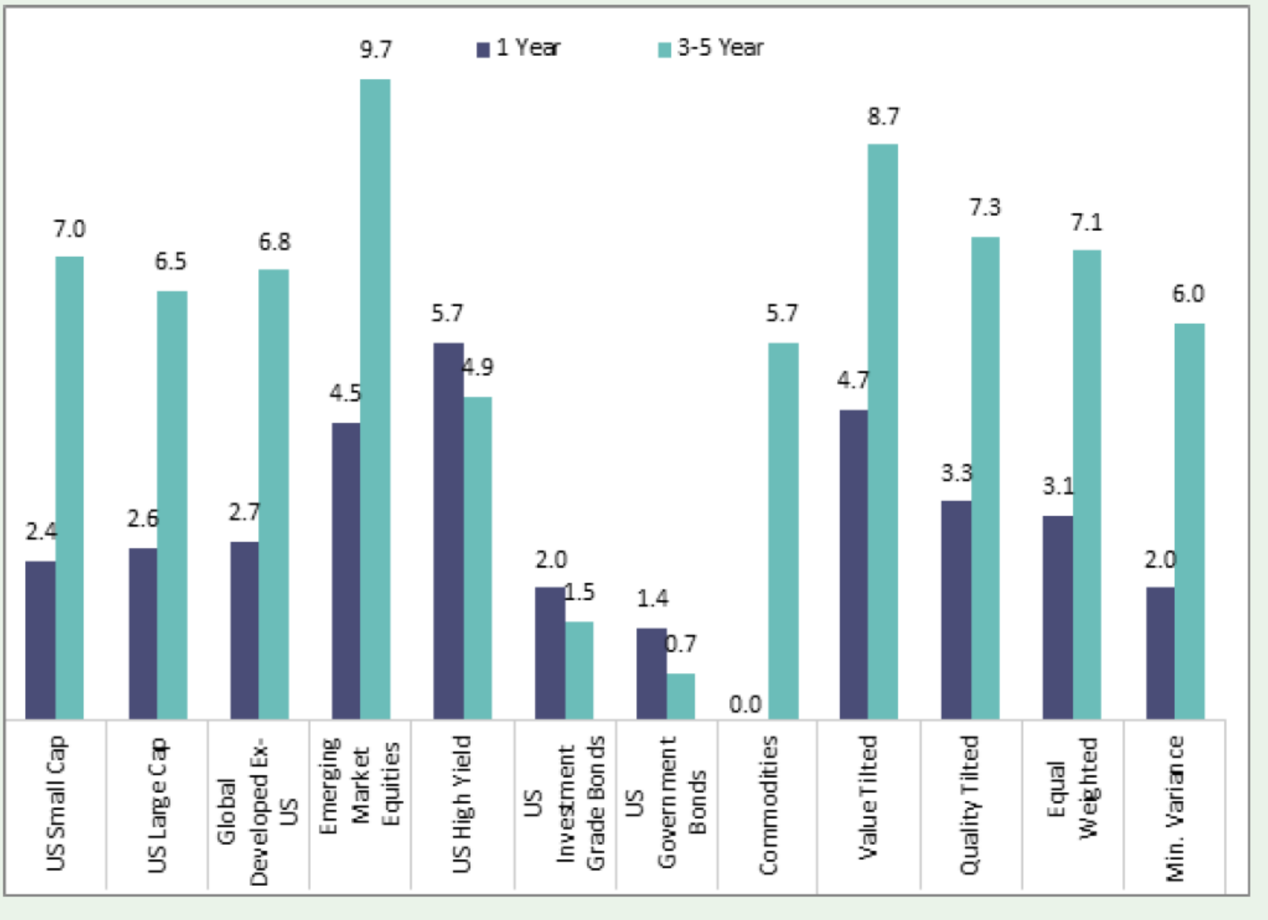
The Outlook is Supportive for Value

Part of the reason for the newly emerged investor optimism in Value comes from the more attractive economic background. (Value shares cannot be expected to outperform in a time when investors are very nervous and are hunting for growth, in which case they would be bidding up any stocks showing any earnings growth to a larger premium.) As we stand, the US economy is relatively strong and we are seeing an improving earnings trend, helped particularly by the bounce in the Energy earnings forecast. Meanwhile in Europe, investor sentiment is improving given the supportive quantitative easing of the ECB.

In a low return environment, investors look for their returns where they can find them. Most investors will look to equities for better returns than fixed income or other assets, including commodities, in the next few years. Within equities, SSGA's research team, ISG, forecasts that Value will outperform other factors including Quality and Minimum Variance during both the next 12 months and over longer periods, such as three to five years.

The chart below shows forecast returns for Value-Tilted equities of 4.7% (vs. 2.7% for Global Developed) for one year and 8.7% (vs. 6.8%) for three to five years, albeit with slightly higher volatility.

Chart 3: Asset Class Forecasts (returns in %)



Source: State Street Global Advisors (SSGA) Investment Solutions Group. As at 30 June 30 2016.

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