A tale of two styles: Growth versus value

Growth stocks are on track to close out their single biggest year in terms of outperforming value stocks since S&P started tracking the data. As a result, investors' portfolio results are more likely than ever to closely reflect their relative exposure to growth and value, with the S&P 500 Growth Index up 28% year to date and the S&P 500 Value Index actually down 3%. At 31 percentage points, this gap is the widest on record, larger than any single year in the late 1990s tech bubble. The magnitude of growth outperformance prompts several questions.

First, where are we and how did we get here? Second, given where we're at, how similar is today to the tech bubble for growth stocks? And finally, what can investors reasonably expect going forward?

Where are we and how did we get here?

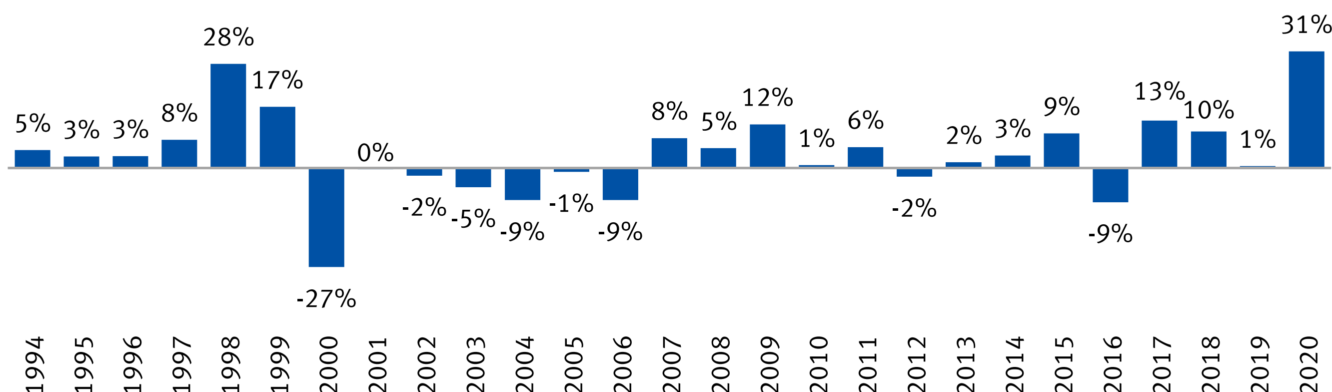
Assessing equity markets today unveils a trend of strong outperformance by growth stocks in 2020, but dialing down to smaller time frames, we also see that much of growth's momentum has stalled, if not dissipated. After reaching peak outperformance at 43 percentage points on Sept. 1, the S&P 500 Growth Index's lead over the S&P 500 Value Index shrank to 31 percentage points by Dec. 4. A useful thematic way to think about the evolution of the style

Growth has outperformed, but its momentum may have stalled

Growth relative to value in 2020

Source - RBC Wealth Management, FactSet; data through 12/4/20, indexed to Jan. 1, 2020 = 100

Annual differential of growth to value since 1994



Note: Differential is defined as calendar-year return of S&P 500 Growth minus calendar-year return of S&P 500 Value.
Source - RBC Wealth Management, FactSet; data through 12/4/20

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trade in 2020 is by first considering the work-from-home trend that powered technology-oriented companies in the first eight months of the year, and then considering the subsequent reversal in which those same firms have given up some of their momentum to more cyclical companies as the economic recovery has taken hold.

The fundamental way to think about this trend is through the lens of underlying earnings and interest rates. Relative earnings for growth, a measure of the trend in growth's earnings against the trend in value's, have not been stronger since the Great Recession. Put differently, the underlying earnings per share (EPS) trend in 2020 has proven far stronger for growth stocks than for value stocks. In fact, EPS for the S&P 500 Growth Index is on track to grow 0.3% this year, while the S&P 500 Value Index's EPS is on track to decline 25.1%. This earnings differential of 25.4% is strikingly similar to growth's year-to-date outperformance of 32%. Furthermore, the relative earnings trend has started to favor value stocks just as growth's leadership has started to slow.

Earnings of the S&P 500 Growth Index accelerated sharply relative to the S&P 500 Value Index in 2020

Relative earnings of growth versus value

Source - RBC Wealth Management, FactSet; data through 12/4/20

One other key factor underpinning the growth-versus-value trade is interest rates. Growth stocks tend to prefer low interest rate environments, while value stocks typically do better when rates are higher. The reason is straightforward. By definition, growth stocks generate a greater share of their full-life value in future earnings than value stocks do. Future earnings, in order to be properly priced today, must be discounted back to today's value, and interest rates are a cornerstone of this discount factor. Interest is a component of a company's total cost of capital, so when interest rates rise, discount factors rise. When discount factors rise, future earnings lose value in today's dollars. When future earnings are worth less today than they were yesterday, companies with a greater share of profits being generated in the present—i.e., value stocks—receive higher valuations. As a result, value stocks tend to outperform growth in rising interest rate environments because the time value of money dictates that future earnings are losing value while earnings at hand are becoming a larger portion of current stock prices.

When relative earnings and interest rates are considered together, growth stocks' earnings have held up far better than value stocks' earnings during a period when interest rates in the U.S. were at or near all-time lows. However, recent months have seen earnings prospects for value stocks improve in tandem with a modestly rising interest rate environment. These drivers have had, and will continue to have, an impact on the style trade.

Is the tech bubble reborn?

Investors could be forgiven for seeing shades of 1999 and the then-looming tech bubble in today's markets. Growth leads value by more in 2020 than in any single year prior, including 1998 and its 28 percentage points of outperformance. Even so, the S&P 500 Growth Index would have to climb by an additional 14 percentage points relative to the S&P 500 Value Index in order to match its two-year run in 1998 and 1999. If 1997 is added to the equation, growth would need to extend its outperformance by an additional eight percentage points. Put differently, while 2020 was the best single year on record for growth stocks, growth's three-year run ending in 1999 was 1.3x larger than its run over the past three years.

Valuations are also far less onerous for growth stocks today than in the run-up to the tech bubble's collapse. The tech bubble's peak valuation for the S&P 500 Growth Index was 42.7x next-twelve-month earnings, while the 2020 peak was a much lower 29.2x, and has since fallen to 27.5x. This valuation trend is also evident on a relative basis. When measured against the S&P 500 Value Index, the peak growth valuation prior to the tech bubble bursting represented a 186% premium, while 2020's peak premium was a much lower 71%. Although growth stock valuations are elevated today, they are nowhere near the levels seen in the dotcom-fueled frenzy of the late 1990s.

Relative valuation of growth to value, while elevated, is nowhere near the tech bubble highs

Relative next-twelve-month price-to-earnings ratio of S&P 500 Growth to S&P 500 Value

Source - RBC Wealth Management, FactSet; data through 12/4/20

Finally, proper calibration of expectations is imperative in today's volatile investment landscape. Growth has massively outperformed in 2020, but this outperformance does not appear unwarranted when the gap in earnings trends is taken into account. Similarly, growth is more expensive today than it has been since the tech bubble burst, but growth stocks' earnings are far larger and more lasting today. In addition, interest rates, while they may rise slightly in the near term, face structural headwinds to a reversal of the downwards trajectory seen over the last 39 years.

Where do we go from here?

Taking all of these factors into account, it would be unsurprising to see value work better than growth in 2021, but the portfolio implication is a nuanced one. Growth will likely go through periods of outperformance, as it has for much of the last four years, as will value. That does not mean that a period of value outperformance requires growth stocks to go through an existential crisis akin to the bursting of the tech bubble. Instead, tilting portfolio exposure to value stocks may be the right idea over the next 12 months, but we continue to favor a balanced investment approach with exposure to both growth and value stocks because the future is always uncertain and the tailwinds that have propelled growth stocks in 2020 will not abate overnight.

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