CIBC

WHEN INTEREST RATES RISE, TILT TOWARDS VALUE & AWAY FROM GROWTH? NOT SO FAST!

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Summary

- Conventional wisdom asserts that changes in interest rates are a reliable determinant of performance differentials between Value and Growth equity investment styles.
- Using more than four decades of data, we find this assertion to be false.
- Style tilting is hard to do well, and indicators that reliably identify periods of Value or Growth outperformance are rare.
- We favour a Core investment approach that strategically blends many investment styles within a holistic portfolio equity allocation.

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Introduction

The universe of equity managers encompasses several investment styles, or philosophies. These include Passive versus Active, Large Cap versus Small Cap, Quality, Income, Value, and Growth. Strategic blends of several styles also exist, including GARP that combines elements of Value and Growth investing.[2] Each manager using a particular style seeks to add value to investor portfolios by continuously screening firms in their investment universe according to specific attributes. These include low price to earnings ratios and high dividend yields for Value investors and high earnings growth potential for Growth investors. Risk is then allocated to firms positively identified by this first screen according to a secondary assessment of risk-adjusted expected returns and correlations. The outcome is a portfolio of regularly updated over- and underweight positions relative to an identified benchmark index that aims to maximize long-term risk-adjusted portfolio performance.

[2] GARP stands for Growth at a Reasonable Price.

Historical Performance of Value & Growth

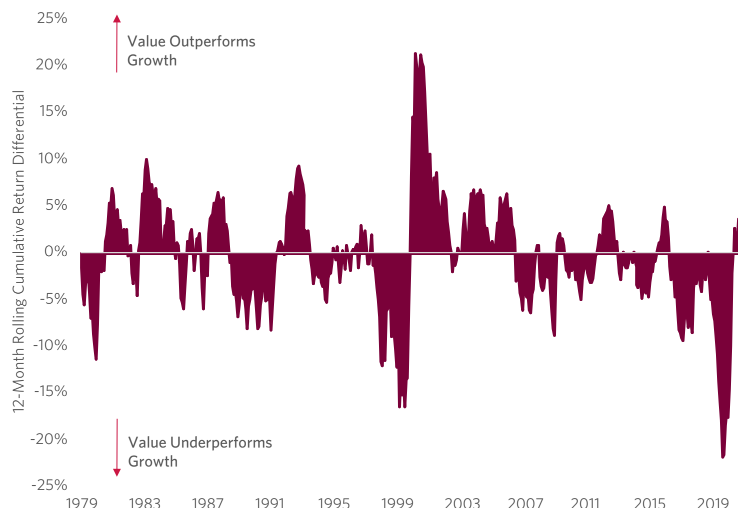
In this note, we focus on two investment styles, Value and Growth. Over the long term, defined as the period since January 1979 and measured using Russell 1000 indexes, the performance of these styles has been broadly the same. Both have realized historical annual average returns of 12%, in round numbers (in USD). The difference in annualized monthly returns between Value and Growth over this sample is 23 basis points, in favour of Growth. In the context of an annualized standard deviation of returns to Value of 15% and 17% for Growth, and an annualized standard deviation of the relative monthly returns between these styles of 9.3%, this performance differential is insignificantly different from zero.

We can thus make the general statement that there is no evidence one style has persistently outperformed the other over the past forty three years, even if we have observed episodes of relative out- and under-performance. They both have merit. This conclusion underscores our focus at CIBC Asset Management (AM) on a Core equity style across our suite of managed solutions, including SMART and ICS Total Solution portfolios, that strategically blends multiple investment styles. In so doing, we aim to maximize long-term expected performance by strategically harvesting diversification benefits that accrue from combining allocations to various investment styles.[3] The whole is expected to be greater than the sum of the parts.

Is There Merit in Tactically Tilting Between Styles?

The relative performance of these styles does vary through time, as the attractiveness of one over the other waxes and wanes for reasons we will discuss below (Chart 1). Time variation in relative style performance often tempts portfolio constructors to actively tilt between investment styles, including between Value and Growth, in an effort to further increase expected portfolio performance.

Chart 1 – Time Variation in the Performance of Value and Growth



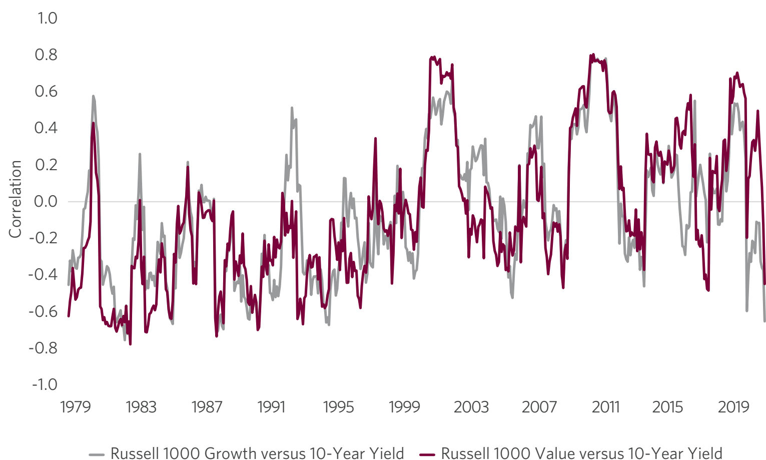
The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: evestments; FRED®; Bloomberg. Sample: January 1979 to March 2022. Monthly data accessed at May 30, 2022.

Is there merit in seeking to tilt portfolio equity risk between investment styles? In the following analysis, we test this proposition using more than forty years of data. Investors who are tempted to tilt require a reliable leading indicator to identify periods when Value is likely to outperform Growth, and vice versa. A common belief of style investing states that changes in interest rates steadfastly delineate such periods; when rates are rising, so the argument goes, Growth underperforms Value because earnings expected to accrue far into the long term are discounted at a higher rate, thereby reducing their current worth relative to more stable earnings generated by Value-oriented corporations.

Let's accept conventional wisdom for the moment, and consider the correlation of returns to Value and Growth with changes in interest rates (Chart 2). Again using our sample beginning in 1979, and a 10-year U.S. Treasury interest rate, coincident full sample average pairwise correlations are statistically identical: -0.10 for Value and -0.08 for Growth. In other words, when held up to a more scientific review interest rate increases are equally bad news for Value and Growth stocks. That's one strike for conventional wisdom.

[3] These portfolio solutions do allow for tactical risk taking, within and between asset classes based upon a rigorous assessment of relative expected returns, including as a result of prospective macroeconomic conditions. But this tactical tilting does not include between investment styles.

Chart 2 – Rolling 12-Month Correlations Between 10-Year U.S. Treasury Yields & Returns to Value & Growth



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: evestments; FRED®. Sample: January 1979 to March 2022. Monthly data accessed at May 30, 2022.

Things get more interesting when we consider only the – admittedly short – sample since January 2021. Now, the correlation between changes in 10-year interest rates and monthly returns to Value is +0.17, but -0.33 for Growth. It appears that something different has happened in recent months, lending credence to the narrative that rising rates are relatively bad for Growth equities, at least in the current episode.

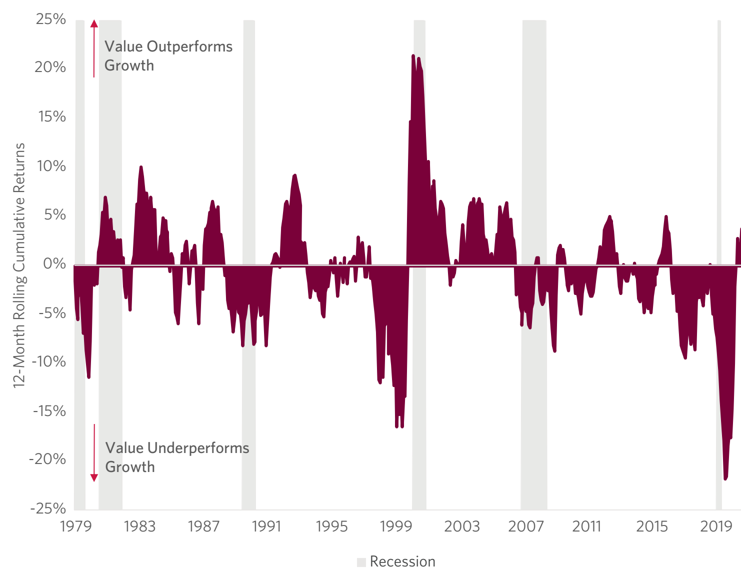
Not so fast! It is worth verifying this tempting narrative given we have 40 years of data to the contrary – being fooled by randomness (and a good story) is a very human trait after all. To verify the rigor of this contradictory finding since 2021, we also calculate pairwise correlations using the 2-year U.S. Treasury interest rate. This is often considered a superior measure to the 10-year rate as it better measures forward-looking market expectations of future central bank policy initiatives. Using this rate, average pairwise correlations are once again statistically the same for the full sample: -0.14 for Value versus -0.20 for Growth. They are also insignificantly different since 2021: -0.55 and -0.63.

What explains this conundrum? Perhaps we are looking in the wrong place. Maybe it is not the behaviour of Value and Growth that is different since 2021, but the behaviour of 10-year interest rates instead. How so? One candidate is central bank asset purchases that have distorted the bond market. These purchases have not exclusively concentrated on the 10-year segment of the yield curve, but a large proportion have been at maturities longer than 2 years. So they are certainly a possible contributing factor to our contradictory evidence.

What about other evidence? Perhaps analysis of betas, which allow us to consider the magnitude of equity style returns and well as their correlation, will reveal differences between returns to Value and Growth during periods of rising and falling interest rates consistent with popular belief? Unfortunately not. For our full sample since 1979, both betas are negative, meaning that rising interest rates have on average been bad for both Value and Growth equities; moreover, for the full sample Value's beta is actually more negative, contradicting conventional wisdom, although this difference is again not statistically significant. Two strikes.

Perhaps Value always outperforms Growth in recessions, which by extension will likely be associated with an expectation of lower interest rates? Again, there is no consistent evidence to substantiate this assertion. Value did outperform Growth handily during the 2001 recession. But not in most other recessions that have occurred since 1979 (Chart 3).

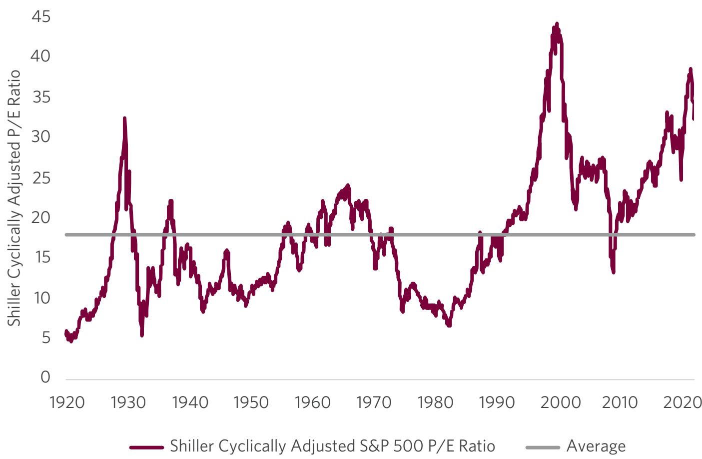
Chart 3 – Value & Growth Investment Style Returns During Recessions



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: evestments; FRED®; Bloomberg. Sample: January 1979 to March 2022. Monthly data accessed at May 30, 2022.

And therein may lie a clue. 2000 saw the burst of the last Tech bubble. Growth equity valuations reached extreme levels, just as they did at the end of 2021 (Chart 4). This suggests we should rely on a thorough analysis of valuation fundamentals - for markets, sectors, individual firms, and styles – to determine prospective returns, rather than looking to cyclical changes in interest rates in isolation to provide a reliable indicator of relative equity performance. A rigorous fundamental analysis of valuations is the cornerstone of robust and repeatable investment processes, and forms the foundation of everything we do at CIBC AM.

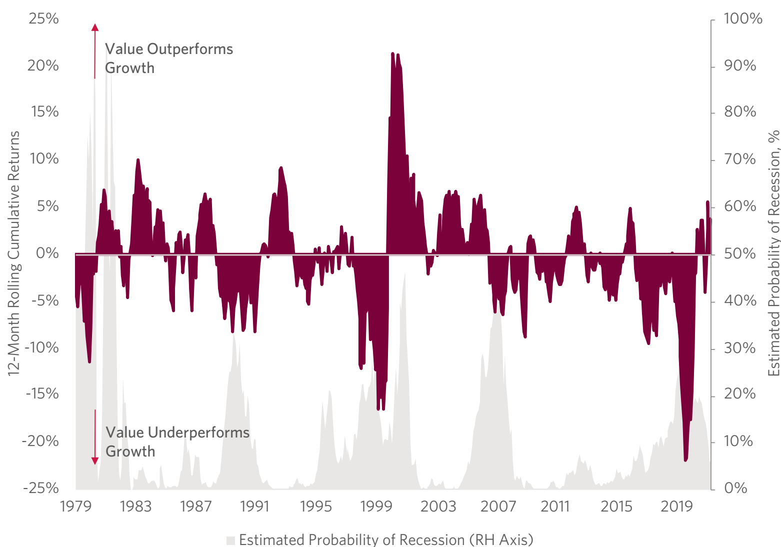
Chart 4 - S&P 500 Cyclically Adjusted P/E Ratio



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Robert Shiller. Sample: January 1920 - May 2022. Data accessed as at June 14, 2022.

Perhaps we can resuscitate conventional wisdom by estimating recessions ahead of their actual occurrence. To do this, we use the New York Fed's estimate of the probability of recession over the next 12 months, which is based upon the 10-year – 3-month Treasury yield curve slope (Chart 5). For our stylized narrative to hold, Value will outperform Growth whenever this probability rises meaningfully. Using this approach, conventional wisdom was again valid around the 2001 recession; Value outperformed Growth. But this instance remains an exception, not the rule. Strike three for conventional wisdom.

Chart 5 – Investment Style Performance & Estimated Recession Probability



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg, Federal Reserve Bank of New York. Sample: January 1979 to March 2022. Monthly data accessed at May 30, 2022.

Conclusion

To summarize our findings, the correlation of returns to Value and Growth with changes in interest rates appears statistically identical over the long term. There is no evidence that Value consistently outperforms Growth during periods of rising rates, or underperforms during episodes of falling rates. Relative performance depends upon underlying valuation fundamentals that are determined in part by economic conditions. Since January 2021, Value has outperformed Growth concurrent to rising rates. This appears to be an exceptional outlier, arguably driven at least in part by the distortionary impact on interest rates of largescale central bank asset purchases.

What to do with this conclusion? As with all investment decisions, it is important to differentiate between tactical and strategic decision-making. The analysis presented in this note has highlighted the difficulty of consistently adding value by tactically tilting between investment styles, including Value and Growth. It is hard to identify predictive indicators of relative style performance that exhibit an appropriate level of precision. Certainly, conventional wisdom surrounding the role of changes in interest rates does not appear to survive the test of data. Style-based tactical tilting is not something we recommend, or practice.

On a strategic level, we see merit in both Value and Growth-centric equity investment styles. At CIBC AM, across in-house equity investment teams and our approved list of sub-advisors, we champion both styles, and combine Value and Growth managers within strategic portfolio construction to realize the best of both worlds. This makes good sense: the cumulative performance of both styles has been strong over the past four decades as a whole, and there is no reason to think their long-term performance will be substantially inferior on a forward-looking basis. Including allocations to superior Value and Growth managers, as well as so-called GARP managers who strategically blend elements of both styles in a coherent and profitable manner, allows client portfolios to benefit regardless of which style is in the ascendency during any given period. A strategic focus on Core, and an aversion to tactical style tilting, is king.

Let’s connect

Should you have any questions about this report or anything else, please do not hesitate to connect:

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