Betreff:	(BN) Lost Decade for Value Stocks Tests Faithful Who Say End is Nigh
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Datum:	6:30 Dienstag, 31.Mai 2016

Lost Decade for Value Stocks Tests Faithful Who Say End is Nigh
2016-05-31 04:00:01.0 GMT

By Lu Wang
(Bloomberg) -- Hopes are high again for buying low.
Exchange-traded funds that track value stocks, the ones trading cheapest to earnings and book value, have received $5.5 billion of fresh cash in 2016, data compiled by Bloomberg show. The inflows stand out in a market where money is being withdrawn from practically everything else. Growth stocks, enjoying the longest winning streak over value in history, have seen withdrawals of $6.2 billion.
While trying to beat the market with cheap shares has been a lost cause since 2006, the tactic may have found a champion in financial companies, a group whose valuations slid to a 14-year low relative to the rest of the market earlier this year. Banks are getting an extra boost from prospects the Federal Reserve is about to raise interest rates, an action signaling faith in the economy that often boosts their profits.
“We’re really at the very early innings of a new cycle,” said Dan Miller, who helps oversee $28.6 billion as director of equities at GW&K Investment Management in Boston. “Value has done so poorly for so long and it’s under-owned among investors. All we need is for investor interest to pick up a little and that could be enough to sustain the improvement.”

Growth Dominance

Using a formula created by Ned Davis Research that tracks changes in the relative performance between the two styles, growth has been in an uptrend versus value since July 2006, a stretch of dominance that outlasts virtually every other feature in the American stock market. At present, growth’s edge has gone on about three times what it normally has since 1932 and is the longest in history.
Value versus growth is more than just an argument for market theorists -- a preference for value shares could be an indication that investors are preparing for an improving economy, something the stocks have historically needed to thrive. One reason for growth’s hegemony over the last decade has been the ability of those companies to appreciate even when gross domestic product expands slowly.
Banks make up about 30 percent of large-cap value stocks, roughly three times the next biggest industry, energy. As much as anything, it’s been their inability to sustain rallies that has held the style back. Financial companies remain 37 percent below the record highs they reached nine years ago, by far the most of any S&P 500 industry.
After concern over a delayed interest-rate increase and an oil-induced credit crisis erased $700 billion from bank stocks

in a seven-month slump through February, the industry is making a comeback. The KBW Bank Index has jumped 18 percent in the past three months, double the increase in the S&P 500, as crude prices staged about an 80 percent rally and the Fed signaled rates may rise faster than anticipated.

The value group needs to prove that its strength can last beyond just a snap-back from a recession scare, according to Ed Clissold, chief U.S. strategist at Venice, Florida-based Ned Davis Research. The problem isn't valuation: banks traded at less than 1 times book value in April, compared with 2.8 for the S&P 500. That's the largest spread since 2002.

"The catalyst is going to be better economic growth and the visibility on financials," Clissold said. "Once those things are in place, then you could talk about probably a once-a-decade type of rotation."

Preferred Destination

The trajectory of growth versus value is closely watched by investors and each style has a devoted group of followers in the equity market. ETFs that employ the techniques have seen assets almost quadruple in the past 10 years, with each garnering more than $50 billion in new money. Value ETFs were the preferred destination for cash last week, raking in more than $700 million, compared with $420 million that went to growth funds.

It's too early to declare victory for value yet as forces underpinning its lower returns in the past, from sluggish economic expansions to rampant investor distaste for banks, are still in place, according to David Chalupnik, the head of equities at Nuveen Asset Management, which oversees about $148 billion in Minneapolis.

In all previous cycles where value outperformed, better returns started with an economic acceleration. That's not happening now. Extending the slowest recovery since World War II, first-quarter GDP growth just weakened to 0.8 percent from the average rate of 2 percent last year.

Missing Thesis

For value to continue working, "you really do need to see better, sustained global economic growth and we don't think the thesis is there yet," Chalupnik said. "Money will go to the Facebooks, the Amazons, the Googles, because no matter what happens to the economy, they're going to continue to grow at a rapid pace."

Value stocks in the Russell 1000 Index have gained 4.3 percent in 2016, compared with 1.1 percent for growth and 2.7 percent in the S&P 500. The advantage is but a blip in the long-term trend, where growth is ahead by more than 30 percentage points since the bull market began in March 2009.

The start of 2016 snapped seven consecutive quarters of lower returns for value that through December had been the longest streak since at least 1992.

"We could be beginning to see a change of trend and that wouldn't be surprising after 10 years of pretty much a one-way move," said Scott Clemons, the chief investment strategist at Brown Brothers Harriman Private Banking in New York, which oversees $26.7 billion. "I interpret the fund flows as greater confidence in the visibility of U.S. economic activity."

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