Rediscovering the Potential of Downtrodden Value Stocks
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The coronavirus crisis and recession have pummeled value stocks as investors shun riskier parts of the market. Yet these conditions have left some higher-quality companies trading at valuations that underestimate their ability to withstand shorter-term stress—and their longer-term recovery potential.

Value stocks have been unloved by investors for years. After about a decade of underperformance, the economic damage from the coronavirus crisis has been especially painful. With the world reeling from a global health crisis and economic shock, global and US value stocks fell harder than the broader market during the sell-off. And even though they’ve clawed back losses in the recovery since March, value stocks still haven’t caught up with the market.

The MSCI World Value Index had fallen by 15.9% in the year to date through June 18. In the US, the Russell 1000 Value Index was down 14.5%. Both trailed the broader benchmarks by over 10% in that period.

So why has this year been so harsh for value investors? Mostly because value stocks are widely seen to be cyclically sensitive, which makes them more vulnerable to macroeconomic downturns. Indeed, value stock underperformance intensified over the past three years amid growing concerns that the global economic recovery since the global financial crisis was running out of steam. Those concerns were magnified by last year’s US-China trade dispute. Then, the economic recession driven by stay-at-home measures to combat the virus escalated those fears. Despite attractive valuations relative to their growth peers, value stocks sold off further as these concerns materialized.

Deep Discount: Value on Sale in COVID-19 Crisis

Now, however, value stocks are deeply discounted. The MSCI World Value is 58% cheaper than the MSCI World Growth, based on a combination of three value metrics: price/sales, price/cash flow and price/forward earnings (Display, left). That’s almost the deepest discount in 20 years. In the US, the Russell 1000 Value trades at a 56% discount to its growth counterpart (Display, right)—also close to historical low levels. And in US small- and mid-cap stocks, the value-to-growth discount is even deeper.
Evaluating the Recovery Potential

This extraordinary discount for value stocks implies significant recovery potential. To evaluate the return potential, we looked at three periods over the last two decades when valuation spreads between value stocks and growth stocks were as wide as they are today.

At the starting point for each period, spreads had widened beyond the 70th percentile of their historical levels. They eventually compressed to the 50th percentile, over periods of at least three years. We think this analysis is a good proxy for today’s highly uncertain environment in which value stocks could still face pressure and widen further.

During these periods, the cheapest 30% of global and US stocks on a price/cash flow basis outperformed the broader market by a wide margin (Display, left). Value stocks with the lowest leverage performed even better.

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*Historical analysis does not guarantee future results.
As of May 31, 2020

Source: FactSet, MSCI, Russell Investments and AllianceBernstein (AB)
The Quality Connection

For some investors, value stocks are seen as a good way to position for a macroeconomic recovery. But we think that this is the wrong mindset today because the size and speed of a macroeconomic rebound depends on how countries emerge from the coronavirus—something no investor or epidemiologist can predict with certainty. Many companies are facing significant risks and could become value traps. Even with many countries coming out of lockdowns and starting to reopen their economies, we don’t know how long this crisis will continue and we’re only just beginning to see the impact of the recession. For many companies, there are valid concerns about their ability to survive.

But some companies will successfully overcome these short-term challenges. Those with more resilient businesses, strong balance sheets and better profitability to support solid free cash flows should be well positioned to deliver long-term returns to patient investors. Top-notch management teams are also essential for steering through tougher times.

Looking Beyond the Controversies

Companies like these can be found in various sectors facing controversy because of the crisis. For example, concerns about depressed construction activity have pushed down shares of companies across the sector. But United Rentals, which rents construction equipment in North America, has more flexibility than peers to manage equipment and order cycles, as it did successfully during the GFC.

The slowdown of industrial activity is weighing on manufacturers. However, some market segments may see demand rise in a post-coronavirus world. If governments invest more in rail infrastructure as demand for air travel decreases, train manufacturers such as Alstom in France could benefit.

Even within the stricken air-travel industry, not every company will be pushed to collapse. AerCap, the Ireland-based airplane leasing company, was considered vulnerable to a near-shutdown of global air travel. Yet the company effectively provides liquidity to airlines by leasing its fleet; if an airline goes bust, AerCap gets its plane back. And with a newer fleet of shorter-haul aircraft, AerCap might be in the right place to help the impaired global airline industry cope with the new reality.

Value investing doesn’t have to rely on an economic recovery. By finding companies with higher-quality attributes in industries facing controversy, we believe investors can position for a long-term recovery of value stocks without taking on excessive risk in a highly unpredictable market environment.

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