Insights
Fundamental Value Equity

March 2023

Enduring Value

Investing with a Margin of Safety

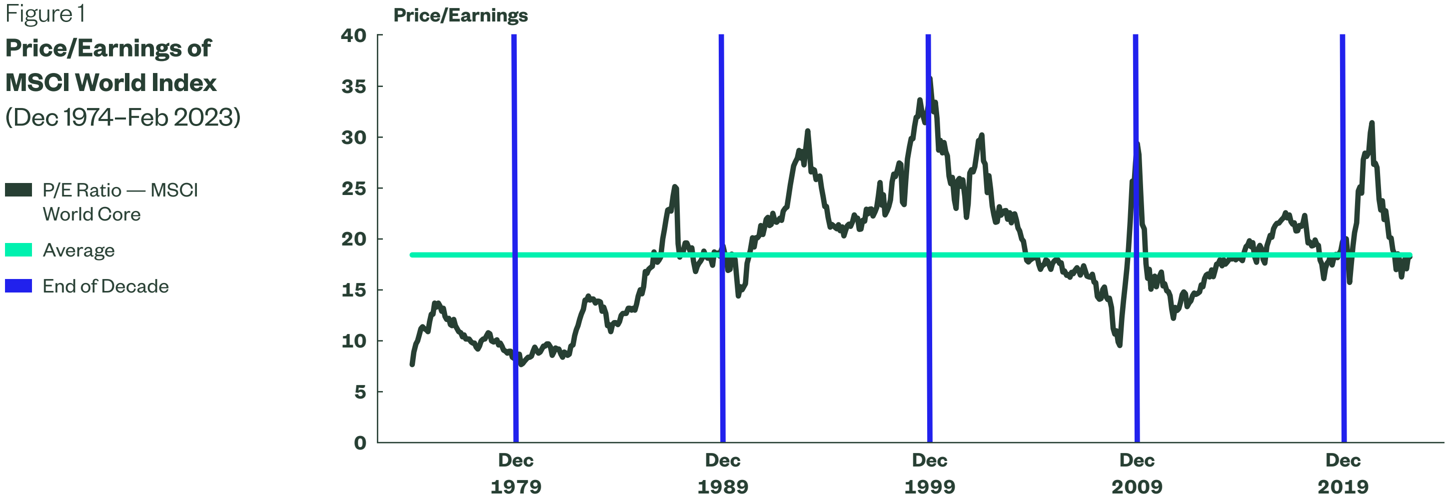
Conor McGorrian, CFA
Portfolio Strategist

Value investing is a tried and tested approach that has delivered for investors over the long term. At State Street Global Advisors, the Fundamental Value Equity Team's philosophy is relatively simple: we seek to buy stakes in good quality businesses for significantly less than they are worth. It's a common-sense approach to investing where we manage risk by buying cheap stocks and give ourselves a margin of safety for when things go wrong.

Value investing has endured through the decades because it delivers by avoiding the bubbles and manias which can intermittently blind investors to risk. In fact, there have only been two periods of extreme dislocation where the Value style has struggled for any significant length of time. One was the internet bubble of the late 1990s — the so-called Dotcom boom. The other is the period since 2017 when abnormally low interest rates fuelled speculative bubbles in everything from growth stocks to private equity to cryptocurrency.

Now that interest rates are rising, many of these risky bets have come unstuck. We have successfully pursued our approach to Value investing over many years. As the world returns to a more normal economic situation, we believe we can once again demonstrate the strength of our approach to stock selection.

Figure 1
Price/Earnings of MSCI World Index
(Dec 1974–Feb 2023)



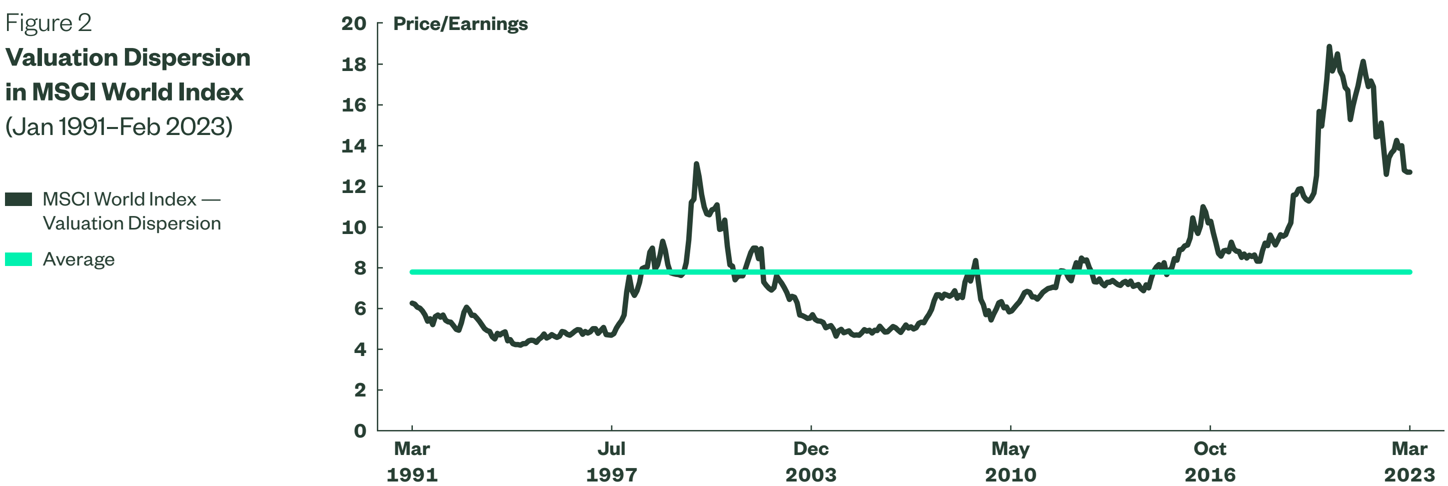
Source: State Street Global Advisors, MSCI as of 28 February 2023.

Figure 1 shows the price-to-earnings (P/E) multiple for the MSCI World Index since its inception in 1974. While the long-term average has been 19x, the valuation multiple has jumped higher in times when speculation is rampant in the market. Equity markets fell in 2022 as central banks raised interest rates rose to combat a sharp rise in inflation as the global economy recovered from pandemic-driven lockdowns. The impact was exacerbated by Russia's invasion of Ukraine and its effect on global fuel and food prices. Equity markets derated sharply to the point that the MSCI World Index is now trading on a P/E of 18.4x, which is in line with its long-term average. Earnings have fallen slightly from the peak but have remained surprisingly resilient; on the face of it, investors would seem to have a reasonable entry point at current levels.

Looking Through the Market's Reasonable Valuation

While the MSCI World Index looks reasonably valued, this average hides a wide variation across stocks, sectors and regions. Figure 2 shows the gap between the valuation of the cheapest and most expensive quintiles of stocks within the index. While the valuation gap has narrowed from the extremes of 2020, it is still at levels comparable with the peak of the internet bubble in 2000.

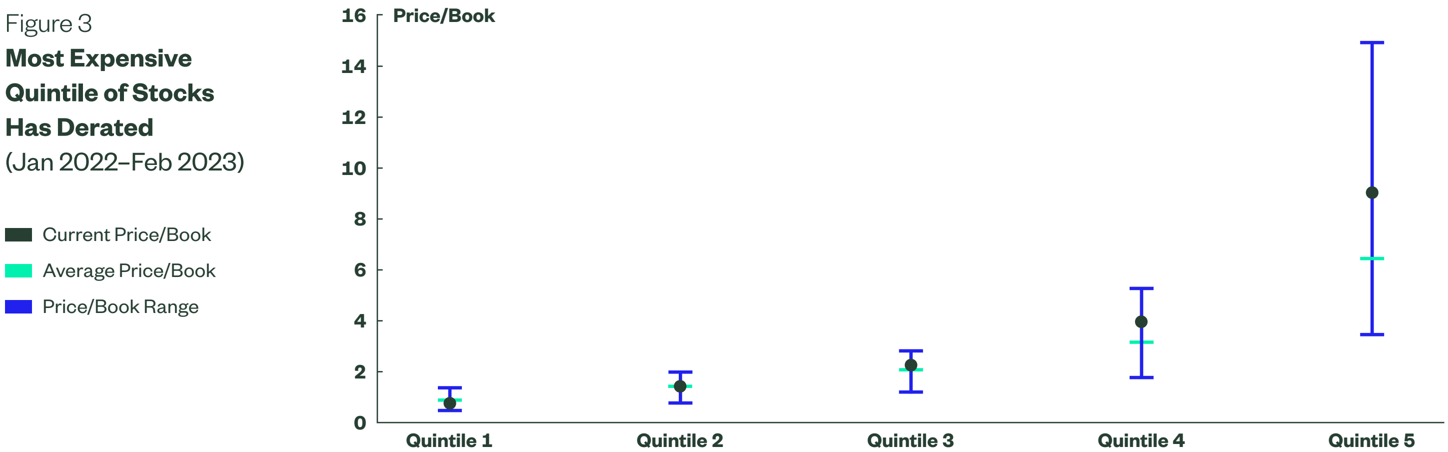
Figure 2
Valuation Dispersion in MSCI World Index
(Jan 1991–Feb 2023)



Source: State Street Global Advisors, MSCI as of 28 February 2023.

As Figure 3 illustrates, the derating in the market over the past year has been concentrated overwhelmingly in the most expensive parts of the market. After several years when the cost of capital was essentially zero, rising interest rates have hammered the valuations of every speculative asset from the growth darlings of the technology sector to over-valued private equity investments, meme stocks, and crypto assets. But even with this dramatic correction, some parts of the market remain extremely expensive relative to their history. Investors should be wary. While current conditions are more favourable than they were a year ago, investors should still exercise care and caution in selecting their investments.

Figure 3
Most Expensive Quintile of Stocks Has Derated
(Jan 2022–Feb 2023)



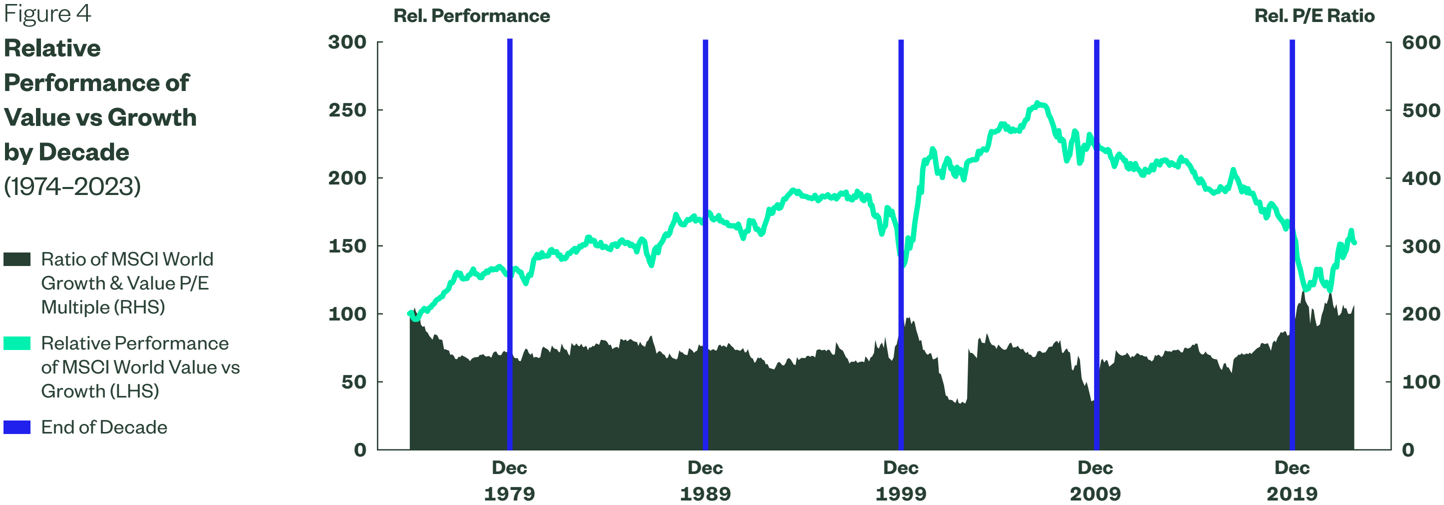
Source: State Street Global Advisors, MSCI as of 28 February 2023.

The correction has restored some sanity to markets and has pushed investors to think about the proper valuation of stocks. This creates an environment that is ideal for stock pickers, such as the Fundamental Value Equity team, who can beat the benchmark by identifying good value opportunities. We believe the current setup in equity markets is relatively attractive, but to understand it in the proper context we must go back to the Global Financial Crisis of 2007 and understand the impact that had.

The Evolving Fortunes of Value

The MSCI World Index peaked in late 2007 and then proceeded to halve as the problems in subprime erupted, bursting property bubbles around the world and leading to a wave of bankruptcies and bailouts. The Global Financial Crisis (GFC) led to the deepest recession seen in decades and the recovery from it was very slow. The crisis also marked the start of a long period of underperformance by Value stocks which struggled in this environment as evident in Figure 4.

Figure 4
Relative Performance of Value vs Growth by Decade
(1974–2023)



Source: State Street Global Advisors, MSCI as of 28 February 2023. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

The depth of the recession after the bursting of the housing bubble and the subsequent slow pace of recovery weighed heavily on stocks in the Financial, Industrials and Materials sectors. High unemployment, weak demand, and excess capacity in many parts of the economy depressed earnings in the traditional Value sectors. At the same time, stocks in the Growth sectors were delivering their earnings and maintained their premium rating over Value stocks. The premium didn't expand through the early years of the recovery, but Growth outperformed due to better fundamental performance. This period from 2007 to 2017 was challenging for Value investors, but the stock-picking skill of the Fundamental Value Equity Team helped us to overcome the style headwind.

Low Interest Rates Inflate Bubble

We saw a shift in the market from 2017 onwards. Growth stocks benefitted from investors chasing momentum, fuelled by ultra-low interest rates and an appetite for speculation. This mania was initially manifested through the FAANGs[1] phenomenon: stocks in Technology and Communications such as Apple, Google and Facebook were considered 'sure things'. This thinking spread to the private equity market where 'unicorns' (unlisted start-ups with a valuation above $1 billion) such as WeWork, Uber, and Robinhood achieved sky-high valuations on the promise of huge market share through innovative business models. Speculation was rife in the initial public offering (IPO) market and SPACs (special purpose acquisition company), or blank cheque companies, re-emerged; essentially, investors handed over their cash without knowing what they were buying.

Risk Seekers Fuel Extraordinary Market Moves

The Covid-19 pandemic provided the backdrop to the unleashing of a further wave of risk-seeking behaviour as investors 'gambled' on meme stocks, cryptocurrencies, and NFTs (non-fungible tokens). Throughout it all, a cohort of investors largely ignored extremely expensive valuations, dubious business models, and massive cash burn in their haste to be part of the new thing. Growth stocks saw a huge rerating and the valuation gap between Growth and Value blew out beyond the levels seen at the peak of the internet bubble.

This was a very difficult period for the Fundamental Value Equity Team as, despite delivering good returns for our clients, we could not match the performance of the market – our stock picking approach was simply overwhelmed by the style headwind. Our discipline and consistency are not rooted in blind adherence to a quaint philosophy, but in lessons learned over decades. We know that in seeking to protect and grow our clients' capital, we will miss out on some opportunities. This is invariably challenging but it is a trade-off we are willing to accept because staying true to our mandate is the right thing to do for our clients. We were convinced that the speculative fever in the market could not last.

The Market Rediscovers Value

By late 2020, the MSCI World Growth Index was trading on a P/E multiple of 43x while the MSCI World Value Index was on a P/E multiple of 21x.[2] The premium that investors were paying for Growth over Value was exceeding levels previously seen at the height of the internet bubble in early 2000. By any reasonable analysis, this was unsustainable. All that was lacking was a catalyst to cause the market to reverse direction. That catalyst came late in 2020 with the announcement of the first Covid-19 vaccines.

The rapid rollout of vaccines and a wave of fiscal stimulus set the stage for a sharp recovery from the Covid-induced recession. Pent-up demand and the gradual normalisation of the global economy has created a strong environment for Value stocks. As the world has grappled with significant inflationary pressures, rising interest rates have forced investors to reassess the valuations of many Growth stocks and we have seen dramatic selloffs within this space.

Since the end of August 2020, the MSCI World Value Index has returned 46.13%, outperforming the MSCI World Index by 17% (in euro terms on a total return basis). As Value investors, our approach to investing has faced challenges in recent years so it is gratifying that the basic concept of identifying good quality businesses and buying shares in them at reasonable valuations has been vindicated as a sound and sensible way to safeguard and grow our clients' capital.

As noted earlier, the MSCI World Index is trading on a P/E of 18.4x, which is back in line with its long-term average. The MSCI World Value Index is now trading on a P/E multiple of 12.9x and is significantly below its long-term average. Value has rarely been cheaper in the past 40 years. The P/E multiple of the MSCI World Growth Index has also fallen and stands at 25.9x. This is still higher than its long-term average and a represents a huge premium to Value.

A high level of index concentration still exists though, indicating that there remains a degree of speculative risk in this market for the unwary investor. For example, the five biggest stocks in the S&P 500 still account for almost 20% of the index, higher than the level of concentration seen at the peak of the tech bubble. While so many investors remain herded into a small number of expensive stocks, other investors who remain dedicated to seeking value, thinking like contrarians, and investing with high conviction, should find ample opportunities to deliver long-term excess returns.

At State Street Global Advisors, the Fundamental Value Equity Team have successfully pursued their approach to value investing over many years. While risks remain in the market, we believe the current situation offers an attractive opportunity to investors seeking an approach that can deliver for the long term. For those who are willing to stand apart from the herd, avoid speculation and take a considered approach to investing we suggest that Value stocks are starting from a very attractive point today and have plenty of room to perform well into the future.

Endnotes

1 FAANG = Facebook, Apple, Amazon, Netflix, Google.

2 Source: MSCI as of 31st August 2020.

About State Street Global Advisors

For four decades, State Street Global Advisors has served the world's governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of index and active strategies to create cost-effective solutions. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we have become the world's fourth-largest asset manager* with US $3.48 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2021.
† This figure is presented as of December 31, 2022 and includes approximately $58.60 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

ssga.com

Marketing communication

State Street Global Advisors Worldwide Entities

Abu Dhabi: State Street Global Advisors Limited, ADGM branch is regulated by the Financial Services Regulatory Authority (FSRA). This document is intended for Professional Clients or Market Counterparties only as defined by the FSRA and no other person should act upon it. State Street Global Advisors Limited, ADGM Branch, Al Khatem Tower, Suite 42801, Level 28, ADGM Square, Al Maryah Island, P.O Box 76404, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. T: +971 2 245 9000. **Australia:** State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services License (AFSL Number 238276). Registered office: Level 14, 420 George Street, Sydney, NSW 2000, Australia. T: +612 9240-7600. F: +612 9240-7611. **Belgium:** State Street Global Advisors Belgium, Chaussée de La Hulpe 185, 1170 Brussels, Belgium. T: +32 2 663 2036. State Street Global Advisors Belgium is a branch office of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Canada:** State Street Global Advisors, Ltd., 1981 McGill College Avenue, Suite 500, Montreal, Qc, H3A 3A8, T: +514 282 2400 and 30 Adelaide Street East Suite 800, Toronto, Ontario M5C 3G6. T: +647 775 5900. **France:** State Street Global Advisors Europe Limited, France Branch ("State Street Global Advisors France") is a branch of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors France is registered in France with company number RCS Nanterre 899 183 289, and its office is located at Coeur Défense – Tour A – La Défense 4, 33e étage, 100, Esplanade du Général de Gaulle, 92 931 Paris La Défense Cedex, France. T: +33 1 44 45 40 00. F: +33 1 44 45 41 92. **Germany:** State Street Global Advisors Europe Limited, Branch in Germany, Brienner Strasse 59, D-80333 Munich, Germany ("State Street Global Advisors Germany"). T: +49 (0)89 55878 400. State Street Global Advisors Germany is a branch of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Hong Kong:** State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288. F: +852 2103-0200. **Ireland:** State Street Global Advisors Europe Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered Number: 49934. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300. **Italy:** State Street Global Advisors Europe Limited, Italy Branch ("State Street Global Advisors Italy") is a branch of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Italy is registered in Italy with company number 11871450968 — REA: 2628603 and VAT number 11871450968, and its office is located at Via Ferrante Aporti, 10 - 20125 Milan, Italy. T: +39 02 32066 100. F: +39 02 32066 155. **Japan:** State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan. T: +81-3-4530-7380. Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association. **Netherlands:** State Street Global Advisors Netherlands, Apollo Building 7th floor, Herikerbergweg 29, 1101 CN Amsterdam, Netherlands. T: +31 20 7181 000. State Street Global Advisors Netherlands is a branch office of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Singapore:** State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore). T: +65 6826-7555. F: +65 6826-7501. **Switzerland:** State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16. **United Kingdom:** State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350. **United States:** State Street Global Advisors, 1 Iron Street, Boston, MA 02210-1641. T: +1 617 786 3000.

For use in EMEA: The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the Markets in Financial Instruments Directive (2014/65/EU) or applicable Swiss regulation. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This communication is directed at professional clients (this includes eligible counterparties as defined by the appropriate EU regulator) who are deemed both knowledgeable and experienced in matters relating to investments. The products and services to which this communication relates are only available to such persons, and persons of any other description (including retail clients) should not rely on this communication.

The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor.

All information is from SSGA unless otherwise noted and has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.

This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

Investing involves risk including the risk of loss of principal.

The value style of investing that emphasizes undervalued companies with characteristics for improved valuations, which may never improve and may actually have lower returns than other styles of investing or the overall stock market.

Past performance is not a reliable indicator of future performance.

Equity securities may fluctuate in value in response to the activities of individual companies and general market and economic conditions.

The views expressed are the views of Fundamental Value Equity Equity through March 17, 2023, and are subject to change based on market and other conditions.

The trademarks and service marks referenced herein are the property of their respective owners.

ID1494825-5598382.1.1.GBL.RTL 0323
Exp. Date: 04/30/2024