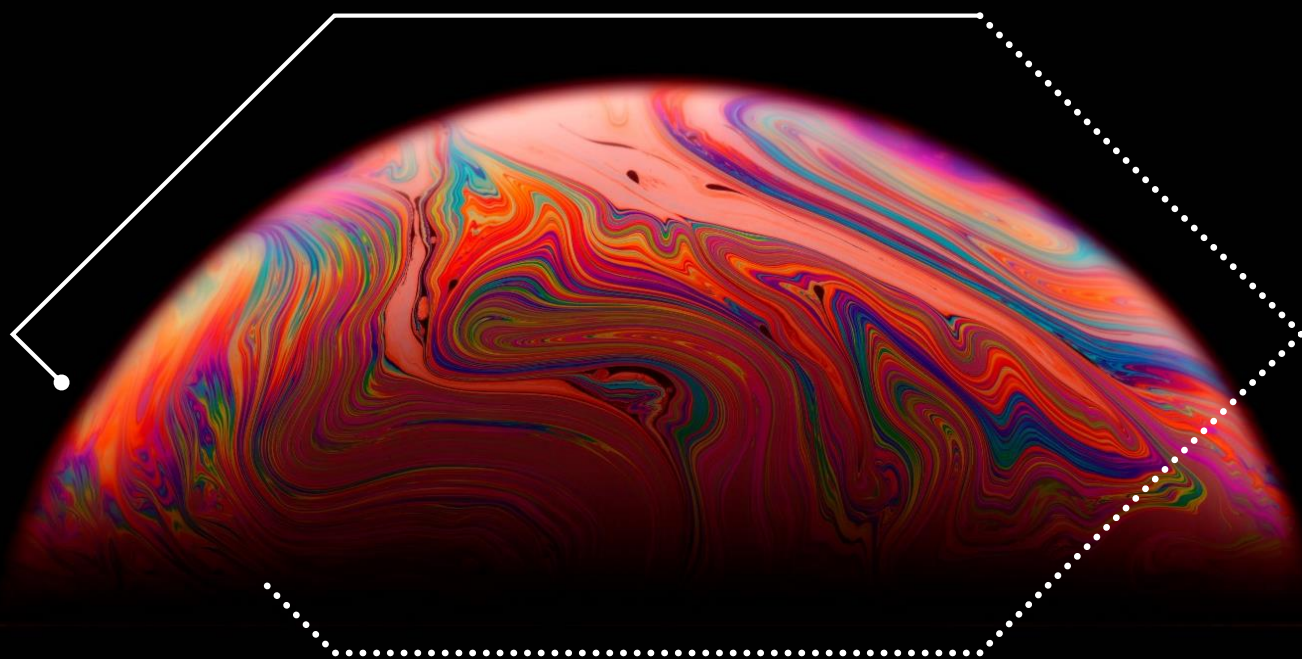


# Equity Insights

Q4 2023

For professional investors only



Exploring the value anomaly  
in European equity markets

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# Foreword



We agree that companies with solid growth tend to be good stocks. However, we also believe that investors currently underestimate the key role that valuation plays in long-term performance

Today, most investors have given up on 'value', believing that any future outperformance will be short lived. Investing in 'growth' stocks is also being supported by a scenario of low global growth rates in which investors are looking for the rare areas of highly promising growth prospects.

We don't dispute the fact that companies with above average growth can be attractive but we also believe that investors may have forgotten the key role that valuation plays in determining future shareholder returns. Our view is that in recent years, investors have been overpaying for the growth that companies will deliver in the long term. Concretely, this means that a company may have a perfectly sound and dynamic business, but trade at an overly optimistic valuation: they are priced for perfection. At the opposite end of the spectrum, value companies trade at a valuation discount because they are priced for low growth or disappointment. Potentially, they can outperform simply by meeting or beating this low bar. In short, a company's future business growth could be relatively weak, but the stock could still be highly rewarding as an investment.

The purpose of this paper is to show that there has been a misallocation of capital in recent years. Investors have been obsessed with growth stocks no matter what the price. They have also been avoiding lower growth companies no matter what the price. The result is overcrowded trades in the growth segment with no room to disappoint versus a wide range of neglected stocks in the value segment with ample room to improve and positively surprise.

To illustrate our point of view, we analyse the relationship between stocks' prices and their fundamentals. Looking at value stocks' performance over the past 25 years, we also demonstrate that the last 5 years look like an anomaly, which has gradually created an investment opportunity.

I trust you will find this publication an interesting and useful resource.



**Pascal Pierre**

Head of European Equity  
HSBC Asset Management

# The theory behind value investing



Value investing has been the most prominent and successful stock investing approach since it was introduced by Benjamin Graham close to a century ago.

Fama & French, Nobel laureates for their work on market inefficiencies tested the relevance of Value investing from a theoretical and empirical standpoint. Although Value has generated abnormal returns historically, it is still not clear whether this is an anomaly or compensation for risk.

Why does buying companies with low valuation metrics (PEs, PBs...) make sense from a purely theoretical point of view? To address the issue, we need to understand the relationship between valuation ratios and stock returns.

## How are equities valued?

We start off by reminding the general model for valuing assets. A well known accounting identity expresses the relationship between the present value of an asset, the income stream it generates in the future and to which the holder of the asset is entitled ( $C_1, C_2, \dots, C_n$ ) and an endogenous return  $R$ .

$$V_t = \sum_{i=1}^K \frac{C_{t+i}}{(1+R)^i} + \frac{V_{t+K}}{(1+R)^K}$$

In other words,  $R$  is what you earn if you pay  $V_t$ , receive  $C_{t+1}, C_{t+2}, \dots, C_{t+K}$  and sell the asset at  $V_{t+K}$ . The value of the asset when you sell it is the terminal value of the asset.  $R$  is also called the discount rate, the internal rate of return (IRR), or the return investors require to hold the asset. This is an accounting identity. It works ex-ante as well as ex-post. It is not a theory or a subjective view. It shows the relationship between asset prices, asset returns and asset yields. It is simply the iteration of a very simple formula:

$$1 + R_{t+1} = \frac{V_{t+1} + C_{t+1}}{V_t}$$

When measuring future returns on an investment, whether real or financial, investors will typically discount the future stream of revenues. For stock investors who earn a dividend when holding equities, a dividend discount model (DDM) is appropriate. Because certain companies do not distribute dividends, a discounted cash-flow approach (DCF) is also often used. Today, investors will predict a stream of dividends or free cash-flows, plug the discount rate (cost of equity for the DDM, weighted average cost of capital for the DCF) and calculate a fair value of the stock. Although this is perfectly correct, it completely minimizes the sense of this accounting identity.  $R$  is viewed as an exogenous parameter to calculate a fair value of a given stock at any point in time; this approach neglects the fact that  $R$  will be your return over the entire period. For example, lowering the discount rate (your future returns) to increase the present fair value of the stock can be misleading. For two stocks that are at fair value, the one with the lower discount rate will have a lower future return. Of course, there is a risk dimension to this: the stock with the higher discount rate is perhaps riskier and deserves a risk premium. We will give a concrete example later.

If we apply the present value relation to dividends, we obtain:

$$P_t = \sum_{i=1}^K \frac{D_{t+i}}{(1+R)^i} + \frac{P_{t+K}}{(1+R)^K}$$

where  $P_t$  is the stock's price at  $t$ ,  $D_{t+i}$  the future dividend at  $t+i$ ,  $R$  the discount rate and  $P_{t+K}$  the terminal value. Again,  $R$  is necessarily the average total return of the shareholder over one period if he pays  $P_t$ , receive  $D_{t+1}, D_{t+2}, \dots, D_{t+K}$  and sells the stock at  $P_{t+K}$ . It is worth mentioning that the dividends are always reinvested and that the total shareholder return is going to be  $(1+R)^K - 1$  over  $K$  periods.

The Gordon Growth Model is a simple version of the DDM where it is assumed that dividends will grow at a constant rate, duration of equity is infinite so that terminal value is negligible:

$$P_t = \sum_{i=1}^{\infty} \frac{D_{t+i}}{(1+R)^i} \approx \frac{D_{t+1}}{R-g}$$

where  $g$  is the expected constant dividend growth rate to perpetuity. If we isolate future returns  $R$ , we get:

$$R = \frac{D_{t+1}}{P_t} + g$$

This equation highlights the fact that future returns are driven by the current dividend yield ratio and future growth. With certain assumptions on growth, the formula gets even simpler:

$$R = \frac{E_{t+1}}{P_t}$$

Where  $E_{t+1}$  is next period's earnings per share. So the earnings yield and by extension the PE ratio is a good proxy for future returns. The higher the earnings yield (or the lower the PE ratio), the higher the future returns.

The PB-ROE formula is a more refined version of the Gordon Growth Model where we inject a company's equity book value. Whether it be the Gordon Growth Model or the simpler formula based on earnings, ROE and PB, we see that there is a direct link between valuation ratios and future returns. A DCF approach would give the following:

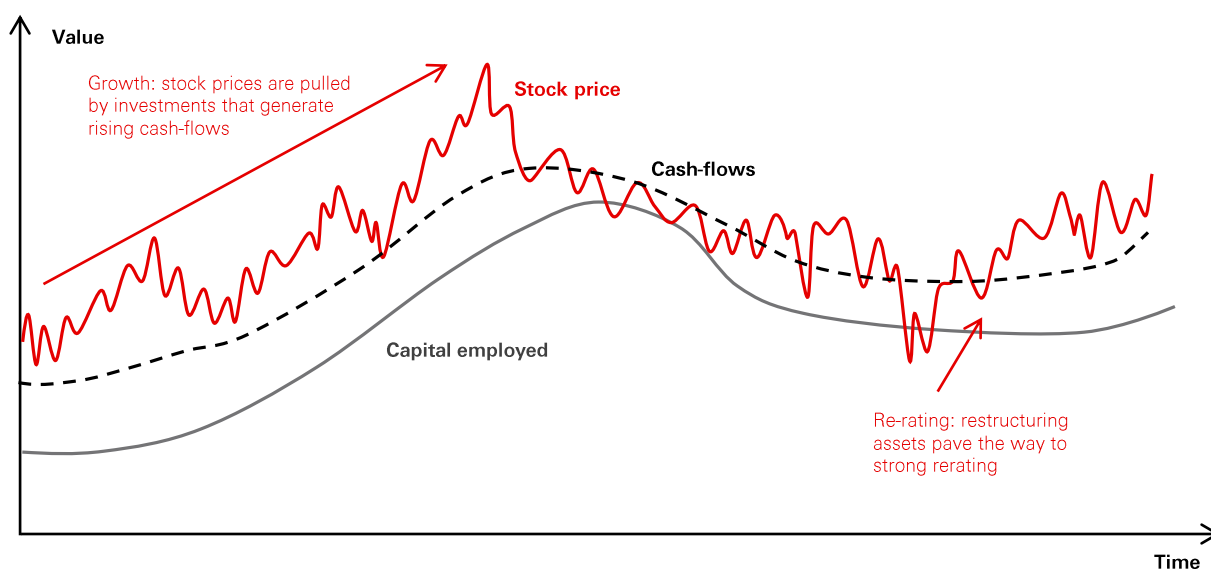
$$WACC = \frac{FCF_{t+1}}{EV_t} + g$$

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## In practice

We demonstrated that there is a clear relationship between valuation ratios and future stock returns. This doesn't address the key question: why does value work in the long term? The Gordon Growth Model shows that a stock can have a low dividend yield (i.e. high valuation) if the future growth in dividends is strong. A stock that has above average valuations should have above average growth. In this case, equities are efficiently priced. But markets are only partially efficient as indicated by the fact that stock prices are more volatile than underlying fundamentals. This creates mispricing that value strategies exploit. Investors tend to overpay for growth stocks and underpay for value stocks. We can illustrate this with the following chart that shows how the different components of equity returns operate.

Figure 1: Stock price vs fundamentals



Source: HSBC AM, October 2023. For illustrative purpose only.

This chart shows the typical dynamics of a company's fundamentals as well as its stock price. Capital generates profits that in turn drive the stock price. This chart also shows that capital, profits, and stock prices have different time frequencies. Capital cycles tend to be long (several years) as supply and demand adjust at a slow rate while profit cycles are shorter in nature as supply and demand adjust more rapidly, depending on commodity prices, wages, inventories, etc. Stock prices are much more volatile: supply and demand adjust immediately and result from a change in investors' expectations. The excess volatility can be explained by the fact that investors' long-term expectations change too frequently, especially given the slow nature of capital. The changes in long term expectations have a significant impact on stock prices, hence the excess volatility. This is in line with the theory defended by Robert Shiller (who shared the Nobel Prize in Economics with Fama in 2013).

In these charts, we acknowledge the fact that growth stocks have superior fundamentals and growth rates. We simply feel that investors tend to overpay for some of these growth stocks. Likewise, we are perfectly comfortable with the fact that value stocks tend to have weaker fundamentals. We think that whilst this might be partially justified (value traps for example) some value stocks are underpriced given future growth prospects. Active fundamental equity investing is precisely about challenging the markets expectations regarding growth prospects of a specific company (which is embedded in the stock price).

# Analysing the value risk-premium

Despite having strongly outperformed over the past 100 years, value has underperformed for the past 15 years. We analyse in more detail what has happened over this period.

Stock price returns can be decomposed into:

$$(1 + R_t) = \frac{P_t}{P_{t-1}} = \frac{P_t}{E_t} \times \frac{E_t}{E_{t-1}} \times \frac{E_{t-1}}{P_{t-1}} = \frac{P_t/E_t}{P_{t-1}/E_{t-1}} \times \frac{E_t}{E_{t-1}}$$

This equation shows that the return of a stock can be decomposed into two components: a change in the valuation of the stock and a change in the earnings. We use this decomposition to analyse the relative performance of a value portfolio.

The following charts show the cumulative gain of a value portfolio, the monthly relative returns of the same value portfolio (smoothed over three months), and the two components of these monthly relative returns i.e. the relative change in valuation and the relative change in earnings.

Figure 2: Cumulative relative returns Value

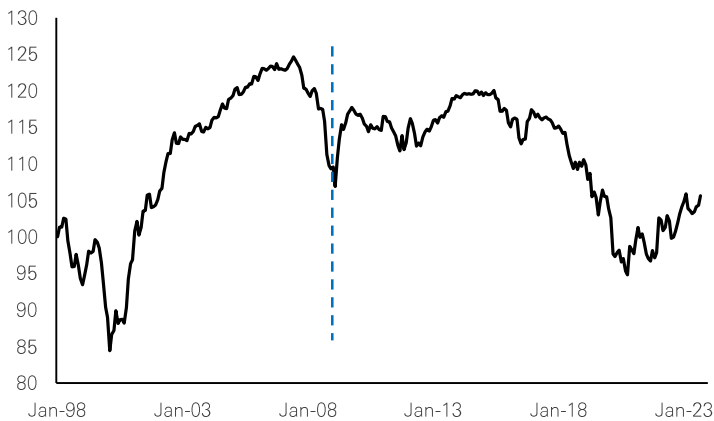


Figure 3: Monthly relative returns (smoothed over 3 months) of Value

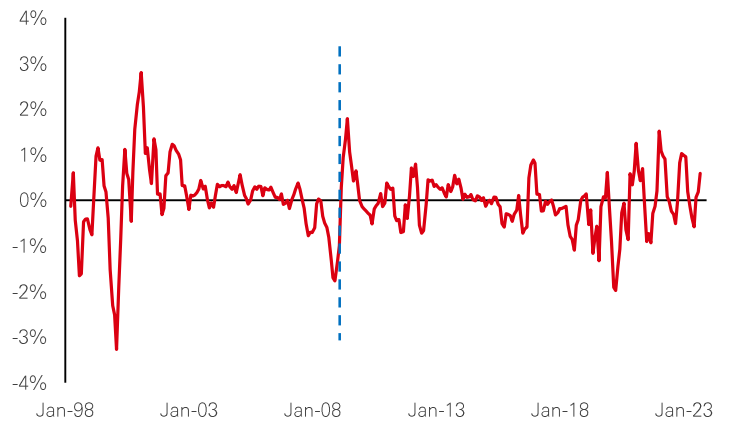
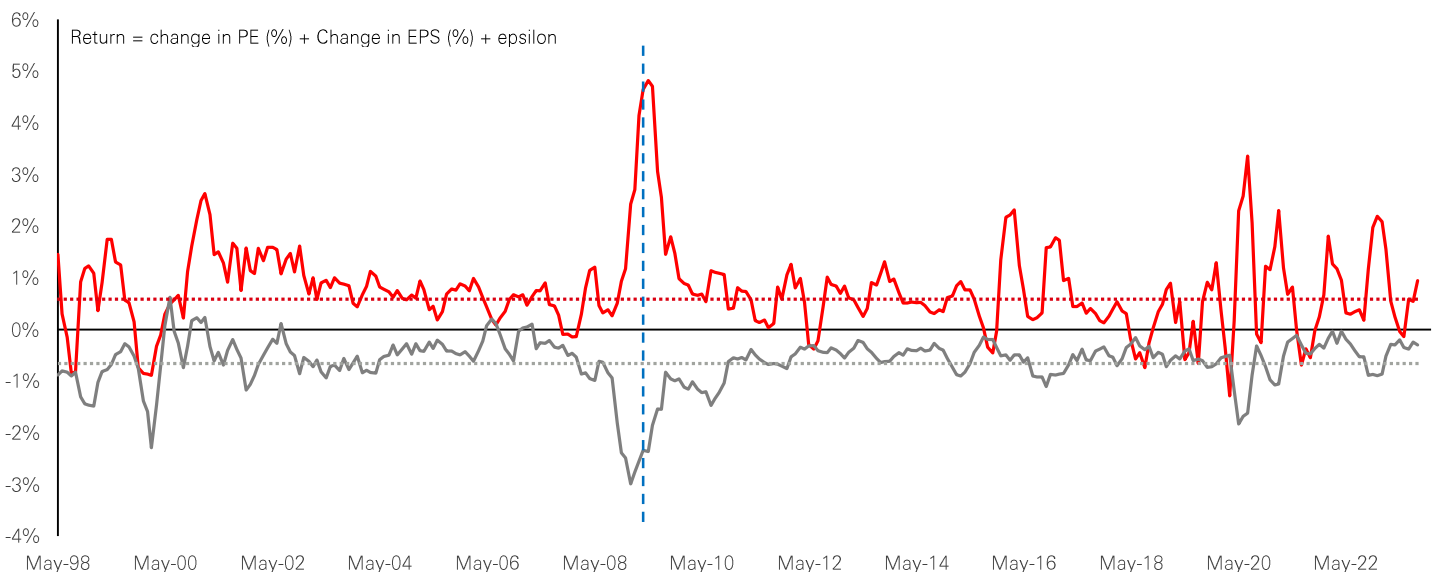


Figure 4: Relative monthly change in valuation (red) and earnings (grey)



Source: HSBC AM, Factset and Bloomberg data, October 2023. **Past performance is no guarantee of future returns.**

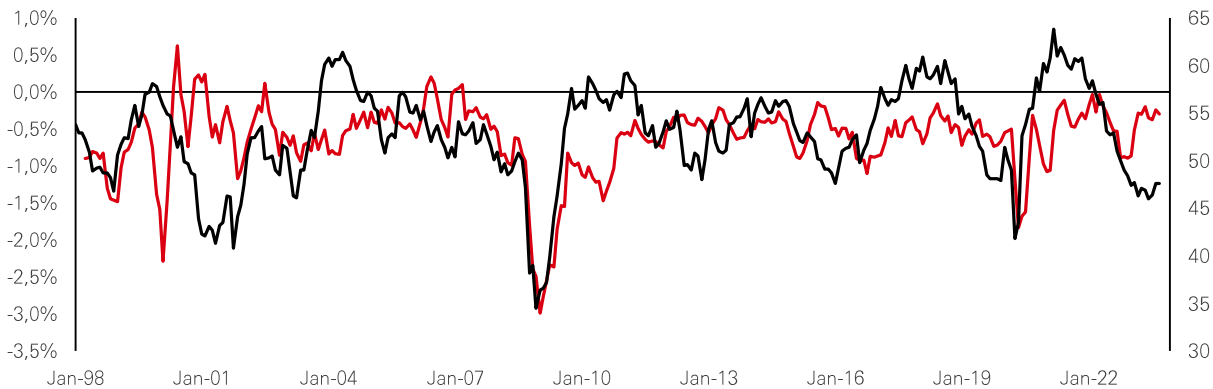
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The decomposition of the relative returns gives us a clear view of what drives value. The fact that the relative change in earnings almost always contributes negatively to relative performance is not surprising as value stocks tend to have less healthy fundamentals and tend to underperform economically. On the other hand, changes in valuation are almost always positive. Indeed, value stocks tend to overreact with regards to poor fundamentals, creating a valuation anomaly and a subsequent rerating. Over the whole period, the earnings effect is on average -0.63% per month while the valuation effect is on average at +0.77%. Overall, the effect is positive by +0.02% per month (second order effects have a negative contribution).

These charts also show that these two different effects are cyclical in nature. We have identified some factors that drive these two effects.

Regarding the earnings effect, the chart below shows the significant correlation with the ISM index. This suggests that value earnings are more cyclical than earnings in general. For example, a strong negative earnings effect always coincides with recessions (2008 and 2020). Periods of strong economic growth (2004-2007, 2011-2015, 2021-2022) were periods where the earnings effect is less negative. Currently, the earnings effect is holding surprisingly well given the level of the ISM index. Much of this comes from strong earnings momentum in the banking sector for example.

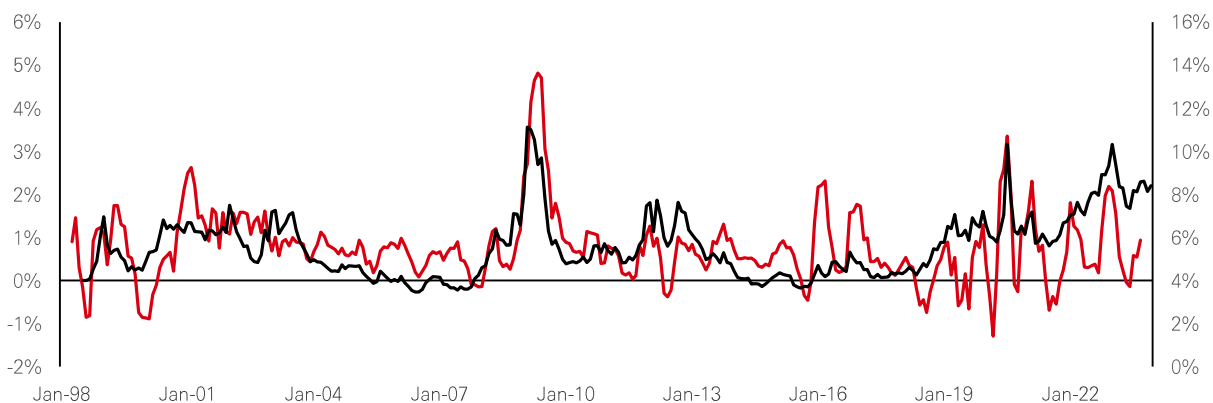
Figure 5: Relative change in earnings for value (red, lhs) vs. ISM index (black, rhs)



Source: HSBC AM, Factset and Bloomberg data, October 2023. **Past performance is no guarantee of future returns.**

Regarding the valuation effect, the chart below shows the strong correlation with the value spread, measured by the difference in earnings yield between the value portfolio and the whole universe. In fact, the value spread tends to lead the valuation effect by around three months.

Figure 6: Relative change in valuation for value (red, lhs) vs. value spread (black, rhs)



Source: HSBC AM, Factset and Bloomberg data, October 2023. **Past performance is no guarantee of future returns.**

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We can decompose the relative performance of value into six periods.

1. 1998-2000: This period was characterised by the inflating internet bubble. As such, internet, and tech stocks, all identified as growth stocks, outperformed value.
2. 2000-2007: Strong outperformance of value as the tech bubble deflates. Value outperforms thanks to a mild earnings effect and a strong valuation effect as value was significantly cheap relative to growth. Moving towards 2007, the main contributor to value outperformance was strong earnings. Valuation potential was limited as the value spread returned to historical lows. This environment is in line with an over-leveraged economy and banking sector which translated into unsustainably strong earnings.
3. 2007-2009: Global Financial Crisis. Massive underperformance of leverage with banks being at the forefront of the underperformance. Value underperforms dramatically. In the last leg of the bear market, valuation dispersion increases considerably and reaches historical highs by early 2009.
4. 2009-2015: Rebound in value as global economy recovers. The euro crisis, again affecting banks, temporarily interrupts the recovery of value between 2010 and 2012.
5. 2015-2022: Strong underperformance of value stocks as risks of deflation increases and global interest rates fall near and even below zero with central banks' quantitative easing. Global pandemic in 2020 will be the high point of this massive monetary stimulus.
6. 2022-2023: Rise in inflation and interest rates as major economies recover from global pandemic and as central banks inverse the massive liquidity injection of the prior years to stop inflation from rising. Value outperforms as short duration assets seem more immune to rising interest rate than long duration assets (growth).

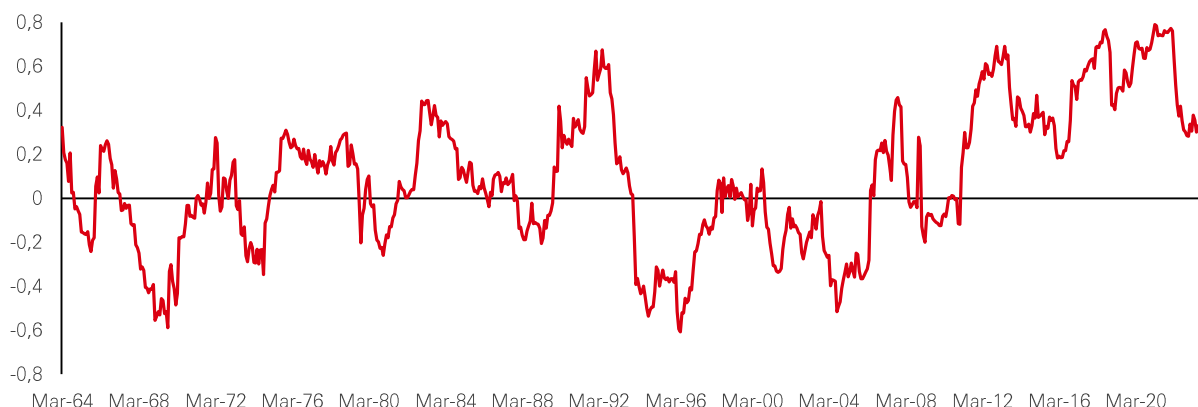
In summary, the performance of value stocks over the past 23 years is quite straightforward. Value earnings tend to underperform, have a cyclical bias. Value benefits from a positive valuation effect which is determined by the value spread. The more value stocks are attractive, the more the valuation effect will be strong. This has worked quite well up until 2018. We notice a disconnect in 2018, where despite a large value spread, the valuation effect is on average flat and even negative. This in turn has increased the value spread even more as there is no mean reversion effect through arbitrage. Although fundamentals have not deteriorated and earnings were at least average, it is exclusively valuation that has driven the underperformance. The fall of long-term interest rates to – and even below – zero has been seen by market observers as the main reason for this unusual phenomenon. We address this issue in the following section.

## **Value and interest rates**

Interest rates have been the main argument to explain the value / growth spread. The argument goes as follows. Recall the discounted valuation model: in such models, growth stocks have a longer duration than value stocks as most of their value is embedded in the long term – future income streams, terminal value, etc. The sensitivity of growth stock valuations to interest rates is thus greater than for value stocks – where value is embedded in the short term. Relative performance of value stock tends to be correlated to interest rates. Value underperforms when interest rates fall and outperforms when interest rates rise.

Historically, correlation between value and interest rates has never been significant and there are periods when correlation was even negative – interestingly during the inflationary environment of the 70s. Over the recent period, sensitivity of value to interest rates has increased dramatically and even reached 0.8 after falling back to 0.3.

Figure 7: Rolling 2-year correlation between US Value / Growth and US 10-year rates



Source: Kenneth French Data Library ([mba.tuck.dartmouth.edu/pages/faculty/ken.french/data\\_library.html](http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html)), Bloomberg, October 2023.  
**Past performance is no guarantee of future returns.**

So, although in theory it makes sense that Value / Growth should be in part affected by interest rates, the relationship is not empirically robust. We analyse in more detail how interest rates should affect stock valuations based on their growth characteristics.

We have constructed 2 valuation models: one for a value stock (company V) and one for a growth stock (company G). The tables below give the characteristics of each company as well as their sensitivities to a change in the discount rate.

Figure 8: Comparing a value and a growth stock

10-year DDM	Company V		Company G		15-year DDM	Company V		Company G				
	Data	Change	Data	Change		Data	Change	Data	Change			
Discount rate	8%	7%	8%	7%	Discount rate	8%	7%	8%	7%			
Current price	79.9	86.0	7.6%	130.3	142.4	Current price	74.3	81.8	10.0%	262.4	258.6	14.23%
Current dividend per share	5	5	1	1	Current dividend per share	5	5	1	1			
Current dividend yield	6.3%	5.8%	0.8%	0.70%	Current dividend yield	6.7%	6.1%	0.4%	0.39%			
Dividend CAGR	0%	0%	20%	20%	Dividend CAGR	0%	0%	20%	20%			
Terminal dividend per share	5	5	5.16	5.16	Terminal dividend per share	5	5	12.84	12.84			
Terminal dividend yield	5.0%	5.0%	2.5%	2.5%	Terminal dividend yield	5.0%	5.0%	2.5%	2.5%			
Terminal price	100	100	247.7	247.7	Terminal price	100	100	616.3	616.3			
G vs V			1.71%		G vs V			4.19%				

Source: HSBC AM, October 2023. **Past performance is no guarantee of future returns.**

#### Company V:

- The starting dividend is 5;
- The 10-year and 15-year forward CAGR is 0%;
- Terminal value is based on a terminal dividend yield of 5% which is consistent with the value status of the company.

#### Company G :

- The starting dividend is 1;
- The 10-year and 15-year forward CAGR is 20%;
- Terminal value is based on a terminal dividend yield of 2.5% which is consistent with the growth status of the company.

We apply the same discount rate to both companies, starting at 8%. This means that for both stocks, total return will be 8% per annum; stock V will have lower capital gains but higher reinvested dividends; stock G will have stronger capital gains (driven by the growth in profits) but very low yield. If we lower the discount rate by 100 bps, the fair values increase respectively by 7.61% for V and 9.32% for G. The impact of the fall in the discount rate, in this configuration, is only +171 bps for stock G vs stock V. This is significantly less than the empirical measure (+440 bp). To get something comparable to the empirical measure, we would need to extend the valuation model to a 15-year period; this assumes we are able to forecast profits over that horizon and that companies are able to sustain growth over such a long period. Also, bear in mind that the growth differential of 20% would need to apply to all the stocks of the universe: all the value stocks – or an average of the value index – would have 0% CAGR while all the growth stocks – or an average of the growth index – would be able to grow their profits by 20% per annum. This doesn't seem realistic to us. In fact, even the 'growthiest' stocks haven't been able to grow their profits by 20% per annum over the past 15-20 years. Over the past 15 years, less than 5% of European stocks have been able to generate more than 17.5% CAGR of their profits.

Figure 9: European value vs growth and US 10-year rates



Source: HSBC AM, Bloomberg data, October 2023. **Past performance is no guarantee of future returns.**

Figure 10: Sensitivity of the value/growth to changes in long term rates is almost 4.5



Source: HSBC AM, Bloomberg data, October 2023. **Past performance is no guarantee of future returns.**

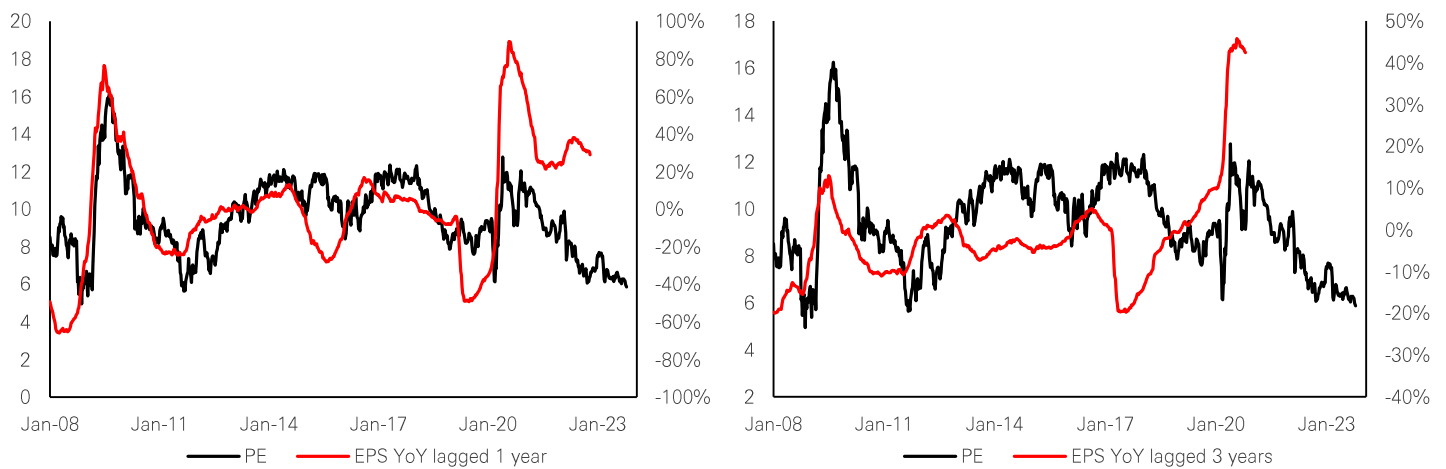
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## Valuation ratios and future growth

We mentioned in the introduction that we think that equity markets are only partially efficient. This implies that current valuations do not accurately reflect future growth. This can be tested at an index or stock level. For each sector of the EuroStoxx, we run regressions and test whether the PE ratio for a sector predicts earnings growth one and three years out. Although valuations seem to have some predictive power for earnings growth in the next 12 months, there is little predictive power for forward 3-year CAGR. Often, the relationship between current valuations and future growth is statistically significant,  $R^2$ s are on average of 0.2.

Below, we show the banking sector's PE ratio and earnings growth one and three years out.

Figure 11 and 12: Banks PE ratio and EPS growth 1 year and 3 years out

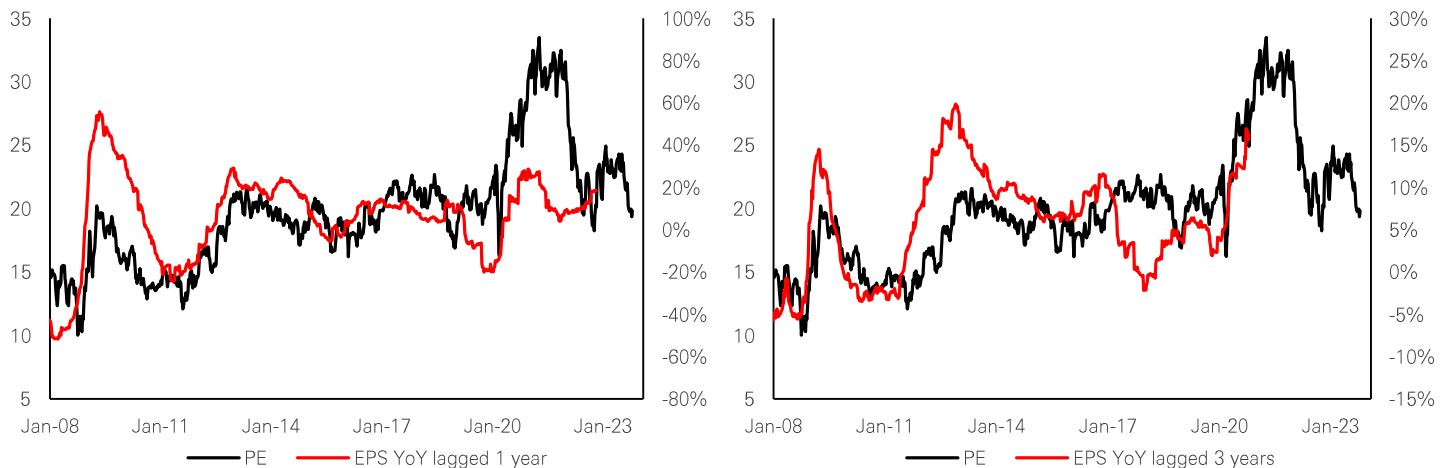


Source: HSBC AM, Bloomberg data, October 2023. **Past performance is no guarantee of future returns.**

The correlation for the 1-year forward growth is quite high ( $R^2$  at 0.25) but notice that it seems to have broken down since 2020. Today, given the historically low PE ratio for the sector, investors are pricing in a 40-50% cut to the sector's earnings in the next 12 months.

Below are the same charts for the Tech sector.

Figure 13 and 14: Tech's PE ratio and EPS growth 1 year and 3 years out



Source: HSBC AM, Bloomberg data, October 2023. **Past performance is no guarantee of future returns.**

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For the Tech sector, one year out, we can see a disconnect starting in 2020 that is corrected in 2022. Today, the current valuation of the tech sector implies that earnings will grow by 30% over the next year. Three years out, the market, given current valuations are pricing a 20% CAGR for earnings, which seems very aggressive.

### **Value at the stock level: comparing a growth stock and a value stock**

Let's take two concrete examples, a growth stock and a value stock, and do a simplified valuation on each company.

The first company belongs to the nifty-fifty universe of Eurozone equities. It has a 400 billion euros market value, has grown over the past 10 years on average by 9% per annum. Operating margins were on average of c. 20% but have increased significantly in the last 2 years to more than 26%. The ROIC for the business was historically 11% but the increase in margins has pushed the ROIC to 15% in the last 2 years. We assume that margins are going to stay at a record high level of 26%, and that the ROIC stays at 15%. As it has done historically, 70% of the operating cash-flow is reinvested in the business for an ongoing annual growth rate of 9% (the historical average). Profits would grow by c. 8.5% per annum, in line with sales. Free cash-flow would also grow by 8.5% per annum. The fair Enterprise Value for this company suggests a comfortable discount rate of 7.5%. So over the next 10 years, in a scenario where margins and ROIC stay at a record high and allow the business to grow by 10% per annum, the investor will be rewarded with a 7.5% return.

The second company is a large Eurozone bank. It has a 72 billion market value while its book value is 126 billion (so Price to Book of 0.7). Its current ROE is 7% while the 10-year average ROE is c. 8%. We assume that this company will not be able to increase its ROE to more than 8%. 70% of its earnings will be given back to shareholders and this will allow the bank to reinvest 30% of its earnings in the business and make it grow by c. 2.40% per annum. The terminal value is based on the fact that the bank would trade at its book value in 10 years. To justify the current market value of the bank, the discount rate is at 15.5%. So in a scenario where the bank's ROE stays at 8%, equity increases by 2.35% per annum and the bank returns 70% of its earnings to shareholders, the investor will be rewarded with a 15.5% return.

The difference in these two investment cases is striking. Investing in the bank would allow the investor to double their return versus the growth company. Obviously, one would argue that the bank's business model is riskier and deserves a premium relative to the nifty-fifty stock. This is probably true. But does an 8% risk premium make sense? Isn't the nifty-fifty company (a consumer discretionary company) also exposed to cyclical risk factors?

## Concluding comments



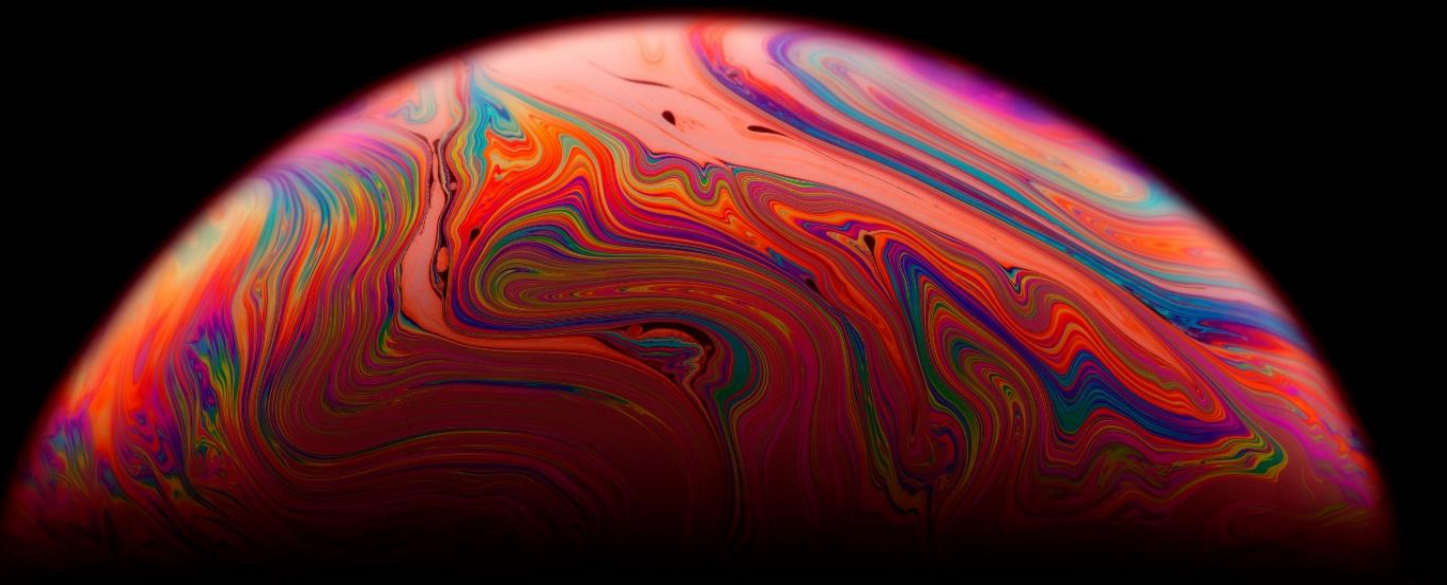
Our analysis identifies a series of coinciding signals suggesting that the current value / growth spread is largely speculative and, potentially, bubbly in nature.

These past 15 years have been challenging for value investors. Although the underperformance can be explained over much of this period, our view is that an anomaly has appeared over the last 3-5 years, with investors capitulating on value. Moreover, investors seem to have capitulated on the concept of valuation, taking decisions solely based on profit growth.

As the recession risk is raising across developed markets, the fact that value earnings have been more cyclical over the past 15 years contributed to this shift in market sentiment. But value earnings are currently holding up surprisingly well, as illustrated by the banking sector growing its earnings by 30% on a year-on-year basis. Yet the market is expecting bank earnings to fall by 30% in the next 12 months (assuming valuations are a good indication of future growth).

Despite a small rebound over recent weeks, the valuation spread between value and growth stocks remain at record highs. And multiple signs suggest that this valuation anomaly could start to fade, revealing a significant outperformance potential for value stocks. Indeed, timing this recovery is almost impossible, but maintaining an underweight stance on value seems to be a risky strategy, in our view.

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