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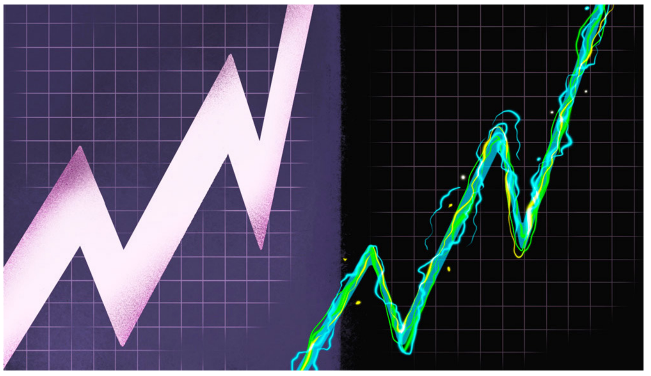
The Danger of Pinning Value's Rebound on Rising Rates

New research argues that there's not a straightforward relationship between interest rates and the performance of value.

By Grace Chung



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Investors need to rethink the relationship between interest rates and value stocks, according to research from Acadian Asset Management published on Wednesday.

Challenging the widespread narrative that rates are directly related to the performance of value equities — low interest rates are to blame for disappointing performance and vice versa — the report argues that forces including the economy, policies, and market sentiment also play a crucial part in how rates bode well or poorly for the strategies.

"Depending on how value is defined, and how value changes its colors over time, you need to pay attention to how value is exposed to different parts of the environment currently," Vladimir Zdorovtsov, director of global equity research at Acadian, told *Institutional Investor*.

Citing the TMT bubble, the technology, media, and telecommunications sector, as an example, the report highlighted how market sentiment influenced the relationship between interest rates and value and its impact on economic and policy conditions. "As tech valuations collapsed, value dramatically outperformed growth for much of 2000-2001," the report stated. "Bonds simultaneously rallied as deteriorating sentiment and economic softness weighed on Treasury yields in 2000 and as the Fed slashed policy rates beginning in January 2001."

Over the last 10 to 15 years, strategies that use quantitative techniques to pick securities, including value stocks, have been mass-marketed to investors, according to Seth Weingram, director of client advisory for Acadian. But investors need to realize there is no one size fits all approach. "...to really identify mispricings, it requires nuance, it requires sophistication," he said.

One of the firm's strategies requires defining value through peer groups, that is, taking an "apples to apples" approach versus what Weingram calls an "apples to oranges" view currently employed by many managers. For example, in order to identify mispricings, Acadian looks at behavioral factors such as when the fundamentals of one stock are priced differently from comparable firms. It also looks at where the opportunities are by determining value signals and then combining those with other relevant information to form portfolios and manage risks and costs.

"If you're really blurry on your perspective on where value opportunities arise, you're likely to make mistakes [with] genuine mispricings," said Weingram. "Unfortunately we find that those types of points are just overlooked and it's weird after so many years with value investing having developed as much as it has." Other researchers have also recently pushed for a more "dynamic view" of value strategies.

Acadian also digs into the issues posed by the overlap between value and growth stocks.

"The most 'growth-y' quintile would be roughly 50 percent technology, while the most 'value-y' would be roughly 50 percent financials, said Weingram. "But the issues go much deeper. It matters, for example, whether you evaluate market prices relative to book value, earnings (and backward or forward-looking), or other fundamental attributes; whether those fundamentals are adjusted for intangibles and how; whether value is interacted with other types of information, such as sentiment-related effects and momentum."

Other people, he notes, tend to look at value from a cyclical perspective, with value stocks being tied to industrials or other sectors whose fortunes are dependent on economic cycles. In a robust economy, he explains, the fundamentals and earnings growth of those stocks could improve, which could then cause interest rates to rise.

In the end, investors should view value's relationship to rate as just one more piece of information.

Because the relationship between interest rates and value depends on the confluence of many factors, investors should not expect that value-oriented investments will respond consistently to rate increases or decreases. In the present environment, if robust economic activity causes real interest rates to rise, then cyclically sensitive low P/B stocks might benefit. The same stocks might suffer, however, if rates rise due to inflationary expectations that also trigger fears of central bank tightening. By the same token, falling interest rates do not necessarily bode poorly for value, despite the post-GFC experience.

What's more, with asset managers having defined and implemented value strategies in very different ways, few of these investments will respond to rates in the same way.

"There's a lot of talk today about value and interest rates — both of those things are very complicated animals. What you really need is a meaningful conversation around this issue and to look through the underlying drivers of interest rates, that look into the health of the economy, policy, [investor sentiment] and the richness of assessing that," Weingram added. "Value isn't dead. Value is an important part of a multi-factor investing approach."