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# Growth or value? For active managers it can be both

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# Introduction

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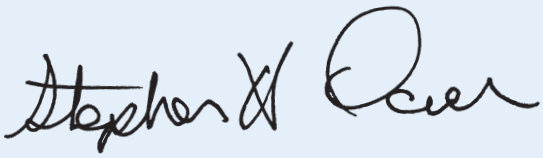
Dramatic rotations between traditionally defined "growth" and "value" stocks were observed throughout this year, driven by the COVID-19 pandemic and other macro influences such as indications of rising inflation. From my perspective, investors need to reframe our thinking around the growth and value classifications. The traditional growth or value distinction for stocks based on index construction is misleading. It draws arbitrary boundaries between companies, based on simple statistical measurements and rules. Active asset managers assess company valuations in a more nuanced way, considering things like intangible assets in their valuation process. We asked five of our equity teams to offer their views on the growth versus value debate. Here are some of our key takeaways:

- Our colleagues at Mutual Series, who we consider truly deep value investors, lead off with an interesting perspective on the role of intangible assets in their valuation process. Investing in value is not just about statistical cheapness or accounting value—it requires understanding economic value.
- The value team at ClearBridge Investments disputes the popular narrative that value stocks are generally not sustainable investments. The key is an active investment approach focused on investing in high-quality businesses with competitive advantages. This approach can both generate excess returns while satisfying responsible investing objectives.
- Inflation is front and center of any discussion of markets today, and historically leads any growth versus value debate. Some managers believe the recent uptick in inflation could become a secular trend, resulting in a sustained rotation from growth to value style investing. The innovation team at Franklin Equity Group disagrees and holds tight to its long-held philosophy that innovation is implicitly deflationary over time.
- In the tradition of Sir John Templeton, Templeton Global Equity Group suggests that too often, particularly in passive investment strategies, investors think formulaically or one-dimensionally about value. They call their approach "compound value," because—like a chemical compound—it results from the union of multiple elements that can include price, quality, growth and event—the tangible, fundamental and probable change likely to unlock value.
- Specialists in the small-capitalization (small-cap) space, our colleagues at Royce find that the COVID-19 pandemic offered many quality businesses the opportunity to prove their durability. Companies were able to bolster competitive positions and emerge with greater earnings and cash flow power. Many of the defensive measures taken to preserve cash flow have also evolved into permanently reduced cost structures.



## A false dichotomy

The growth versus value argument begs the question—what are we referring to when we talk "growth" versus "value" stocks? How is this distinction made? And perhaps most significantly for active asset managers, should these concepts be considered mutually exclusive?

We asked several of our investment managers to weigh in on the discussion around growth and value. Despite their different investment philosophies and processes, they all agreed that the traditional growth or value distinction (see "Growth Versus Value: A Primer" section below) for stocks is misleading. It attempts to draw boundaries between companies based on statistical measurements and rules, where active asset managers assess each company individually. Defining and assessing a growth or value investment is nuanced. It is not binary—and should not always be thought of as mutually exclusive. Is it hot or is it sunny? Perhaps both. Presumably, growth is not without value, and vice versa. There's a lot of overlap.

As my colleague from Templeton Global Equity Group, Sandy Nairn, recently observed, "we are corralled into a discussion based on index methodologies that often make little sense. A US value stock could be a growth stock if it changed its domicile to Europe, for example." Adding to the nuance, as stocks evolve, they will often shift between these traditional "value" and "growth" statistical characterizations.

In some ways, the bucketing of value and growth suggests investors are pursuing different outcomes, which of course they are not. The journey may be different in terms of process, but the end objective is the same—to buy assets at a discount to intrinsic value. This is the universal goal. Finding and measuring that discount is the challenge. One of the current challenges in valuing companies and distinguishing between growth and value is considering intangible assets which, by definition, are not included in standard accounting practices.

With all the interest in intangibles, in the Investment Institute we created intangible-intensity rankings to gauge which sector and country valuations may be more impacted. The general conclusions are informative. Sectors that have high intangible sensitivity include health care, information technology, and communication services. These are companies whose business models are committed to investments in innovation and effective processes. From a geographical perspective, developed markets are more intangible-intensive relative to emerging economies, which could help explain some of the relative outperformance seen in the developed world.

## Economic value and quality

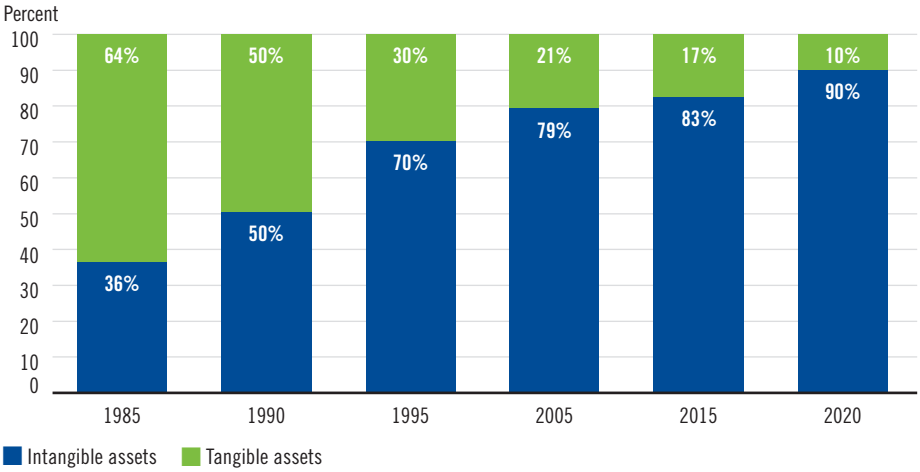
When considering the attractiveness of an investment, our managers prefer to think in terms of "economic value" and "quality." These measures require more in-depth, rigorous analysis of company fundamentals. Economic value is not listed on a company's financial statements. Simple ratios like price-to-book (P/B) and price-to-earnings (P/E) do not capture all economic value, and they fall short when identifying quality stocks. For example, when adjusting for research & development (R&D) and operating expenses as part of the earnings calculation, the P/E of traditional growth stocks narrow their premium over value stocks.

In Chapter 1, our colleagues at Mutual Series expand on the idea of economic value, observing that the accounting value of an asset, which is the value listed on the balance sheet, can differ meaningfully from the underlying economic value of the asset. Economic value reflects things like competitive positioning in the marketplace, business strategy, corporate culture of innovation, growth prospects, and perhaps most significantly, intangible assets such as R&D or intellectual property. These are non-monetary assets without physical

**THE GROWING SHIFT TO INTANGIBLES**

**Exhibit 1: Intangible and tangible assets as percentage of S&P 500 Index market value (in US$)**

December 31, 1985–December 31, 2020




Sources: Franklin Templeton Investment Institute, FactSet. As of May 2021. Net tangible assets are used, which are calculated as total assets minus intangible assets (report on balance sheet), less total liabilities. Portion of mark value related to intangible assets is calculated by subtracting net tangible assets from market capitalization. The analysis on a constituent level and arithmetic sum is used as an aggregation method. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

substance, but in today's marketplace they are very significant to valuations. According to research we have done within the Institute, around 90% of the S&P 500 Index's market capitalization can be attributed to intangible assets at the end of 2020, as compared to roughly 36% at the end of 1985, as seen in Exhibit 1. Companies that invest heavily in intangibles—meaning non-physical assets—like information technology infrastructure, branding and R&D have significantly outperformed hard-asset-heavy counterparts.

In Chapter 2, our colleagues at ClearBridge Investments discuss their approach to sourcing high-quality stocks in the value space that offer the potential for excess returns and satisfy environmental, social and governance (ESG) objectives as well. This is very interesting, as historically, value stocks have been considered part of resource-intensive, heavy emitting sectors. This assumption is based on the composition of passive indexes, such as the Russell 1000 Value Index, which is comprised largely of sectors with high carbon intensity (hence the association of value investing and old economy smokestack industries).

As active investors, however, ClearBridge has been successful in sourcing high-quality businesses that offer both value and sustainability. For example, the Deere company, which manufactures agricultural, construction and forestry equipment, is firmly ensconced in the industrials sector. Typically, Deere would be overlooked by sustainability focused investors, assumed to be a capital and carbon-intensive company. On the contrary, Deere is a leader in precision agriculture and its use of artificial intelligence to improve application of agrichemicals is discussed in detail in our piece.

With inflation a hot topic as it pertains to any discussion of growth versus value, Franklin Equity Group offers an interesting perspective in Chapter 3 on the role of innovation and its inherently deflationary characteristics. Consider the rise of asset-light businesses as an example—companies with the many intangible assets discussed earlier. Asset-light companies lower inflation by reducing capital expenditures and increasing market supply, which then reduces costs to end consumers. These companies have lower capital requirements for investments. For example, e-commerce companies do not buy expensive store fronts; ride-sharing companies do not buy their own vehicles, etc. Not only can this reduce inflationary pressures on the prices of real estate and cars, but these businesses have variable-cost structures that keep costs lower.

## GROWTH VERSUS VALUE: A PRIMER

The notion that a rigid distinction needs to be drawn between "growth" and "value" can be traced to the development of industry benchmarks for each style. These definitions were established in academic and commercial circles during the late-1980s and early-1990s, based on the construction of buckets of securities determined to be either value or growth based on subjective mathematical calculations and rules.

Traditionally, the growth style is defined by metrics such as earnings per share (EPS) and sales per share (SPS). Typical characteristics of growth stocks include rising earnings and sales ("revenue"). High growth rates often drive higher "earnings multiples," meaning investors show a willingness to pay more per unit of current earnings, with the expectation that growth should eventually "catch up," so to speak.

How do investors typically measure these so-called "multiples?" Here are two common ratios:

- Price-to-earnings (P/E) ratio. Basically, this is a company's stock price divided by EPS. It could be based on the past 12 months' earnings per share ("trailing P/E") or on the company's future expectations for earnings ("forward P/E").
- Price-to-book value (P/BV or P/B) ratio. This is the stock price divided by the stated value of its net assets (total assets minus intangible assets and liabilities).

If the growth rate is high, then investors might be willing to pay more for a company's stock, and these ratios will be higher. So, in a sense, high P/E and P/B ratios define growth because no one can guarantee the actual future growth rate of earnings.

Growth stocks tend to show up in fast-growing industries like technology and pharmaceuticals. Think of the "FAANGM" stocks: Facebook, Apple, Amazon, Netflix, Google (Alphabet), and Microsoft. These are among the classic growth stocks of our day.

Conversely, value stocks typically have low P/E and P/B ratios and lower expected growth rates. Financial companies, automakers, and commodity producers are often priced at low valuations and thus get called value stocks.

Asset-light models are cheaper to run than a traditional retailer who pays a fixed rent/commercial mortgage, or a taxi company that must own, maintain, and store its own cars.

In Chapter 4, our colleagues at Royce find that the COVID-19 pandemic offered many quality businesses in the small-cap value space the opportunity to prove their durability. They were also able to bolster competitive positions and emerge with greater earnings and cash flow power. Many of the defensive measures taken to preserve cash flow have evolved into permanently reduced cost structures, such as smaller real estate footprints from permanent moves to hybrid or full work-from-home models. These higher-quality companies had the balance sheet strength to make these moves, while smaller or more highly leveraged competitors were focused mostly on survival. This has strengthened their moats, broadened their addressable markets, and/or increased their long-term, "normalized" operating margins relative to pre-pandemic levels.

Finally, our colleagues at Templeton Global Equity Group highlight their approach to finding true quality and economic value in Chapter 5 with the introduction of their "compound value" approach. The team suggests, as we have observed, that the concept of value is too often associated with the value factor, causing investors to think formulaically or one-dimensionally about stock selection. Like a chemical compound, compound value results from the union of multiple elements, including cash flow and assets (price), intangible assets, predictability and risks associated with fundamentals (quality), the rate of change and sustainability of growth, and probability of tangible events likely to unlock value.

The approach is rooted in the philosophy of our founder, Sir John Templeton. "Remain flexible and open-minded about types of investment," he wrote. "There are times to buy blue chip stocks, cyclical stocks, corporate bonds, US Treasury instruments, and so on. And there are times to sit on cash…The fact is that there is no one kind of investment that is always best."

Indeed, as active asset managers, our different investment teams seek to build portfolios that may not align with narrowly defined and arbitrary labels. Value and growth are generic terms. A good growth or value manager will think within their parameters, but even in those parameters they are selecting stocks in an idiosyncratic way. It is about how they make valuation decisions.

## Contents

# Modern values

**Christian Correa, CFA**
Chief Investment Officer, Franklin Mutual Series

**Grace Hoefig**
Director of Research, Portfolio Manager, Franklin Mutual Series

**Tradition and evolution, value and growth, manpower and technology. Why these seemingly opposed concepts should be embraced by today's value investor.**

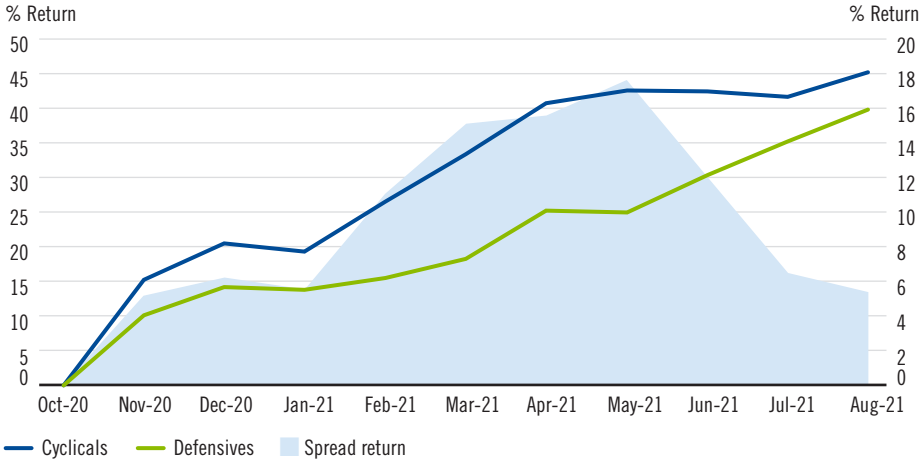
The rotation into value stocks accelerated in late 2020, as developed countries began vaccinating their populations and reopening their economies. The spread of the COVID-19 Delta variant has caused a pullback in the pace of economic reopening, pausing the strong rotation into more cyclical, value-oriented areas of the market, as seen in Exhibit 2. However, it is reasonable to expect that as more countries vaccinate wider swaths of their populations, the variant's spread will be curtailed, sentiment will improve, and the rotation into value stocks will resume. We believe this is a major catalyst in the world economy and the trend favoring value stocks which started in the United States will spread across the globe as other countries reopen, lifting the depressed stock prices of companies positioned to flourish in a strengthening economy.

At Mutual Series, we are value investors. Our focus is on estimating the fair value of a company, then investing in those companies we think are trading materially below our estimate of fair value, with the expectation that with the right catalysts in place, the stock price will appreciate. There are many types of companies that can fit this mold. A company may be profitable and operating well in an out-of-favor sector. A company may be unprofitable with a clearly defined path toward profitability. A company may be unprofitable but poised to grow its cash flows, which may lead to stock price appreciation. The key is the stock needs to be trading at a discount to fair value to be considered.

There are a lot of tools in our kit which we can use to identify an investment candidate. Therefore, many of the companies in our portfolios may fall outside of the deep value style box, yet still fall right into our wheelhouse. Early value investors did not have as many levers to pull. Before the value investing evolution occurred, the name of the game was statistical cheapness and mean reversion.

**LET'S GET CYCLICAL**

**Exhibit 2: Market capitalization-weighted rate of returns of cyclical versus defensive sectors in the Russell 1000 Index (in US$)**
October 31, 2020–August 31, 2021




Source: Bloomberg. Cyclicals: Consumer Discretionary, Energy, Financials, Industrials and Materials. Defensives: Consumer Staples, Communication services, Health Care, Information Technology, Real Estate, Utilities. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

## The before times

**The origin of species**

In the beginning, there were railroad bonds. The seeds of Mutual Series were sown in 1949 by Max Heine, who often said his investment strategy was "to buy a dollar for fifty cents." One of Max's early investments was in railroad bonds. The bonds of the bankrupt Penn Central Railroad were selling at such a deep discount, the price was less than the value of the steel and other materials used to construct the

Some investors still play the value game as it was originally defined. Others have evolved and no longer view statistical cheapness as the gold standard of value investing. To truly unlock shareholder value, we believe you need to identify companies that are not only trading below fair value but have catalysts which will drive price appreciation.

tracks. The investment was successful, and his deep value strategy was created. However, value investing is no longer so simple. Our railroad story illustrates the classic value strategy, which is based on valuation of a company's hard assets and price reversion. Historically, if an investor could find an investment that was statistically cheap, meaning it was selling for less than the accounting value of the company's hard assets, it was likely a sound investment, as the temporarily depressed price would eventually revert. This strategy has been competed away, popularized by investors such as Warren Buffett, and is no longer effective on its own. As more investors have utilized the strategy, its efficacy has been diluted. Furthermore, as the marketplace and the nature of corporate assets have grown more complex, traditional accounting methods used for valuing a company's assets have become outdated. To determine a company's fair value, we focus on the economic value of an asset, not the accounting value. Economic value is a function of the value of physical assets, the business strategy and competitiveness, the value of intangibles such as R&D, and the corporate culture of innovation. Understanding the drivers of economic value is a key component of our fair value estimate for a company.

**A new dawn**

In recent years, investors have increasingly focused on the economic value of intangible assets when analyzing stocks. Companies that invest heavily in their information technology infrastructure, branding, R&D pipeline and other valuable intangible assets have significantly outperformed their hard-asset-heavy counterparts. Valuable intangible assets such as brand names, customer lists and intellectual property, which may be the source of a company's competitive advantage, can drive profitability and customer loyalty. Often, the value of these assets is significantly understated on a company's balance sheet, if included at all. Our research team examines these intangible assets and incorporates their economic value when estimating the company's fair value, as these attributes and endeavors lead to future cash flow generation. Cash flow generation is an important input when determining the value of a company.

The term economic value may be new to some people. Economic value is the evolved descendent of accounting value. The accounting value of an asset is the dollar amount listed on a company's balance sheet, which is usually the amount spent to buy the asset adjusted for depreciation or amortization. Value investors often assumed that if they could buy a company for less than this accounting value, then the odds of losing money were low. This made valuation simple and direct. For a long time, this was a successful strategy although it was never perfect—even hard assets such as property, plants and equipment can be overvalued or undervalued on a balance sheet. Accounting value is an incomplete version of what our analysts really care about—economic value. Economic value is the ability of an asset to generate cash flow. It can only be estimated, as it is a function of actions happening in the future. We estimate economic value by looking at current cash flow, the potential for future cash flow growth and potential variations to these estimates which may lead to upside and downside scenarios. Economic value is an estimate, so it is less certain than accounting value, but it is a holistic measure which considers the assets, their position in the market, and views about the potential future of the economy. Determining the likely fair value of an asset requires extensive analyst insight into a company and the environment in which it operates.

Some investors still play the value game as it was originally defined. Others have evolved and no longer view statistical cheapness as the gold standard of value investing. To truly unlock shareholder value, we believe you need to identify companies that are not only trading below fair value but have catalysts which will drive price appreciation. Modern value investing encompasses concepts beyond price-to-earnings (P/E) and price-to-book (P/B) ratios, which investors can screen for passively.

## Process makes perfect

There are many ways to be a value investor. We believe in a rigorous analysis of company financial statements, taking the time to determine the economic value of all assets and look at subject companies through a series

of different lenses. Like tracking an evolving creature through time, an investment candidate can take many forms.

We keep mentioning fair value. This is a critically important concept, because if we cannot estimate fair value, we cannot determine whether an investment opportunity exists. In the previous section, we discussed economic value, which is the ability of an asset to generate cash flow. Again, since the future is unknowable, this cash flow generation is just an estimate. Our base case of what we think would be a reasonable price for a company's stock is referred to as our fair value. We align our analysis of fair value at fiscal year three (FY3) across companies to assess the upside potential of the stock. Recognizing that value opportunities can take multiple years to be realized, aligning our valuation analysis a few years out enables us to look beyond the short-term nature of many investors. Taking the work one step further, we complement our primary fair value analysis with scenario analysis that looks at potential upside and downside cases to help ensure we have a thorough understanding of the possibilities.

Cash flow generation can occur in many ways. The company may be profitable, with temporarily depressed cash flows as it has just completed an investment cycle. The company may be temporarily unprofitable but have a well-defined path laid out toward profitability. The management may be moving the company in a new direction, teetering on the verge of a catalyst that will unleash a wave of value. A company might have more value as the takeover target of another company versus its value to current investors as a going concern. The company may be generating a free cash flow[1] yield less than its average cost of capital but may be capable of reversing that in the future. The company may be experiencing challenges in the short term but have longer-term opportunities in the pipeline the market has not recognized. We consider all these possible scenarios as we select investment candidates. However, it all comes back to the one key question we have as value investors: is the stock currently trading at a price below our estimate of fair value? All else aside, if the answer to this question is yes, then to us, it is a value stock.

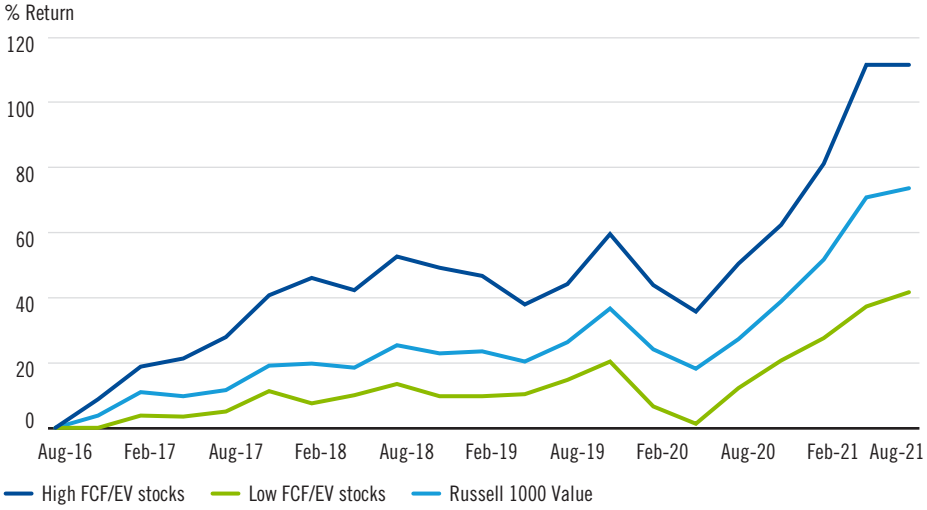
Just because a company's story has a growth component, doesn't mean it can't be a viable value investment. We believe a keen analysis of a company's growth prospects, if applicable, can be part of determining the upside potential for a company's stock price. Sales, margin and free cash flow growth are all part of this equation. As seen in Exhibit 3, stocks with high free cash flow to enterprise-value[2] ratios outperform the larger universe of value stocks. The age-old question of whether to invest in growth stocks or value stocks ignores the fact that the two cannot be divorced. Growth can happen organically or be caused by catalysts. Either is fine with us if it meets our value criteria.

Identifying catalysts is also a key part of our investment process. We look for companies with a high probability of undergoing changes to close the gap between the stock price and our estimate of fair value. In addition, we can monitor the progress toward completion of a catalyst to make sure our investment thesis remains on track. Catalysts that may lead to positive change include things such as management changes, corporate restructuring and capital structure changes.

These attitudes and practices are prime examples of how our approach plays itself out in our portfolios. We are unconstrained in terms of how we identify value, and we look for opportunities across the market. We focus our research efforts on understanding the key drivers of a company's business model and using it to determine a company's fair value. When we uncover an entity selling at a significant discount, regardless of what its ratios might be or what index it has been assigned to, we consider it a value stock. We consider the growth potential

### CASH IS KING

**Exhibit 3: High and low free cash flow (FCF) to enterprise-value (EV) ratio compared to Russell 1000 Value Index performance (in US$)**
August 1, 2016–August 1, 2021




Source: Bloomberg. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

of the company's cash flows and how those cash flows can be used to create value, through organic and inorganic capital allocation or returning money to shareholders. We have been value investors for nearly 70 years. In that time, much has changed. Our evolved approach to value investing has opened up our investment universe so we can better assess the modern complexities of today's companies to determine where the true opportunities lie.

## Rise of the machines

**The investor's guide to the galaxy**

As investors have evolved, so has their ability to build and employ more complex tools. Just as modern people can travel greater distances across space on the back of improved technology, modern value investors are able to find opportunities within the vast investable universe and better manage diversified portfolios with the help of new technology platforms. While we employ a bottom-up process, the team members employ several technological tools to assist them with identifying investment candidates and assessing risk. First, a quant tool assists the team in identifying potential investment ideas.

The quant program flags companies that meet certain criteria. It is run and maintained by our quantitative analysts, who work closely with our team to augment the fundamental research process. The program uses factors to sort companies based on criteria such as the ratio of assets to enterprise value and R&D yield. Using these different measures of price and value to look for undervalued assets, the quant tool identifies economic anomalies an analyst can then examine. These metrics are proprietary to the Mutual Series team. To be clear, the program is not a replacement for our bottom-up, fundamental research process. Our analysts are always engaging with and dissecting companies. The quant tool merely highlights companies that may deserve a second look. After the team's analysts determine what they believe is the economic value of a company's assets and determine a fair value for the stock, the utilization of megasectors further informs the investment process by shaping how we construct diversified portfolios and better understand the risks being taken.

**What a tool**

In the beginning, there was GICS. In 1999, S&P and MSCI designed the Global Industry Classification Standard (GICS) to group companies by principal business activity. Part of the theory behind sorting companies in this way was companies with similar businesses are affected by the same forces. When these forces ebb and flow, the stock prices of these similar companies tend to move in tandem. For nearly 20 years, GICS was the gold standard for tracking how areas of the market were behaving. However, just as value investing has evolved, so have the tools used by value investors. Our team felt the GICS classifications were deficient when it came to the insight it provided about stock price movement and market activity. There had to be a better way to inform the decision-making process. Enter the Mutual Series Megasectors, our proprietary method for examining how areas of the market move, and a complimentary component to our fundamental stock picking.

A megasector is a group of industries from across the market that have moved together over the last 25 years, as seen in Exhibit 4. Megasector analysis was developed using a statistical clustering technique looking at the stock price relationships between industry groups. When choosing stocks for a portfolio,

**CLUSTER BUSTER**

**Exhibit 4: Megasectors group industries together by business and economic drivers, not just business similarity**

| Stable businesses | Normal economy | Hard assets | Financials | Technology |
|---|---|---|---|---|
| 1. Healthcare equipment and services | 1. Capital goods | 1. Materials | 1. Banks | 1. Technology hardware and equipment |
| 2. Pharmaceuticals and biotechnology | 2. Consumer durable and apparel | 2. Transportation | 2. Diversified financials | 2. Software and services |
| 3. Household and personal products | 3. Commercial and professional services | 3. Energy | 3. Insurance | 3. Semiconductors and semiconductor equipment |
| 4. Utilities | 4. Retailing | 4. Automobiles and components | | |
| 5. Food and staples retailing | 5. Consumer services | 5. Real estate | | |
| 6. Food beverage and tobacco | 6. Telecommunication services | | | |

For illustrative purposes only and not representative of the performance or portfolio composition of any Franklin Templeton fund.

it does not increase diversification to load up on stocks exhibiting the same tendencies. Examining which megasector a company falls into can help maintain proper diversification across the portfolio by taking a more in-depth look at all the factors driving a company's stock price and how many companies within the portfolio exhibit the same tendencies. Once a portfolio is constructed, the megasector information is also used to monitor diversification and risk across the portfolio.

After examining 25 years of historical market movement, we identified five megasectors. The first is stable businesses, which includes health care, consumer staples and utilities companies. These companies do not exhibit as much volatility in recession periods as more cyclical sectors. Next, there are two cyclical megasectors, normal economy and hard assets. Companies in the normal economy group exhibit less cyclicality than the companies in the hard assets group. Financials companies move with the cyclical side of the market, but they have separate drivers, such as interest rates, and behave differently than the normal economy and hard assets cyclicality buckets, so they are in a megasector by themselves. Finally, technology is its own megasector. These relationships will likely evolve over time, as they are based on the dynamics of market behavior, which we know to be ever-changing.

## I'm going back to the start

In the beginning, there was statistical cheapness based on the accounting value of hard assets and price reversion. We have evolved. Our investment approach focuses on stocks trading at a discount to our assessment of fair value, which is based on the economic value of hard and intangible assets. Our analysis process is holistic, allowing us to capitalize on opportunities other value managers may write off because a company does not appear to be statistically cheap or because it does not fit neatly into the value style box. A deeper analysis of economic value can reveal opportunities that may otherwise go unnoticed. Companies—both profitable and unprofitable, at various points across the value spectrum, catalyst ready or rigid in their stance—are all on the table, providing a wide array of opportunities to unlock shareholder value across a myriad of economic environments and market cycles. It is a historic time right now. The economy is waking up from a pandemic-induced slumber. We are poised and ready to take advantage of the opportunities this environment has to offer.

### PASSIVE (NON) AGGRESSIVE

Many investors opt to receive exposure to some areas of the market through passive investing. While this is certainly a viable option for gaining exposure to efficient, widely researched and understood market segments, we recommend investors gain exposure to value stocks via active investment.

Our method of analysis goes deeper than rote calculations based solely on accounting values. The accounting value of an asset, which is the value listed on the balance sheet, can differ from the underlying economic value of the asset. Economic value is what matters. Economic value reflects an asset's potential contribution to cash flow growth and the company's competitive positioning in the marketplace in addition to its monetary value. Economic value isn't listed on a company's financial statements. Ratios such as P/B and P/E do not automatically include economic value. This is why these simplistic ratios fall short when it comes to identifying value stocks. We believe a full assessment of economic value is key to determining the fair value of a company and, by extension, whether a stock is trading at an attractive discount.

In addition, GAAP[3] accounting requires companies expense items such as marketing and R&D costs through their income statement when the cost is incurred. The result is these expenses reduce book value and depress EPS, which is used in the calculation of the P/E ratio. This is an uneconomic analysis, as it assumes any value associated with these expenses is exhausted during the accounting period. In our opinion, these expenses can create long-term sustainable competitive advantages and the cash generated by these activities often benefits the company for many years. An index based on rote calculations of P/B and P/E ratios will not calculate these metrics based on the economic value of the company's assets. However, active investors who look beyond metrics and factors and treat value investing as a holistic strategy can capture these nuances.

# A quality value approach embracing sustainability can perform in varying markets

**Dmitry Khaykin**
Portfolio Manager, ClearBridge Investments

**Robert Feitler**
Portfolio Manager, ClearBridge Investments

## Key takeaways

- While a passive approach tends to sacrifice sustainability through indiscriminate exposure to high-emitting sectors, an active approach to value investing enables a dual purpose of generating excess returns while satisfying ESG objectives.
- Companies enabling the transition to electric vehicles (EV) and the development of alternative energy sources are excellent examples of companies with sustainability trends that are the growth drivers of the business.
- As strong management teams will focus on long-term planning, which will require prioritizing sustainability, it makes sense to actively seek out high-quality, high-return businesses run by strong management teams that are prudent stewards of capital.

## New vs. old economy

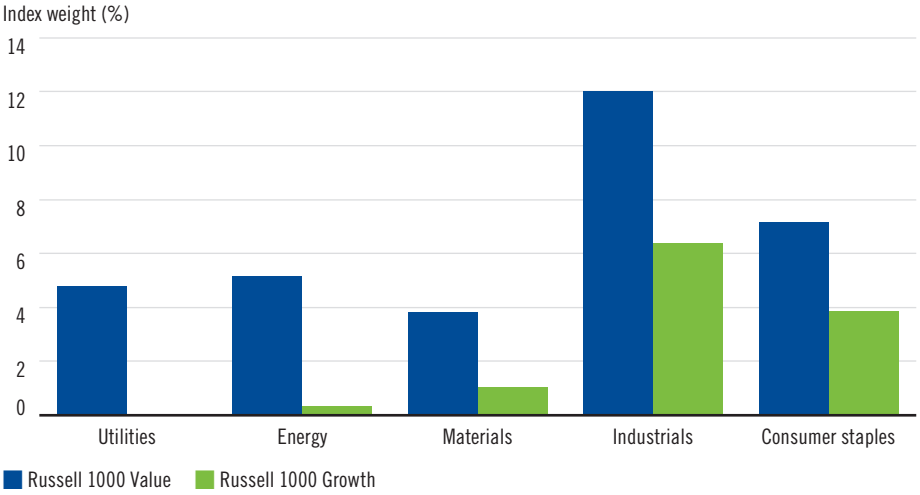
ESG investing and growth stocks—technology-focused companies with small carbon footprints supporting ESG goals such as renewable energy—at times seem to be inherently aligned. On the contrary, value stocks are viewed as resource-intensive heavy emitters. It is natural, therefore, to be concerned if the rotation into value jumpstarted by November 2020 vaccine announcements means compromises for investors on either returns or sustainability goals.

If we just examined a large-capitalization (large-cap) value benchmark like the Russell 1000 Value Index, it is easy to see why value investing tends to be associated with old economy smokestack industries and is considered heavy emitting. The Value Index is composed largely of sectors with high carbon intensity (Exhibit 5). Along these lines, underweights relative to a growth benchmark like the Russell 1000 Growth Index, which includes low-emitting sectors like information technology, consumer discretionary and communication services, suggests a further constraint to achieving sustainability.

For a passive value portfolio this would be true. While a passive approach tends to sacrifice sustainability through indiscriminate exposure to high-emitting sectors, an active approach to value investing doesn't have to, especially if an actively managed value strategy is focused on competitively advantaged, high-quality businesses. Such a focus enables a dual purpose of generating excess returns and satisfying ESG objectives. In addition, an approach that focuses on companies with strong ESG characteristics need not sacrifice returns, as analysis shows companies with better ESG ratings see superior returns as long as they avoid deterioration.

**VALUE'S CARBON-COST**

**Exhibit 5: Top five carbon-emitting sectors ($tCO_2e$/$M) in the Russell 1000 Index, value/growth exposure (in US$)**
As of June 30, 2021




Sources: FactSet, MSCI. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges. **Past performance is not an indicator or a guarantee of future results.**

Many companies, regardless of whether they are considered growth or value stocks, are benefiting from sustainability themes as they enable important societal goals. The need to identify and allocate capital toward these businesses argues for an active and differentiated approach to value investing.

We expect greater returns from companies that are contributing to the transition to a more sustainable economy. By paying special attention to businesses with revenues underpinned by sustainability drivers and companies that are simply misunderstood or whose positive ESG attributes are overlooked, a quality approach to value investing may foretell strong ESG characteristics, overcoming a bias of non-ESG friendly investing. Lowering emissions is one way a quality-driven, active approach may gain on the benchmark.

## A differentiated view on sustainability opportunities

Many companies are not given proper credit for their sustainability contributions, and an active approach to value investing enables a differentiated view of these companies. Contrary to the perception that value stocks are just old economy smokestack companies, many deploy innovative technologies for a more sustainable future.

**An example of helping sustainable agriculture**

An industrial equipment maker like Deere is easily lumped in with capital- and carbon-intensive industries, and it can be easily overlooked by sustainability-focused investors. Deere, in the industrials sector, manufactures agricultural, construction and forestry equipment. Yet, the company has many environmentally friendly elements to its business for which it is given less credit by ESG ratings agencies than it deserves.

Deere is a leader in precision agriculture, which applies new technologies in planting, spraying and irrigation tasks to improve yields while reducing the use of water and harmful pesticides and herbicides. Its AutoTrac steering system, for example, reads the soil and steers planters to nearly eliminate overlapping passes on the field, reducing fuel consumption and associated emissions, as well as seed and chemical use. Similarly, Deere has an artificial intelligence (AI)-based See & Spray technology that can dramatically reduce the use of chemicals. The See & Spray precision sprayer uses computer vision and AI to detect weeds as a farm sprayer passes over fallow ground and precisely sprays herbicides only where needed. It has a hit rate of 98%, similar to broadcast sprayers, which spray indiscriminately, yet it uses an average of 77% less herbicide than broadcast sprayers. In a meeting with Deere, we learned of one field trial for cotton in which herbicide consumption costs declined to US$25,000 compared to US$250,000 the previous year. In addition, Deere's ExactEmerge planter is designed to increase the accuracy of spacing, depth and population of seeds, improving farmers' bottom lines while benefiting the environment. Similarly, Deere's proprietary cold recycling technology used in road construction can reduce time and materials used and improve paved surface durability while lowering emissions and construction costs.

## Sustainability-driven revenues are maximizing value

Many companies, regardless of whether they are considered growth or value stocks, are benefiting from sustainability themes as they enable important societal goals. The need to identify and allocate capital toward these businesses argues for an active and differentiated approach to value investing. Such an approach would look for strong, competitively advantaged franchises operating within stable to growing end markets, and invest in these at attractive valuations, rather than screen for cheap stocks or passively invest in broad-based market indexes. As active value investors, we may purchase select stocks more commonly held in growth portfolios; however, we will do so opportunistically, at what we consider attractive entry points. An active value approach allows us to target companies with sustainability trends that are the growth drivers of the business. Companies enabling the transition to EVs and the development of alternative energy sources are excellent examples of these.

**Driving EV innovation**

An example of an ESG leader is TE Connectivity, which makes connectors for a wide range of uses, including automobiles, data centers and medical devices. TE Connectivity's products help enable environmentally friendly solutions like EVs—where they enjoy twice as much content per vehicle as compared to traditional internal combustion engine (ICE) vehicles—which reduce reliance on fossil fuels. Its products also enable socially valuable innovation such as advanced driver assist systems/autonomous

vehicles, which should improve vehicular safety. Increasing connector content in EVs, we believe should see strong growth in the coming years as the world adopts more sustainable policies as seen in Exhibit 6.

The company has also reduced its energy use intensity by 37% and greenhouse gas intensity by 35% over the past decade. The manufacturing process for connectors is very water intensive, but TE Connectivity has been able to reduce its water usage by 29% over the past decade as well. The company is best in class across all of these metrics.

On the social front, in addition to enabling autonomous vehicles, TE Connectivity has been working to improve its commitment to responsible sourcing and to find alternatives to problematic materials such as cobalt, currently used in the manufacture of EVs, despite the fact that cobalt isn't a directly sourced material for TE Connectivity itself. The company does use gold extensively in its products, which can have negative environmental effects when mined, although TE Connectivity has committed to seeking more mines that are run responsibly for sourcing.

**Driving alternative energy growth**

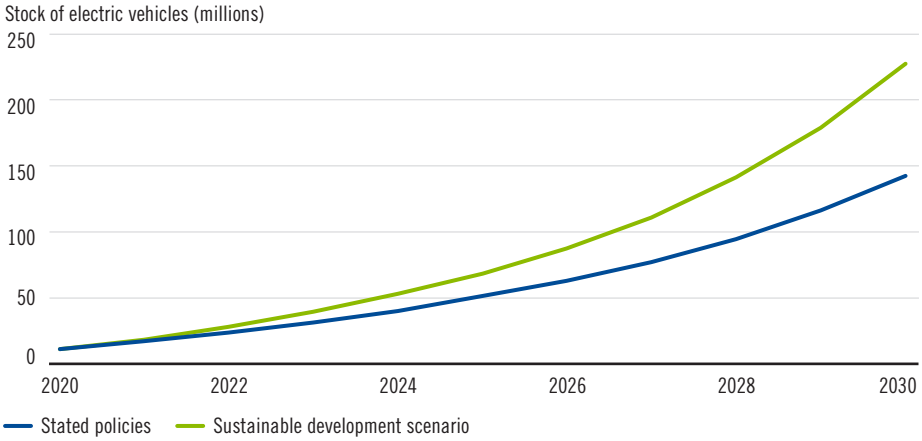
An important corollary to the adoption of EVs will be the increased demand for electricity. Broadly speaking, utilities are the biggest enablers of federal decarbonization policies as they retire coal power generation and replace it with power from renewable sources. In addition, utilities are seeking to integrate hydrogen as a power source into existing natural gas distribution networks and to build out EV infrastructure.

An example of meeting the rising demand for clean energy, Sempra Energy, a California-based utility and infrastructure company, is directing capital toward developing hydrogen, renewable natural gas (RNG), fuel cells and carbon capture and storage. The company recently announced a Hydrogen Blending Demonstration Program, a joint R&D project of its two California subsidiary utilities, SoCalGas and San Diego Gas & Electric (SDG&E). The project is the first of its kind in California and aims to use surplus renewable electricity, generated in the middle of the day, to produce green hydrogen for subsequent injections into the natural gas stream for storage and use. Exhibit 7 illustrates the growing global support for hydrogen technologies, tracking targets and incentives for development and production.

In 2019, SoCalGas set a goal to deliver 5% RNG sourced from organic waste to its utility customers by 2022 and 20% by 2030. Both utilities are seeking the regulatory approval of a program allowing their customers to purchase RNG as part of their natural gas service.

### ELECTRIC VEHICLES POISED FOR STRONG GROWTH

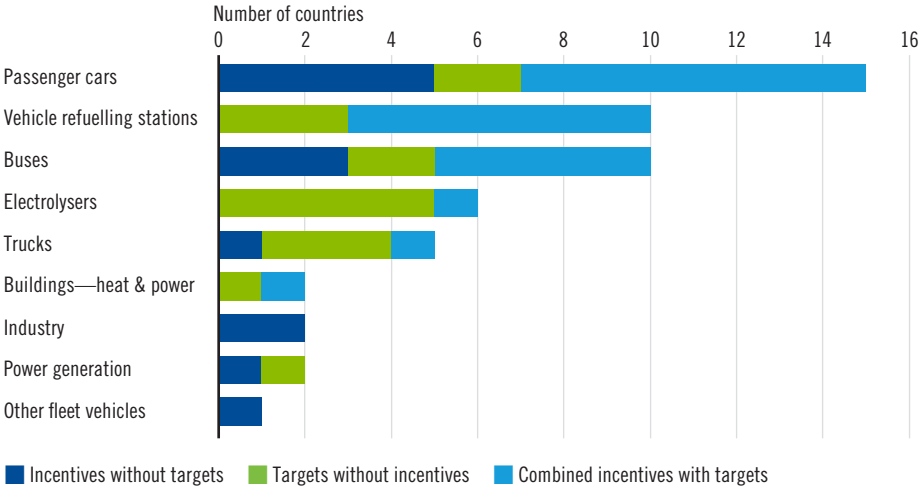
**Exhibit 6: Global EV stocks understated policies and sustainable development scenarios**
2020–2030




Source: IEA, Global EV stock by mode in the Stated Policies Scenario, 2020–2030, IEA, Paris. All rights reserved.
As of April 2021. There is no assurance that any estimate, forecast or projection will be realized.

### GROWING SUPPORT FOR HYDROGEN TECHNOLOGY

**Exhibit 7: Policy support for hydrogen deployment by target application**
As of November 2019




Sources: IEA, Current policy support for hydrogen deployment, 2018, IEA, Paris. All Rights Reserved. Note: In the instance of passenger cars, five countries have incentives for hydrogen production, but not targets to shoot for, two have targets but don't provide incentives while eight have both targets and incentives.

High-quality, high-return businesses are generally run by strong management teams that are prudent stewards of capital. Company management is at the core of all decision-making and firm activity, including where to invest and what areas to avoid. It is an appropriate starting place. Expense control, capital allocation and executive pay are relevant in weighing management quality.

Sempra has robust and highly visible capital plans to build out transmission and distribution infrastructure within its franchise territories in California and Texas to enable increasing use of renewables as mandated by state regulators. At the same time, natural gas will likely continue to remain an integral component of the energy transition and Sempra Energy plays an important role in sustainably liquefying and transporting it both in the United States and in Mexico.

## It all begins with management

High-quality, high-return businesses are generally run by strong management teams that are prudent stewards of capital. Company management is at the core of all decision-making and firm activity, including where to invest and what areas to avoid. It is an appropriate starting place. Expense control, capital allocation and executive pay are relevant in weighing management quality.

Strong management teams will focus on long-term planning, which will require prioritizing sustainability, and will manage companies in such a way that they have financial strength and flexibility to set ambitious yet achievable sustainability objectives. This is evident among the companies mentioned above, where strong balance sheets enable R&D in sustainability-related projects. A corollary is that companies struggling to keep their heads above water are less likely to have the resources to make sustainability gains.

## Conclusion

An active value-investing approach that focuses on durable and resilient franchises operating in stable to growing end markets trading at attractive valuations, rather than tracking a broad-based benchmark or screening for cheap stocks, is advantaged in identifying and investing in companies with strong ESG profiles. Some of these companies could be considered growth stocks, while others have growth characteristics obscured by a lack of understanding of their sustainability efforts. Not only are these businesses best-in-class from a fundamentals standpoint, but they are also typically the leaders in areas of sustainability. As the cases discussed here demonstrate, there is ample opportunity in the value universe to find such companies where sustainability will drive returns, and where returns will further the world's efforts to improve sustainability.

# The deflationary nature of growth

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## Introduction

In recent months, we have seen the age-old growth versus value investing debate re-emerge with periods of sharp outperformance in both strategies. As growth investors, and more importantly as investors in innovation, we would like to present our views on how we perceive some of the arguments for a sustained rotation back to value.

As with all great debates, there are good, coherent arguments with merit on both sides. These arguments range from high growth-stock valuations, potential technology regulations, to even counterintuitively, better growth prospects for value industries. During the February to May 2021 value rotation, one of the loudest arguments for sustained value outperformance was the potential change to a high inflation environment. The argument goes something like this: value outperforms growth during periods of inflation due to higher discount rates of long-dated assets and better pricing for value stocks. As inflation was such an important factor in this most recent rotation, we decided to address our view on inflation and make a case for a continued low-inflation environment. One caveat before we go any further, however; although we are aware of macro factors, they do not drive most of our investment decisions. Similarly, we try not to concern ourselves with the macro fears of a given quarter. We believe they do not drive long-term performance. For example, we believe the advancements in genomics, artificial intelligence, and augmented reality will continue to accelerate independent of inflation. We express more broadly our views on growth

### STYLE ROTATIONS OCCUR FREQUENTLY

**Exhibit 8: Style factor rotations between the Russell 1000 Value Index and the Russell 1000 Growth Index: 2008–2021***
As of July 31, 2021

**Value rotations—Russell 1000 Value Index baseline scenario**

| Start | End | Length (days) | Magnitude of value outperformance |
|---|---|---|---|
| July 15, 2008 | October 2, 2008 | 58 | 11.48% |
| September 21, 2011 | January 11, 2012 | 81 | 6.00% |
| April 18, 2012 | July 23, 2013 | 330 | 14.12% |
| February 27, 2014 | May 7, 2014 | 50 | 4.71% |
| January 25, 2016 | April 27, 2016 | 68 | 6.69% |
| October 24, 2016 | January 3, 2017 | 52 | 6.62% |
| September 4, 2018 | November 19, 2018 | 55 | 7.87% |
| August 21, 2019 | October 23, 2019 | 46 | 4.56% |
| September 2, 2020 | January 14, 2021 | 97 | 11.08% |
| February 2, 2021 | May 13, 2021 | 73 | 15.20% |
| **Average** | | **91** | **9%** |

**Subsequent growth outperformance—Russell 1000 Growth Index**

| Start | End | Length (days) | Magnitude of value outperformance |
|---|---|---|---|
| January 3, 2008 | July 15, 2008 | 139 | 6.84% |
| October 2, 2008 | September 21, 2011 | 775 | 26.75% |
| January 11, 2012 | April 18, 2012 | 71 | 5.63% |
| July 23, 2013 | February 27, 2014 | 158 | 8.06% |
| May 7, 2014 | January 25, 2016 | 449 | 14.25% |
| April 27, 2016 | October 24, 2016 | 129 | 1.16% |
| January 3, 2017 | September 4, 2018 | 436 | 33.63% |
| November 19, 2018 | August 21, 2019 | 198 | 13.81% |
| October 23, 2019 | September 2, 2020 | 226 | 46.16% |
| January 14, 2021 | February 2, 2021 | 14 | 5.77% |
| May 13, 2021 | July 30, 2021 | 57 | 12.64% |
| **Average** | | **241** | **16%** |

*Note: Highest magnitude of outperformance highlighted for each category.

Source: Bloomberg. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

versus value in our paper "Did the Fourth Industrial Revolution Kill Mean Reversion? We Think So."[7]

The narrative associated with the performance of growth stocks over the last decade is that they have unilaterally outperformed value. As we can see in Exhibit 8 on the previous page, this is incorrect. Periodic episodes of value outperforming growth happen frequently and demonstrate market health. Over the last 13 years, style leadership changed 20 times. We have highlighted those periods in the below table. Since the beginning of 2008, value outperformed growth 46% of days and value outperformed for as long as 330 days.

However, despite these frequent style rotations, as seen in Exhibit 9, growth has outperformed value by 287% since 2008! Value outperformance resembles winning points in tennis, maybe even games, but losing the match. Our takeaways for investors are to stay calm, focus on the long term, and not get distracted by the point.

## Innovation is deflationary

In human history, we observe episodes of technological innovation interspersed between stretches of negligible growth. Today, we find ourselves in an epoch of accelerated innovation. This quickening of innovation keeps inflation lower by reducing both the costs of goods and the need for human labor.

Innovation enables the invention and production of goods quickly and cheaply. With other factors constant, innovation shifts the supply curve to the right. This increases output while reducing price.

Computing exemplifies how innovation lowers the cost of goods. In 1971, the first personal computer—the Kenbak-1—cost the equivalent of US$5,066 in today's dollars. The 1975 IBM 5100 Portable Computer weighed 50 pounds and the cheapest version cost approximately an inflation-adjusted US$45,637.[8] Today, nearly everyone owns exponentially more powerful and lighter personal computers or phones for a fraction of the cost of 1970s PCs—see Exhibit 10.

Innovation also creates productivity gains that keep labor costs lower. At the company level, by using leading-edge software one person can do the work 20 to 30 people did in legacy applications.

On the macro level, according to author Matt Klein, "since the pandemic began, the total real value of goods consumed has grown more than 7% while the number of people working in the goods distribution sector—retail, wholesale, truck transportation, warehousing, delivery—has dropped about 2.5%. Put another way, the amount of stuff Americans are able to buy from a given number of retail and logistics workers has jumped 10% in less than a year."[9]

While these are not comprehensive examples, we show how three elements of the innovation economy are particularly deflationary: the rise of e-commerce, the use of asset-light business models and technology-driven productivity offsetting wage inflation.

## Innovations in e-commerce

While e-commerce represents a single case study in many innovations impacting retail, not only is e-commerce deflationary, but some argue e-commerce leads to the Consumer Price Index (CPI) overstating true inflation. CPI measurements may not accurately reflect inflation as they do not incorporate online sales well. Economists cannot sample all online

### GROWTH HAS OUTPERFORMED OVER A LONG PERIOD

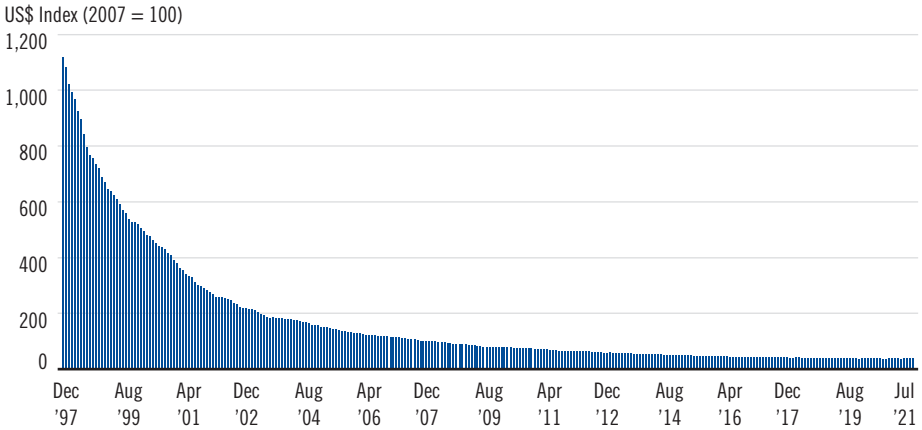
**Exhibit 9: Total performance Russell 1000 Growth Index versus Russell 1000 Value Index**
January 1, 2008–July 31, 2021

| Total Performance | |
|---|---|
| Russell 1000 Growth performance | 470.62% |
| Russell 1000 Value performance | 183.46% |
| Growth outperformance | 287.16% |

Source: Bloomberg. As of July 31, 2021. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

### INNOVATION LOWERS THE COST OF GOODS

**Exhibit 10: Computers, peripherals and smart home assistants CPI: US city average**
December 31, 1997–July 31, 2021




Source: US Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: Information and Information Processing in US City Average [CUUR0000SEEE01], retrieved from FRED, Federal Reserve Bank of St. Louis; August 16, 2021. There is no assurance that any estimate, forecast or projection will be realized.

We expect e-commerce's deflationary effect to grow over time due to lasting changes in consumer behavior post-pandemic. A recent McKinsey study reported that 40% of consumers tried a new kind of shopping during the pandemic. In the same study, 80% of participants believe they will change their shopping habits permanently.

prices and economists also exclude many items sold online from the CPI basket. In a study done from 2014 to 2017, Austan Goolsbee and Peter Klenow found that "online prices of personal computers fell by 12.3%, for example, but the CPI showed just a 6.9% drop. Toy prices online slumped 12%, while the CPI put the drop at just 7.8%. Online prices for photographic equipment and supplies fell 9.2% compared with the 0.6% decline registered by the official measure."[10] Adobe analyzed over a trillion online transactions and found that inversely to the CPI, which increased by 12%, prices of goods online have decreased by 23% since 2014.[11]

Consumers find buying products online is often cheaper, and there are structural reasons for this. E-commerce makes comparison shopping easy, which can pressure online merchants not to raise prices. E-commerce stores generally operate with lower costs than brick-and-mortar stores, allowing merchants to sell at lower prices than traditional retailers. Additionally, consumers can buy products from any geographic location, even locations with a lower cost structure than the consumer's location.

The growth of one single e-commerce company, Amazon, by itself has a deflationary impact. Amazon initially avoided the expenses of brick-and-mortar stores and competed by offering lower prices. As Amazon grew in scale, the company had tremendous bargaining power in purchasing the goods listed on its platform for less, and thus could sell items at a lower cost than most other retailers. As Amazon started operating distribution centers and leasing planes, it removed additional costs from its supply chain. By replacing human labor with robots, logistics algorithms and possibly drone delivery, Amazon should further reduce the cost of delivery and therefore the cost of products sold.

We expect e-commerce's deflationary effect to grow over time due to lasting changes in consumer behavior post-pandemic. A recent McKinsey study reported that 40% of consumers tried a new kind of shopping during the pandemic. In the same study, 80% of participants believe they will change their shopping habits permanently.[12] The pandemic also pulled forward the penetration of e-commerce as a percentage of all retail shopping. Seasonally-adjusted e-commerce as a percentage of all retail sales went from 11% pre-COVID-19 to 14%, even with economies reopening.[13] Likewise, underpenetrated e-commerce areas such as car purchases are increasingly moving online. As e-commerce takes share from traditional retail, it should put downward pressure on prices long term.

## Deflationary innovation in asset-sharing platforms

Secondly, the rise of asset-light businesses is deflationary. Asset-light models reduce inflation by reducing capital expenditures and increasing market supply, which reduces costs to end consumers. Asset-light businesses have reduced capital requirements for investments. E-commerce companies do not buy expensive store fronts; ride-sharing companies do not buy their own vehicles. Not only can this reduce inflationary pressures on the prices of real estate, cars and other assets, but these businesses have variable cost structures that keep the companies' costs lower. Asset-light models are cheaper to run than a traditional retailer who pays a fixed rent/commercial mortgage or a taxi company that must own, maintain and store its own cars.

Additionally, asset-light models can more easily flex supply to meet demand, which again reduces costs to consumers. Airbnb increases lodging capacity in markets without the need for additional capital expenditures for hotels. Uber and Lyft increase the number of drivers on the road for ride-share hailers. Furthermore, as of now ride-share drivers and Airbnb hosts are not full-time employees with benefits. Therefore, these companies have a nimble labor-expense structure, which may reduce costs to the consumer compared to companies with full-time employees.

## Innovation improves productivity

While commodity prices have already started rolling over and most supply-chain-exacerbated inflation should resolve over time, wage inflation can create a pernicious cycle of higher wages, higher prices and workers demanding higher wages to afford higher prices. Underappreciated boosts

to productivity from innovation, as seen in Exhibit 11, may stop the wage inflation spiral.

Elements of COVID-19 exacerbated labor shortages. Many participants left the labor force for health and safety reasons or to care for children not attending school. This, along with extended unemployment benefits, has created labor shortages as the economy reopens. However, we believe innovation will prevent wage inflation from getting out of hand in the long-term.

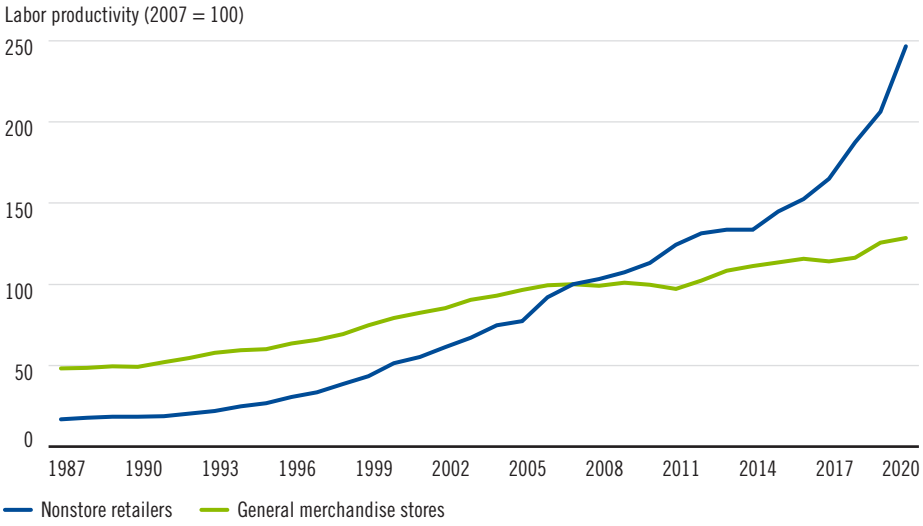
Consider the long-haul trucker as an example of innovation addressing labor-inflation pressures: today, truck drivers are in high demand given the COVID-19 supply chain interruptions. Drivers have enjoyed a sharp increase in wages, with some of this wage inflation passed through to the cost of end goods. Yet, this wage dynamic is temporary, as longer-term companies will likely be able to remove significant human labor cost from this supply chain. We expect innovations like self-driving vehicle technology, automated warehouse facilities, and artificial intelligence to replace humans in managing these supply-chain logistics. Over a multi-year horizon, the future for human drivers in the trucking business appears bleak.

COVID-19 also accelerated innovation across multiple industries, potentially mitigating wage inflation. mRNA vaccines are a monumental scientific breakthrough from the pandemic. Billions of dollars went into the development and production of novel mRNA vaccines as a prophylactic for COVID-19. Researchers also developed new antiviral and monoclonal antibody treatments as viable therapies for the virus. Effective vaccines and treatments allow people to feel safer reentering the workforce, and safer about sending their children to school. This may ameliorate some labor shortage in the near term.

**INNOVATIVE INDUSTRIES, GREATER LABOR PRODUCTIVITY**

**Exhibit 11: Labor productivity—non-store retail versus general merchandise stores: 1987–2020**

As of December 31, 2020




Source: US Bureau of Labor Statistics.

COVID-19 health and safety issues required many office workers to work from home. Companies were forced to pull forward digital capabilities faster than they considered possible to enable millions of employees to work from home. These digital capabilities have made some employees more efficient. Some academics suggests the economy will experience a 5% productivity boost from remote-working arrangements.[14] Imagine salespeople conducting digital demos versus flying halfway around the world, or maintenance employees who can now monitor capital equipment remotely versus individually visiting each site. These types of efficiencies lead to reductions in headcount. Fifty-three percent of executives plan to reduce their workforce due to technology integration, according to the World Economic Forum.[15]

In addition to digitization removing some jobs, technology and change in workplace culture regarding working from home will let some companies hire talent without geographic limits. This will increase the labor pool for some jobs from local to international and increase labor supply, which can further offset wage inflation.

Lastly, fear of workers contracting COVID-19 and supply-chain shortages during COVID-19 will encourage some companies to invest more capital in manufacturing layout and automation. To address high unfilled job openings, some restaurants implemented self-serve kiosks to automate customer-facing jobs. White Castle and Doordash, among others, will also use robot cooks to automate food production.[16] While automation may take time to implement, it too will likely exert downward pressure on wages. Lydia Boussour, an economist at Oxford Economics claims that "the faster dash toward automation puts nearly half of the seven million jobs yet to be recovered from the pandemic at risk—leading to a permanent labor-demand shortfall over the next three to five years."[17]

## Conclusion

We find the debate of value versus growth a false one. In our view, the best value managers and the best growth managers are all looking for companies

In our view, this latest growth pullback was driven by concern over inflation from temporary labor shortages that occurred as the economy reopened post-company reorganizations, worker reevaluations, location movement, and significant government stimulus. In our view, long-term demand for goods did not change, nor did the ability to manufacture them.

that are at a bargain relative to their future free cash flows. In our experience, markets can act like a skittish herd—they can spook easily and run in different directions after a period of relative calm. It is periods such as this when long-term thinking, experienced active management and client education can be particularly helpful.

In our view, this latest growth pullback was driven by concern over inflation from temporary labor shortages that occurred as the economy reopened post-company reorganizations, worker reevaluations, location movement, and significant government stimulus. In our view, long-term demand for goods did not change, nor did the ability to manufacture them. If anything, as companies have reorganized during the pandemic, they emerged more efficient, having embraced new technologies and innovations such as video conferencing, e-commerce, simulation software and co-bots, simply to name a few.

However, we remain open to change should our stance on inflation prove incorrect and the current scare in the market does not dissipate as quickly as we think it should. In that case, we believe growth equities may continue to outperform. We look to history and see that innovative companies can thrive even in an inflationary environment. Equity market returns are positively correlated with moderate inflation. In the five inflationary environments since 1990, businesses with the ability to set prices averaged a 21% return, outperforming price-takers by over 7%.[18] In many cases, the most innovative companies are price-setters. Many of the companies we own sell a product with little to no alternative and can set their own price. In some cases, their pricing power can be realized within seconds as algorithms set prices in real time—allowing these companies to adjust for inflation quickly and maintain profit margins.

We also aim to invest in businesses with asset-light business models. Many investors think of asset-heavy industries such as energy and metals and mining as inflation hedges. We argue asset-light businesses are better inflation hedges than asset-heavy businesses because investments in assets become more expensive as the purchasing power of the dollar declines. After the high inflation of the 1970s, Warren Buffet stated in his 1983 shareholder letter that "a disproportionate number of the great business fortunes built up during the inflationary years arose from ownership of operations that combined intangibles of lasting value with relatively minor requirements for tangible assets."[19]

We believe that active management is critical to successfully navigate these dynamic markets. It is important to us that there is discussion and intelligent conversation about these topics, and that fair consideration is given to all sides.

# Small-cap outlook: What looks likely to continue and what looks likely to change

**Steve Lipper, CFA**
Senior Investment Strategist, Royce Investment Partners

## Increased fundamental differentiation is active management's opportunity

We believe that the market is at the beginning of a period in which greater differentiation in small-capitalization (small-cap) companies' fundamental results—largely due to decisions and actions that companies have taken during the pandemic—will begin to affect share prices. The pandemic offered many quality business models the opportunity to prove their durability just as it gave strong managements a challenge to justify their reputations. Even in industries hardest hit by the pandemic, many quality companies were able to bolster their competitive position and are now poised to emerge with greater earnings and cash flow power as the economy reopens. Many of the defensive measures that companies took to preserve cash flow have evolved into permanently reduced cost structures, such as smaller real estate footprints from permanent moves to hybrid or full work-from-home models. These actions, combined with the proactive moves many of our quality companies made while their smaller or more highly leveraged competitors were focused mostly on survival, have strengthened their moats, broadened their addressable markets, and/or increased their long-term, "normalized" operating margins relative to pre-pandemic levels.

The boating and recreational vehicle (RV) industries offer excellent examples of these kinds of small-cap companies. We made investments in both through the most challenging days of the pandemic and continue to hold companies in each industry based on our view of their ongoing potential for long-term growth. In the case of RVs, the industry has enjoyed growing sales over much of the previous few years as a younger demographic is becoming a reliable source of demand (particularly for smaller vehicles at lower price points) and upgrades, as families grow out of those smaller models. During the second half of 2020 and into 2021, both RVs and boating experienced record-setting retail demand, much of it the result of changes in consumer behavior wrought by the coronavirus.[20] In the case of RVs, these changes were a tailwind for the aforementioned secular shift.

Industry production for both was curtailed in early 2020, when demand was strong.[21] As the summer of 2020 approached and production was resuming, physical distancing was still a necessity, and vacation air travel remained largely grounded. The ongoing effects of the pandemic thus sparked a fresh wave of demand for leisure activities that could be done with small groups, which in turn gave the major players in boating and RVs an atypically lengthy line of sight in terms of production throughout the entire year of 2021. This visibility, along with attendant production levels, has made a meaningful impact in terms of the underlying profitability for the companies we own. And even with travel and other restrictions being lifted, we're continuing to see healthy demand for our holdings in these industries. Indeed, dealer inventories remain depleted or low, and the COVID-19 Delta variant concerns have not adversely affected demand, which remains positive. The pandemic unquestionably elevated demand in these industries, but we believe that consumer behavior has permanently shifted, and that we will see more RVs on the road and more boats in our lakes.

## Small-cap value looks likely to lead amid shifts

We derive our views from our distinctive experience and perspective. Small-cap investing is our primary business, which distinguishes us from other asset managers. As we demonstrated above, understanding trends, recognizing patterns, and identifying the companies that stand to benefit all grow out of our deep knowledge of this broad and diverse asset class.

Our distinct perspective has also provided a very specific lens through which we view the current market. Recent research we've done has led to four key observations that we develop in this piece, two that point to the continuation of existing trends and two that suggest leadership shifts. First, the economic environment and current small-cap valuations support continued solid results; second, the recent return to leadership for small-cap value looks like a sustainable trend; third, we expect a leadership shift with higher-quality

stocks setting the pace; and fourth, we see a stock market increasingly led by differentiation in companies' results and outlooks, offering savvy active managers numerous opportunities to outperform passive indexes. The select areas and themes we outlined above are just a few examples of the compelling opportunities we see for the road ahead.

Along with the historical pattern of trend persistence that follow large spreads in small-cap value outperformance, these factors lead us to a positive conclusion: We expect small-caps to continue advancing, small-cap value to maintain leadership, quality to ascend in importance, and savvy active managers to enjoy significant opportunities to outperform.

## Beyond stock picking: The positive economic environment for small-caps

Unsurprisingly, perhaps, our view of the current state of small-cap valuations is contrarian: we see no cause for alarm. Valuations based on the equity risk premium, which incorporates current interest rates, offer a more revealing signal in our view than the more widely used P/E versus the historical range valuation metric. The current equity risk premium—the latest 12 months' free cash flow divided by enterprise value, minus the 10-year Treasury yield—sits in the 0–1% range, which has historically preceded three-year periods with average annualized returns in the low double digits.[22]

It's also significant that the additional economic expansion seems likely to be both favorable for small-caps and lead to superior results versus large caps. We turn again to history for guidance. During periods of strong economic growth, small-caps have enjoyed a decided performance edge over their large-cap siblings, as seen in Exhibit 12. When nominal US gross domestic product (GDP) growth exceeded 5% in year-over-year periods, the Russell 2000 Index beat the Russell 1000 Index 65% of the time, with an average annual return of 22.1% versus 17.0%. This is especially relevant to the current environment because consensus projections call for nominal GDP growth in the 8–10% range for 2021 and 5–7% for 2022.[23] Any additional fiscal spending would likely raise those projections.

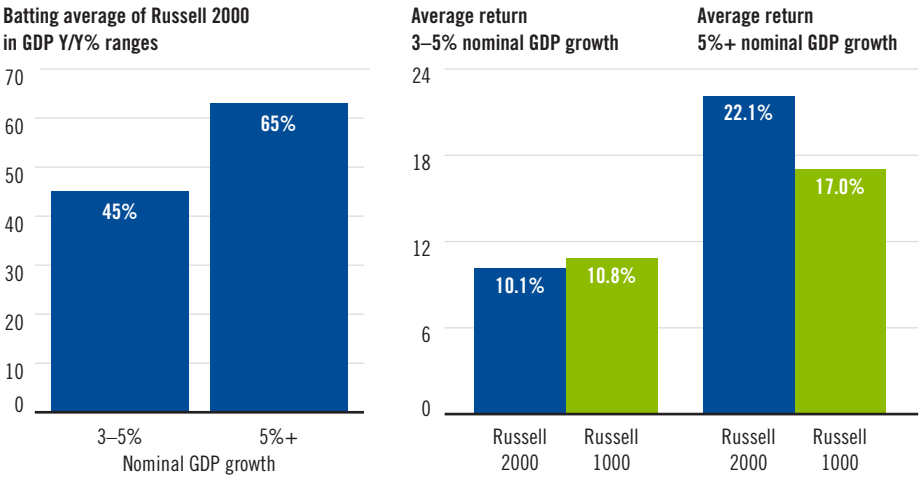
## What follows small-caps' strongest performance periods?

Some commentators have raised concerns about investing in small caps after a period of strong returns. Yet history suggests these apprehensions may be misplaced. We looked at small-cap returns over longer-term periods following their 10 strongest four-quarter periods, such as what we

**SMALL-CAPS HAVE TENDED TO OUTPACE LARGE CAPS IN PERIODS OF HIGH ECONOMIC GROWTH**

**Exhibit 12: Russell 2000 Index vs Russell 1000 Index regimes**

June 30, 2001–June 30, 2021

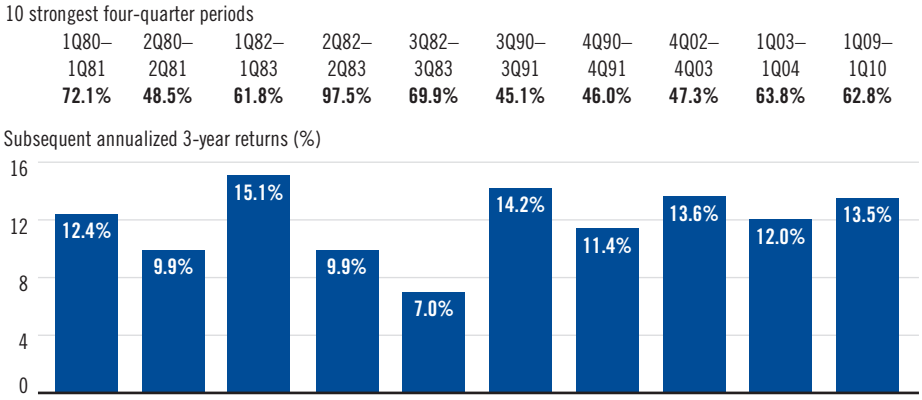



Source: Frank Russell Company. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

**SMALL-CAPS HAVE POSTED ATTRACTIVE RETURNS FOR THE THREE YEARS FOLLOWING STRONG QUARTER-END PERIODS**

**Exhibit 13: Subsequent three-year returns after the Russell 2000 Index's 10 strongest four-quarter periods**

Quarter-end returns as of June, 30, 2021




Source: Frank Russell Company. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

saw for the one-year period ended June 30, 2021. The subsequent three-year annualized returns for the Russell 2000 Index were positive for all 10 observations following these very strong one-year periods, as seen in Exhibit 13. Even more impressive, these average annualized three-year returns that followed the 10 strongest four-quarter periods for the small-cap index was 11.9%—versus the 9.5% average for all quarterly rolling three-year returns since the inception of the Russell 2000 on December 31, 1978. This data indicates to us that this small cap rally has room to run.

Though we are optimistic about the prospects for small-caps in the current market and economic environments, we hasten to add that we also expect results to moderate from the most recent three- and five-year annualized periods for the Russell 2000 Index—which were, respectively, 13.5% and 16.6% for the periods ended June 30, 2021.[24]

## Why the small-cap value cycle looks likely to last

In addition to looking for small caps to continue posting attractive results, we expect small-cap value to continue leading within small cap—and for the same reason as small cap's relative advantage over large caps: Small-cap value has enjoyed a pronounced tendency to outperform small-cap growth when nominal economic growth has been above average. In our studies, nominal GDP growth provides not only a more promising signal of small cap beating large cap but is also a more revealing sign than real GDP growth when analyzing style leadership. Our hypothesis is that small-cap value is both more cyclically sensitive than its growth sibling and a greater beneficiary of inflation for relative earnings growth and valuation.

We looked back over the past 20 years and discovered that in one-year periods with at least 5% nominal GDP growth, the Russell 2000 Pure Value Index outperformed the Russell 2000 Pure Growth Index 70% of the time by an average of 420 basis points (bps), as seen in Exhibit 14. In contrast, when nominal GDP growth fell between 3–5%, the small-cap value index outperformed only 32% of the time and lagged small-cap growth by an average of 100 bps. Keeping in mind the bright forecasts for the global economy we mentioned above, this pronounced edge for small-cap value looks particularly timely.

## Relative valuations favor value

Even in light of small-cap value's recent strong performance, it remains significantly undervalued compared to small-cap growth. In fact, using our preferred valuation metric, Enterprise Value/Earnings Before Interest and Taxes (EV/EBIT), small-cap value was at its lowest relative valuation versus small-cap growth in 20 years at the end of the first quarter 2021, as seen in Exhibit 15 on the next page. We think this extreme relative valuation spread suggests that there's more to come for small-cap value's outperformance.

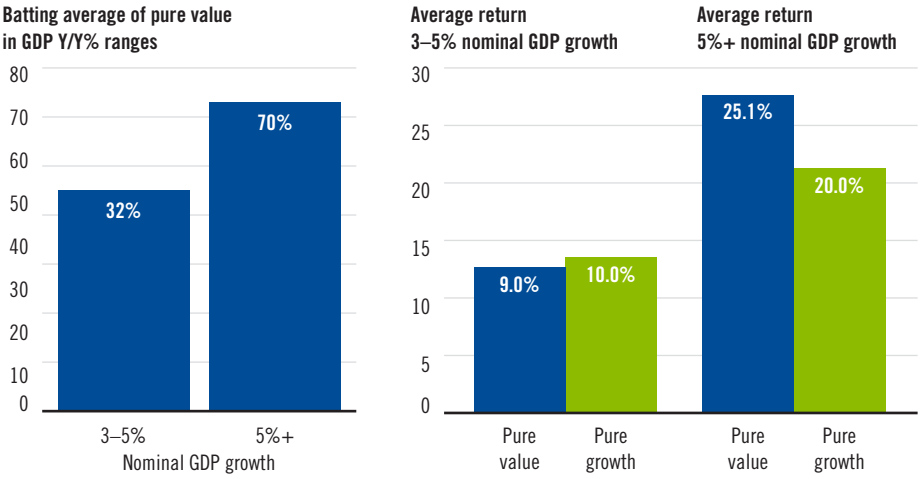
## What might change: High quality ascending?

One of the patterns we have seen over the course of multiple small-cap market cycles is a leadership rotation from low-quality small caps to high-quality small caps as the cycle matures. While Royce's portfolio managers use multiple parameters to identify high-quality businesses, for purposes of illustration we can use a company's relative Return on Equity (ROE) as a straightforward proxy for quality.

We analyzed the performance for the 20% of small caps with the highest ROE's and compared it with the 20% with the lowest ROE's, as seen in Exhibit 16. Our study revealed an illuminating pattern over the last four full small-cap cycles. In the decline phase (market peak to trough), high-quality—that is, high ROE—stocks declined on average less than the index and much less than the low-quality, or low ROE, stocks. This relative leadership

**STRONG ECONOMIC EXPANSION HAS FAVORED VALUE**

**Exhibit 14: Rolling 12-month returns for the Russell 2000 Pure Value vs Russell 2000 Pure Growth Indexes**
June 30, 2001–June 30, 2021




Source: Frank Russell Company. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

reversed in the first year after the market trough, when the average return of low-quality small caps rebounded strongly, leading the index (and high ROE) stocks. However, this leadership pattern reversed again in the second year of the market cycle, when high ROE stocks regained the lead.

This result is consistent with our own experience, in that market rebounds are initially driven largely by valuation expansion, where the lowest-quality stocks rebound the most off their relatively more depressed valuations. Nevertheless, after valuations return to a more historically typical range, the differentiation between company fundamentals begins to drive relative results. And in a more fundamentally focused market environment, the superior attributes of high-quality companies really shine. This observation is also particularly timely as the current small-cap rally extends beyond its one-year anniversary in late March 2021.

### SMALL-CAP VALUE SELLS AT ITS LOWEST VALUATION TO GROWTH IN MORE THAN 20 YEARS

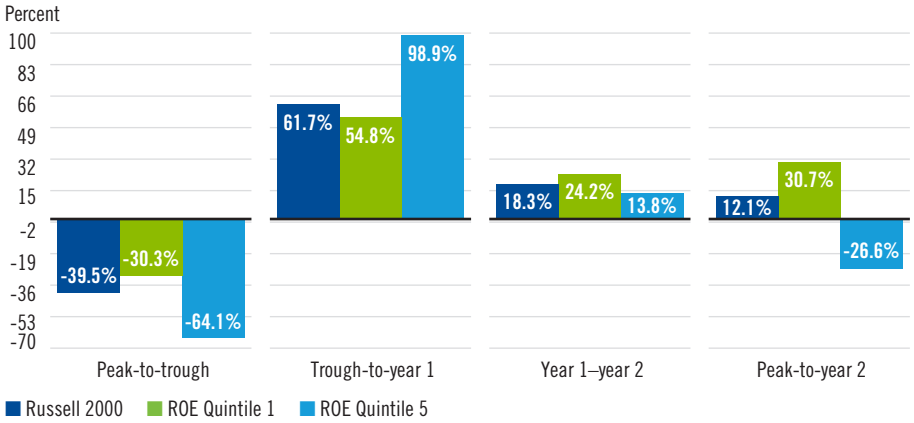
**Exhibit 15: Russell 2000 Value and Growth shifted median relative LTM EV/EBIT1* Russell 2000 Value/Growth Indexes**
June 30, 2001–June 30, 2021


*Last twelve months enterprise value/earnings before interest and taxes.

Source: FactSet. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is no guarantee of future results.**

### HIGH-QUALITY AND LOW-QUALITY STOCKS HAVE HISTORICALLY HAD DIFFERENT PERFORMANCE PROFILES—LOW QUALITY HAS LED EARLY WHILE HIGH QUALITY HAS LED IN THE SECOND YEAR OF SMALL-CAP REBOUNDS

**Exhibit 16: Average Russell 2000 Index return on equity quintile performance for past four market recoveries**




Source: FactSet. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is no guarantee of future results.**

**The chart shows the average returns for the following market cycle periods**

| Peak | Trough | 1 year from trough | 2 years from trough |
|---|---|---|---|
| March 9, 2000 | October 9, 2002 | October 9, 2003 | October 9, 2004 |
| July 13, 2007 | March 9, 2009 | March 9, 2010 | March 9, 2011 |
| April 29, 2011 | October 3, 2011 | October 3, 2012 | October 3, 2013 |
| June 23, 2015 | February 11, 2016 | February 11, 2017 | February 11, 2018 |

## Set a course for small-cap

It's no secret that small caps are leading the equity markets so far in 2021 and that small-cap value is enjoying a dynamic resurgence. Small-cap stocks in general—and value in particular—have done so well, in fact, that certain investors might be under the impression—mistaken in our view—that leadership stints for both may be nearing their end. As small-cap specialists with nearly 50 years of experience, we could not disagree more. Even allowing for the differences among their distinct strategies, most of our portfolio managers continue to identify common areas and/or themes where they are finding attractive opportunities. These include beneficiaries of COVID-19-created shifts in leisure activities, such as the aforementioned boating and RVs industries, well-managed regional banks, particularly those in areas with growing populations, luxury brands in clothing and perfumes, supply chain and logistics experts, and a looser collection of beneficiaries of the robust housing and remodeling markets, including furniture manufacturers and rental retailers, building products suppliers, and title insurance companies.

# Compound value & perfect foresight P/E

**Alan Bartlett**
Chief Investment Officer, Templeton Global Equity Group

## Value versus the value factor

The concept of value investing is too often conflated with the value factor, which causes many investors to think formulaically or one-dimensionally about value. On the contrary, we believe value is one of the most dynamic and creative investment approaches imaginable. At Templeton, our core valuation metric is FY6 P/E, which compares today's share price to our forecast of a company's earnings in six years' time. This metric forces us to be forward-looking and to think creatively about the various ways that value can be created over time.

## The lessons of "perfect foresight"

We recently conducted an analysis to illustrate the efficacy of this approach over time. To do so, we introduced the concept of "Perfect Foresight" FY6 P/E, an *ex-post* metric that divides price by the realized earnings in fiscal year six. The analysis is somewhat theoretical because obviously it's impossible to know what earnings and growth rates will be six years into the future, but *if* we had a crystal ball, what would be the most effective way to invest with that information?

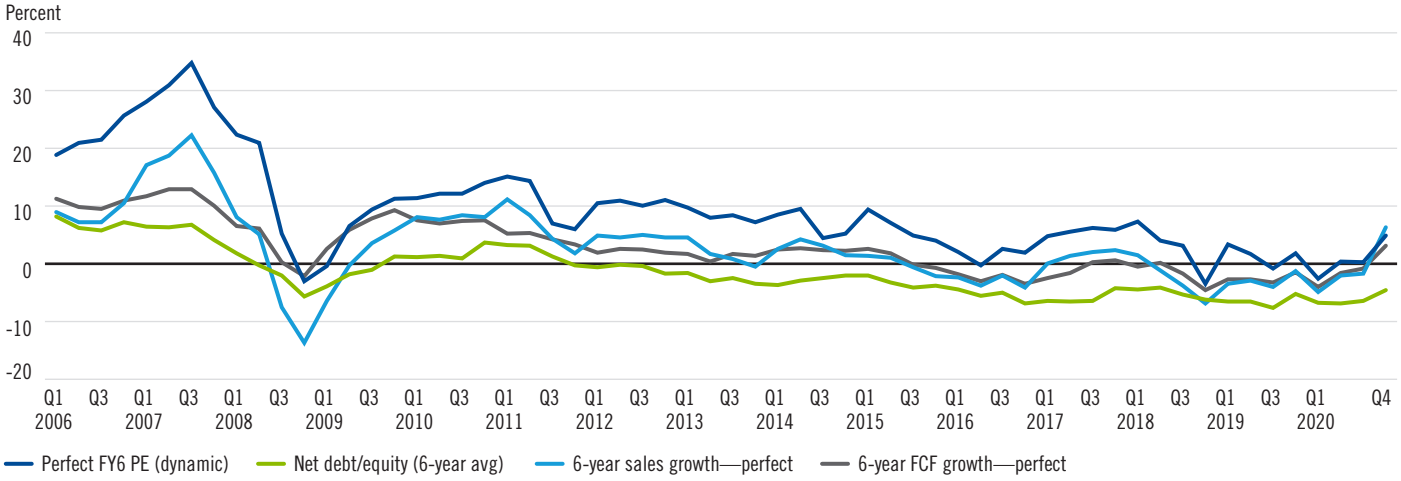
In this study, Perfect Foresight FY6 shows the return of the most attractively priced decile of stocks relative to their actual realized earnings six years into the future. We introduce similar conventions for net debt-to-equity, sales growth and free cash flow growth. As Exhibit 17 shows, Perfect Foresight FY6 is above the other three lines for most of the look-back period, indicating that investing in genuinely "cheap" stocks would have been a more effective approach than investing just in stocks with strong balance sheets or high sales and free cash flow growth—even if you could know those things with perfect foresight.

## Compound value: the union of multiple elements

Our concept of value is rooted in the approach established by our founder, Sir John Templeton. "Remain flexible and open-minded about types of investment," he wrote. "There are times to buy blue chip stocks, cyclical stocks, corporate bonds, US Treasury instruments, and so on. And there are times to sit on cash…The fact is that there is no one kind of investment that is always best."

**PERFECT FORESIGHT**

**Exhibit 17: Equal weighted annualized return over six years in excess of MSCI ACWI for top decile of factor rolling quarterly**
As of December 31, 2020




Source: Templeton Global Equity Group, FactSet. The MSCI All Country World Index (ACWI) captures large- and mid-cap representation across 23 developed Markets and 27 emerging markets countries. MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

## ANALYZING THE PERFECT FORESIGHT

This analysis appears to mostly vindicate a long-term value investment framework, but it also highlights an anomaly—the recent overtaking of "perfect foresight value" by "perfect foresight growth." Indeed, over the past six years, even if we had perfect foresight on the earnings of every company in the market, this would have been outweighed by simply picking companies with the best sales growth and completely ignoring valuation. This is very different from talking about the performance of "growth" and "value" benchmarks. Real valuation—with perfect foresight—has been beaten by just chasing sales growth in the last six years. In our view, this will not persist long term. As far as our analysis can see looking backward it has not in the past, and so we do not expect it will going forward. Markets have become hugely distorted by the apparent "rule change" brought on by sustained low interest rates (which expanded multiples in long-dated growth stocks) and a global pandemic (with "stay-at-home" implications that benefited technology sector "disruptors"). The speculative behavior of parts of the market in recent quarters should be put in this context—including SPACS,[25] cryptocurrencies, meme stocks,[26] etc.

Today, we call this approach compound value, because—like a chemical compound—it results from the union of multiple elements, which can include:

1. **Price:** the cost of a share in earnings, cash flow and assets
2. **Quality:** the predictability, variability and risks associated with fundamentals
3. **Growth:** both the rate of change and its sustainability/duration
4. **Event:** the tangible, fundamental and probable change likely to unlock value

Thinking about value as arising through the union of multiple elements has numerous benefits. First, it expands the opportunity set beyond those stocks that screen cheap on backward-looking metrics (i.e., the value benchmark). Second, it encourages diversification by combining multiple value profiles into a portfolio. And third, it improves the quality of our analysis by introducing new frameworks and data sets for thinking about and monitoring value creation.

The impact of considering multiple characteristics (i.e., growth *and* value *and* quality, etc.) versus just investing in one theme alone is illustrated in Exhibit 18, which calculates the returns of MSCI World Index stocks based on their perfect foresight FY6 P/E and their six-year earnings growth rate.

Clearly, the best-performing stocks were those that combined the cheapest valuation with the highest growth rate. Take, for instance, the left-hand column showing the cheapest group of stocks (titled "6 or Less"). On average, companies that were able to be acquired this cheaply relative to their future earnings delivered very strong returns over the next six years, highlighting the importance of valuation. However, the returns really get supercharged when we combine cheap valuations with a high growth rate (top left of heat map). The stocks that had both the cheapest valuations and highest growth rates delivered annualized gains of 25.4% versus just 15.0% for those stocks that were simply cheap but lacked growth. Over the course of a six-year period,

### COMBINING CHARACTERISTICS

**Exhibit 18: Annualized six-year return average over 11 periods from 2010–2020**

| Sales growth rate over 6 years | 6 or Less | 6 to 8 | 8 to 10 | 10 to 12 | 12 to 14 | 14 to 16 | 16 to 18 | 18 to 20 | 20+ |
|---|---|---|---|---|---|---|---|---|---|
| 20% + | 25.4 | 16.7 | 12.4 | 8.5 | 11.7 | 9.6 | 9.8 | 8.0 | 6.4 |
| 15% to 20% | 19.5 | 15.9 | 13.5 | 10.3 | 10.8 | 7.8 | 4.5 | 4.0 | 1.1 |
| 11% to 15% | 20.3 | 17.0 | 13.0 | 9.7 | 7.9 | 8.0 | 6.7 | 5.0 | -2.3 |
| 9% to 11% | 20.2 | 15.0 | 11.4 | 8.2 | 6.5 | 4.8 | 4.0 | 5.0 | -1.3 |
| 7% to 9% | 18.4 | 14.6 | 12.2 | 10.4 | 8.7 | 7.1 | 5.3 | 6.6 | -1.3 |
| 5% to 7% | 19.0 | 15.8 | 12.8 | 8.9 | 6.7 | 8.5 | 6.1 | 4.3 | -1.2 |
| 3% to 5% | 19.5 | 14.9 | 11.4 | 8.7 | 7.4 | 5.3 | 3.8 | 3.0 | -1.6 |
| 0% to 3% | 16.2 | 13.4 | 10.0 | 8.0 | 7.3 | 5.5 | 4.7 | 1.9 | -2.3 |
| 0% or Less | 15.0 | 11.4 | 9.4 | 8.2 | 6.1 | 4.3 | 3.1 | 1.6 | -4.2 |

Source: Templeton Global Equity Group, FactSet. As of December 31, 2020. For illustrative purposes only and not reflective of the performance or portfolio composition of any Franklin Templeton funds. **Past performance is not an indicator or a guarantee of future results.**

Over the last decade, low interest rates promoted an environment in which strong sales growth could be funded cheaply and turned into profits. So, in reality, many "growth" companies were actually "value." This is why we believe that investors who think in the narrow terms of "value versus growth" are limiting themselves unnecessarily.

that 25.4% annualized gain of cheap stocks with high growth compounds to a 289% cumulative return compared to just 131% for the 15.0% annualized return experienced by cheap stocks with no growth.

The initial reaction to this observation might be to speculate that this group was probably expensive on near-term earnings at the time, and now only looks cheap on perfect foresight FY6 because they massively grew into their multiple. In other words, the top left was probably all "growth" stocks to begin with. Interestingly, however, this was not the case. While 58% of the top left segment of the table were classified as growth stocks by MSCI in the first year of the study, a full 42% were classified as value. Of those, many were cyclicals that benefited from a tailwind; others were successful restructuring stories; and others still were simply misunderstood companies whose prospects were underappreciated by the market.

What becomes apparent is that markets sometimes offer more "value" in stocks that depend on longer-term earnings growth, while at other times markets underprice companies with relatively low growth. Over the last decade, low interest rates promoted an environment in which strong sales growth could be funded cheaply and turned into profits. So, in reality, many "growth" companies were actually "value." This is why we believe that investors who think in the narrow terms of "value versus growth" are limiting themselves unnecessarily. High growth rates enhance the return potential of low valuation stocks, and low valuations enhance the return potential of high growth-rate stocks. Forecasting growth is a critical part of effective value investing. The same could be said for forecasting quality, competitive advantage, asset growth, cash flows, and so on. Combining "cheap" long-term valuations with other attributes not only enhances returns, it mitigates risk because the thesis does not depend on a single factor, but rather, benefits from a variety of drivers.

Because true value arises in a myriad of ways, investors need a framework for classifying the various "types" of value and the impact they can have on portfolio risk and return through a cycle. At Templeton, we have identified five primary types of value, which we introduce below. We have also analyzed our complete database of stocks (every company that our analysts have formally researched and assigned a buy, sell or hold rating) and share some generalized observations about the "type" of stocks that fall in each value category.

1. **Classic value**—*where the past is a guide to the future.* This is the largest value category in our database, comprising nearly 50% of all stocks on the database. Just under half of all classic value stocks hail from either the industrials or consumer discretionary sector, though all 11 GICS[27] sectors have some representation among the classic value stocks in our database. These are stocks investors have become excessively negative on due to cyclical or company-specific challenges that we believe are temporary in nature, and therefore create mean reversion potential for longer-term investors.

2. **Mispriced growth**—*where the future will be better than the past.* This is the next biggest grouping in our database, comprising nearly 25% of Templeton stocks. Information technology stocks comprise the highest share (23%) of our mispriced growth bucket, followed by consumer discretionary (18%), industrials (15%) and health care (14%). Again, all 11 GICS sectors are represented in mispriced growth, though energy, real estate and utilities were the least represented. Mispriced growth stocks are those with strong long-term growth potential that is being underestimated (and therefore undervalued) by the market.

3. **Quality**—*where a longer-term view is appropriate.* Quality is the classification we have assigned to 17% of the stocks in our global database. The most represented sectors within the quality bucket are consumer discretionary (27% of all our quality stocks) and information technology (19%). Industrials (14%), consumer staples (13%) and health care (9%) are also reasonably well represented. As with mispriced growth, utilities, real estate and energy are all the

least represented in the quality grouping. The companies that we characterize as "quality" usually combine durable competitive advantages with strong financial positions and excellent management teams.

4. **Discounted assets**—*where unlocking of asset value drives the thesis.* Discounted asset stocks make up just 7% of all the names on our database. Real estate is the most represented sector in this value grouping (26%), followed by communication services, consumer discretionary and industrials (at 13% each). These are companies whose value resides in their diverse portfolio of physical (in the case of real estate) or intellectual properties. They are often valued using a sum-of-the-parts methodology and valuation tends to be very sensitive to growth assumptions and discount rates. The investment thesis for these stocks sometimes features a catalyst that we believe will unlock the value of an undervalued asset portfolio.

5. **Discounted cashflow**—*where cash generation is key.* The discounted cashflow value type comprises just 6% of the names on our database. 27% of discounted cash flow stocks hail from the basic resource sectors of energy and materials. Other notable sectors in this value category include communication services (19%), consumer staples (14%) and industrials (14%). These types of stocks primarily derive value from their ability to generate steady, reliable and (ideally) growing cash flows. They often have relatively high, but predictable, fixed costs and therefore feature strong operating leverage in constructive environments. Their values tend to be very sensitive to discount rates, growth rates, and in the case of the resource stocks, commodity price assumptions.

This framework helps us focus on what matters most. It encourages diverse investment ideas and promotes accountability and intellectual honesty in our process. It emphasizes price discipline, but acknowledges the multiple ways that value is created. It helps us better understand how portfolios are structured and likely sensitivities to different macro environments and outcomes. In short, it creates a much more versatile and dynamic way of thinking about value than simply relying on accounting metrics to determine what is "cheap." It's a way of ensuring that the key attributes of Sir John Templeton's approach—open-mindedness, discipline, flexibility and a long-term viewpoint—are encapsulated in the work we do today.

**Endnotes**

1. Free cash flow (FCF) is the cash flow available for the company to repay creditors or pay dividends and interest to investors.
2. Enterprise value is a measure of a company's total market value, often used as a comprehensive alternative to equity market capitalization that includes debt.
3. Generally Accepted Accounting Principles (GAAP) is the accounting standard adopted by the US Securities and Exchange Commission (SEC).
4. A Credit Suisse study found that of companies ranked in low, medium and high ESG baskets, companies in the high initial basket outperformed by 2.2% if their ESG ranking remained the same, while companies in the medium basket outperformed by 1.9% and 0.8% if they improved or maintained their ESG rankings, respectively. Companies with deteriorating ESG scores all underperformed. Past performance is not an indicator or a guarantee of future results.
5. Source: John Deere, "+Gain Ground with See & Spray™ Select," Product Video, *YouTube*, March 2, 2021.
6. Source: TE Connectivity. *Connecting Our World, 2020 Corporate Responsibility Report*.
7. See our paper, "Did the Fourth Industrial Revolution Kill Mean Reversion? We Think So," September 2021.
8. Source: Wilson, B. "The man who made 'the world's first personal computer'," *BBC News*, November 6, 2015. Inflation numbers updated as of October 2021 by Franklin Equity Group.
9. Source: Klein, M. "Why the Post-Pandemic Future Could Be Bright: Productivity Gains Could Be Here to Stay," *Barron's*, January 8, 2021.
10. Source: Goolsbee, A. and P. Klenow. 2018. "Internet Rising, Prices Falling: Measuring Inflation in a World of E-Commerce." *AEA Papers and Proceedings*, 108: 488–92.
11. Source: Adobe2021 Digital Economy Index and Consumer Price Index, as of September 2021. Calculations by Franklin Equity Group.
12. Source: Charm, T., Coggins, B., Robinson, K. and J. Wilkie. "The great consumer shift: Ten charts that show how US shopping behavior is changing," *McKinsey & Company*, August 4, 2020.
13. Source: US Department of Commerce, "Quarterly Retail E-Commerce Sales 1st quarter 2021," News Release, May 18, 2021.
14. Source: Barrero, J., Bloom, N., and S. Davis. 2021. "Why Working From Home Will Stick," *Becker Friedman Institute working paper*, No. 2020-174.
15. Source: World Economic Forum, *The Future of Jobs Report 2020*, October 2020.
16. Source: "Amid the Labor Shortage, Robots Step in to Make the French Fries," *The Wall Street Journal*, August 7, 2021.
17. Source: Beilfuss, L. "The Labor Shortage Is Worse Than It Looks, and Help Isn't on the Way," *Barron's*, August 2, 2021.
18. Source: FactSet, US Department of Labor, Institute for Supply Management (ISM), RBC Capital Markets.
19. Source: Berkshire Hathaway, Inc.
20. Source: Statistical Surveys, Inc. (SSI). As of June 2021.
21. Source: RV Industry Association, "Production of RVs Increase In 2020 With Growing New Interest During Pandemic," News Release, December 28, 2020.
22. Sources: Frank Russell Company, Bloomberg. As of June 30, 2021.
23. There is no assurance that any estimate, forecast or projection will be realized.
24. Source: Frank Russell Company. As of June 30, 2021.
25. SPAC, or special purpose acquisition company, is another name for a "blank check company," meaning an entity with no commercial operations that completes an initial public offering (IPO).
26. A meme stock is a stock that has seen an increase in volume not because of how well the company performs, but rather because of hype on social media and online.
27. Global Industry Classification Standard, an industry classification system developed by MSCI and S&P Dow Jones.

## Franklin Templeton Thinks: Equity Markets

highlights the global views our equity investment teams have across developed and emerging economies, sectors, and individual companies. Each quarterly issue spotlights fresh insights that our analysts and portfolio managers bring to active security research, examining risks and opportunities from both growth and value frameworks.

## About the Franklin Templeton Investment Institute

The mission of the Investment Institute is to deliver research-driven insights, expert views and industry-leading events for clients and investors globally through the diverse expertise of our autonomous investment groups, select academic partners and our unique global footprint.

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Templeton Global Equity Group

**WHAT ARE THE RISKS?**

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# Notes

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