PZENA Investment Management

# FOURTH QUARTER 2020 COMMENTARY

## Visibility to recovery helped value shares outperform by a wide margin. Better growth prospects for the next two years at a fraction of the price could be the impetus for a long and sustained value rally.

### MOMENTUM IS WITH VALUE

The market rally off the March 23rd bottom picked up significant momentum in the fourth quarter. Vaccine announcements gave investors visibility to the end of the pandemic and impending earnings recovery, leading to improved sentiment toward value shares.

Fourth quarter returns were decidedly in value's favor, and while the rotation to value has been long-awaited and impossible to predict, it should hardly be surprising. Discrete events, such as the TARP announcement during the global financial crisis or the introduction of vaccines in this COVID downturn, often signal the beginning of long and enduring value rallies, especially when they follow the type of long, deep anti-value cycle of recent experience.

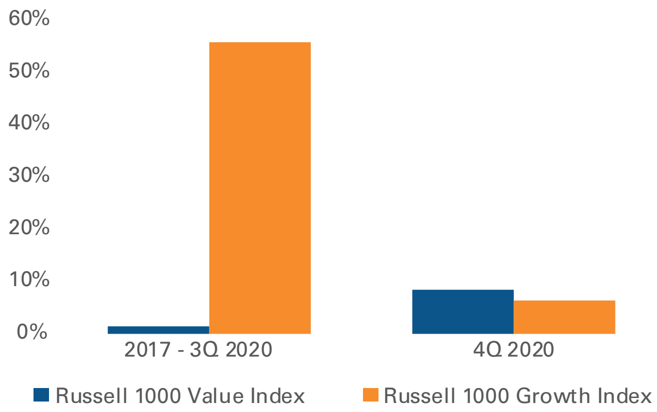
We believe results to date could signal the start of a long pro-value cycle. Several catalysts (see our recent piece: "Catalysts for Change") are aligning in value's favor, the most visible of which are companies' earnings growth as they recover from the COVID recession, and the normalization of multiples that investors assign to those earnings.

### THE 4Q VALUE RALLY IN CONTEXT

Value's powerful fourth-quarter rally was driven in roughly equal parts by EPS growth and multiple expansion, the latter accelerating after the announcement of successful vaccines. However, the massive differential in earnings multiples between value and growth stocks that developed over the last three years was only minimally retraced; value multiples still trail growth by a wide margin (Figure 1). As we wrote last quarter, multiples have historically mean reverted over the cycle. If history is prologue, the re-rating of value stocks is in its early days and can be a powerful contributor to value's returns as this multiple differential normalizes.

[1] Source: FactSet consensus estimates of 2020 earnings

**Figure 1: Value's Multiple Has More Ground to Make Up**




Source: FactSet, Pzena analysis
Percentage change in multiples based on Price/Earnings. Full year 2020 earnings based on consensus estimates as of 9/30/2020 and 12/31/2020.

Earnings, on the other hand, have contributed the most to long term returns, and we expect this cycle to be no different. The vast majority of value's underperformance this year came from a collapse in earnings, setting the stage for a powerful earnings recovery coming out of the downturn.

### RECESSION HIT VALUE STOCKS HARD

The unprecedented impact to the economy from the COVID lockdowns was particularly unkind to cyclical stocks, most notably in energy, financials, and travel-related businesses. The carnage, however, created a once-in-a-generation opportunity to buy market leaders with strong balance sheets and liquidity to survive the severe disruption. Stock selection, however, has been crucial, as many companies faced uncertain futures, including some with financial positions that might not survive a prolonged downturn. For a disciplined value investor, it was an opportunity to deploy capital into well positioned companies that had been valued as if COVID would never end.

The disproportionate impact on earnings can be seen in Figure 2. While the earnings of the Russell 1000 Growth Index are estimated to have risen by 6%[1] in 2020, Russell 1000 Value Index earnings fell by 20%, and the earnings of deep value stocks fell by 21%.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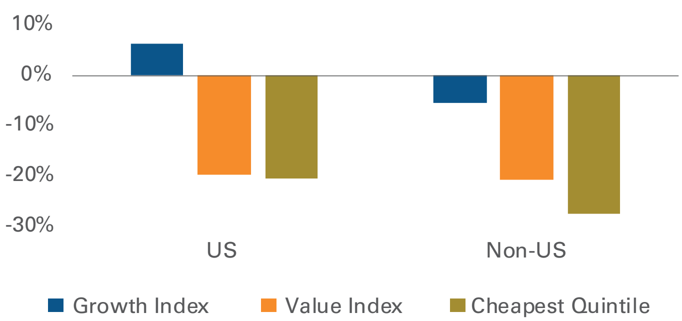
Similarly, outside the US, earnings are estimated to have fallen by 5% for growth stocks, by 21% for value stocks, and by 28% for deep value stocks.

So then, what might we expect as global economic activity recovers?

**Figure 2: Earnings for Value Companies Collapsed in 2020**

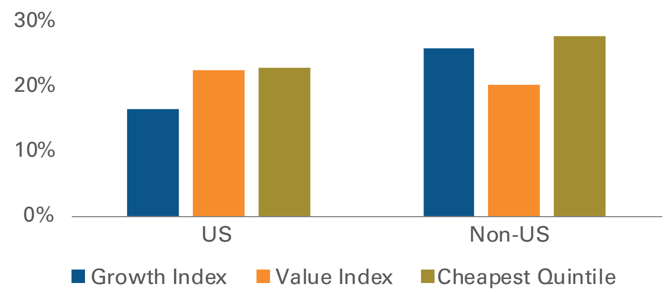



Source: Bloomberg, FactSet, Pzena analysis
Full year 2020 earnings based on consensus estimates as of 12/31/2020. US and Non-US Growth is the Russell 1000 Growth Index and MSCI ACWI ex USA Growth Index. US and Non-US Value is the Russell 1000 Value Index and MSCI ACWI ex USA Value Index. US and Non-US Cheapest Quintile is the cheapest 20% of stocks based on Pzena's estimates of their price-to-normal valuations, measured on an equally weighted basis within their relative universes. Universes comprise the largest stocks by market capitalization for each region as follows: ~1,000 largest US; ~1,500 largest Non-US.

## EARNINGS RECOVERY FAVORS VALUE STOCKS

Companies reacted to the operational challenges of COVID-19 the way they do to any crisis: by cutting costs, drawing down inventories, and suspending capital expenditures. Corporate reaction to the onset of COVID was swift, particularly among the cyclical companies most affected by the downturn. These aggressive actions, coupled with a rebound in economic activity, should provide significant operating leverage to sustain a strong earnings recovery over the next couple of years, especially among value stocks.

**Figure 3: 2020E-2022E Earnings Growth (CAGR) is Faster Among Cheaper Stocks**




Source: Bloomberg, FactSet, Pzena analysis
Full year 2020 and 2022 earnings based on consensus estimates as of 12/31/2020. US and Non-US Growth is the Russell 1000 Growth Index and MSCI ACWI ex USA Growth Index. US and Non-US Value is the Russell 1000 Value Index and MSCI ACWI ex USA Value Index. US and Non-US Cheapest Quintile is the cheapest 20% of stocks based on Pzena's estimates of their price-to-normal valuations, measured on an equally weighted basis within their relative universes. Universes comprise the largest stocks by market capitalization for each region as follows: ~1,000 largest US; ~1,500 largest Non-US.

Looking across the universe of US stocks, the Russell 1000 Growth Index is expected to grow earnings at a 17% compound annual growth rate[2] (CAGR) over the next two years and is trading at 27x 2022 estimated earnings. The Russell 1000 Value Index is expected to grow earnings at 23% annually over the same period and is trading at only 15x 2022 estimates. Importantly, deep value is also expected to grow earnings at a 23% CAGR, while also offering a significant opportunity for re-rating, trading at just 11x 2022 estimates. Even this appraisal might be conservative since 2021 earnings estimates for financials and energy stocks within the S&P 500 Index are 29% and 37% below 2019 results, respectively, setting the stage for potential earnings beats from these two sectors. These two sectors represent a large portion of the cheapest stocks.

Similar dynamics are at play outside the US. The MSCI ACWI ex-US Growth Index is expected to grow earnings at a 26% CAGR over the next two years and now trades at 20x 2022E, while the MSCI ACWI ex-US Value Index is expected to grow earnings at 20%, and trades at 11x 2022E. Once again, deep value offers the best opportunity, with earnings expected to grow at a 28% CAGR, while trading at just 8x 2022E.

[2] Source: FactSet consensus earnings estimates

**2022E P/E Multiples**

| | US | Non-US |
|---|---|---|
| Growth | 27.3x | 20.0x |
| Value | 15.2x | 10.6x |
| Cheapest Quintile | 10.9x | 8.4x |

Source: Bloomberg, FactSet, Pzena analysis
Full year 2022 earnings based on consensus estimates and pricing as of 12/31/2020. US and Non-US Growth is the Russell 1000 Growth Index and MSCI ACWI ex USA Growth Index. US and Non-US Value is the Russell 1000 Value Index and MSCI ACWI ex USA Value Index. US and Non-US Cheapest Quintile is the cheapest 20% of stocks based on Pzena's estimates of their price-to-normal valuations, measured on an equally weighted basis within their relative universes. Universes comprise the largest stocks by market capitalization for each region as follows: ~1,000 largest US; ~1,500 largest Non-US.

## CONCLUSION — EARLY STAGES OF THE VALUE CYCLE

We concluded last quarter's commentary with a simple question: If you're not going to invest in value now, when will you? Vaccine announcements drove a dramatic turn to value in the fourth quarter, as investors saw a path to economic recovery. Given the length of past value cycles, the massive gap in multiples that has yet to normalize, and the prospects for earnings recovery, it certainly seems like an opportune time to turn to value and benefit from what could be a long and enduring value cycle.

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