

THIRD QUARTER 2021 COMMENTARY

The opportunity in value stocks remains compelling. Long-term investors should ignore the noise and focus on cheap valuations, strong operating metrics, and the solid real returns value stocks offer.

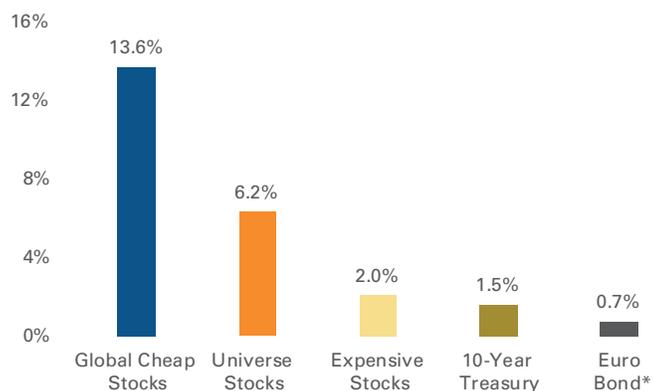
FOCUS ON THE VALUE OPPORTUNITY

We have argued for some time that the opportunity in value stocks is compelling: valuations are cheap, operating metrics are strong, and they offer high single-digit to low double-digit real returns depending on geography. Despite value's fantastic fundamentals, it has seen uneven performance among the ebbs and flows of macroeconomic uncertainties. Given the severe downturn in economic activity that occurred at the outset of the pandemic, it should not be surprising that economic recovery is coming in fits and starts. We believe long-term investors should be rewarded over a long and enduring pro-value cycle if they look past these temporary setbacks, ultimately benefitting from the fundamentals that remain in place.

POSITIVE REAL EARNINGS YIELD FOR VALUE

Value stocks are one of the few investment opportunities offering positive projected real returns, where the earnings yield is well in excess of expected inflation. The earnings yield of cheap stocks, or the price one pays for normalized earnings, ranges from low double digits to mid-teens across the world. Alternatively, investors have bid up the price on global fixed income products to the point where there is little yield to be earned on "safe" assets (Figure 1).

Figure 1 – Cheap Stocks Currently Have Superior Earnings Yields



Source: FactSet, Pzena analysis

Cheap/Expensive earnings yield are based on the median stock within the cheapest and most expensive quintile based on price-to-normal earnings. The quintiles are measured on an equally weighted basis within the ~2,000 largest global stock universe. Price-to-normal earnings are Pzena's estimates. Universe stocks is the earnings yield of the median stock within the entire universe. *Yield of the Bloomberg Barclays Euro Aggregate 10+Y Index. The index is a benchmark that measures the Treasury component of the Euro-Aggregate and consists of fixed-rate, investment grade public obligations of the sovereign countries in the eurozone; the index currently contains euro-denominated issues from 17 countries. Data as of September 30, 2021.

Meanwhile, expensive stocks have continued to get more expensive. Today the market cap of stocks that are trading at greater than 10x sales is more than twice what it was in the internet bubble and three times the market cap of the cheapest quintile (Figure 2).

Figure 2 – Total Market Cap of Stocks with Price-to-Sales Greater than 10x



Source: Kailash Concepts

Universe is the Russell 3000 Index. Data as of August 31, 2021.

However, history has not been kind to stocks that trade over 10x sales. Over the last 32 years, stocks trading at greater than 10x sales have generated a compound annual return of -0.3%, versus the broader US market of about 11.0%.

VALUE CYCLES ARE BUMPY

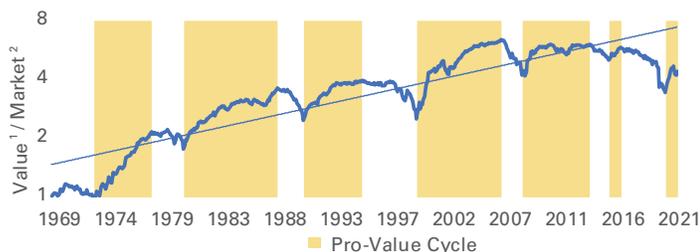
Contributing to the compelling valuation disparity, June 2021 was one of the worst months for value, as the Russell 1000 Value Index trailed the Russell 1000 Growth Index by 7.4 percentage points (one of only 17 months over the past 42 years in which value trailed growth by more than 5 percentage points). And as value trailed again in July and August, investors wondered if the value rally was over.

The anti-value period in markets that has lasted for much of the last decade is a potent reminder of the cyclical nature of value. However, it is such periods, during which the majority of investors give up on cheap stocks, that create the conditions for the strategy to work over the long-term.

While value has outperformed the broader market by 320 basis points per year on average over the last 50+ years, it hasn't happened in a straight

line. In fact, even during powerful value cycles, there are numerous shorter periods in which value underperforms the market (Figure 3).

Figure 3 – History of Value¹ Outperformance Vs. The Market²



Pro-Value Cycles	Value ¹	Market ²	Relative Performance	# Months
Jul '73-Mar '78	134.8%	7.6%	127.2%	57
Dec '80-Aug '88	414.7%	150.3%	264.4%	93
Nov '90-Aug '95	248.4%	117.1%	131.3%	58
Mar '00-Feb '07	190.6%	13.7%	176.9%	84
Dec '08-Jun '14	250.3%	142.8%	107.5%	67
Feb '16-Jan '17	40.2%	19.6%	20.6%	12
Average	213.2%	75.2%	138.0%	62

Cycle To Date

Oct '20-Sep '21	69.7%	32.3%	37.4%	12
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Source: Sanford C. Bernstein & Co., Pzena analysis
 Blue solid line within chart represents a relative index displayed using a logarithmic scale.
¹Cheapest quintile price to book of the ~1,000 largest US stock universe (equal-weighted data). ²Cap-weighted universe data.
 Returns do not represent any specific Pzena product or service.
 We define a cycle as when the relative performance of value vs. the market from the last peak or trough is at least +/-1500 basis points and has persisted for a minimum of 12 months.
 Data in US dollars through September 30, 2021. Past performance is not indicative of future returns.

Over the past 42 years, the Russell 1000 Value Index has outperformed the Russell 1000 Growth in 51% of all months. Interestingly, during pro-value cycles, or periods when value dominates growth, this only improves to 56% (Figure 4).

Figure 4 – Bumps in the Value Cycle

	All Periods	Pro-Value Cycles
Frequency Value Beats Growth	51%	56%
Months Value Trails Growth >5%	17	8

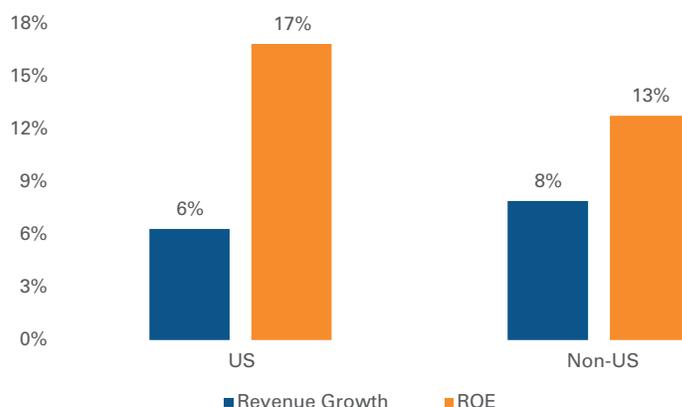
Source: FTSE Russell, Sanford C. Bernstein & Co., Pzena analysis
 Value = Russell 1000 Value Index. Growth = Russell 1000 Growth Index.
 The pro-value cycle dates are derived from the previous figure.
 Data in US dollars from January 1, 1979 – September 30, 2021. Past performance is not indicative of future returns.

Even among the 17 most extreme months of value underperformance, eight of them occurred during pro-value cycles, and four of those happened during the first 20 months of the post-Tech Bubble period, which was one of the greatest value cycles on record. That cycle lasted more than seven years. Investors who clung to growth stocks, failing to appreciate that the cycle had turned, on average missed out on more than 87 percentage points of value outperformance versus the market, or about half the value outperformance for the entire cycle.

STRONG OPERATING METRICS

Low multiples and long cycles are great, but at the end of the day an investor is buying shares of businesses, and ideally good businesses. One typical criticism of cheap stocks is the myth that they are low quality. When taken in aggregate, the profile of cheap stocks is quite different. The stocks currently in the cheapest quintile have generated an historical average return on equity (ROE) in the low-to mid-teens across US and non-US geographies. Additionally, these stocks have historically grown the top line at mid-single digits, proving a fruitful hunting ground for the active value investor (Figure 5).

Figure 5 – Operating Metrics of the Cheapest Quintile



Source: FactSet, Reuters, Pzena analysis
 US and Non-US Cheap Stocks 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. Return on equity and revenue growth average calculated over trailing 10-year period.
 Data as of Sep 30, 2021. Does not represent any specific Pzena product or service.

POWERFUL EARNINGS GROWTH AT A SIGNIFICANT DISCOUNT

Value stocks were hit particularly hard, as the world went into lockdown in 2020. As stocks recover from COVID-19, Wall Street analysts are projecting earnings of value stocks to grow at more than a 20% compound annual growth rate (Figure 6). We believe supply chain disruptions and the Delta variant of COVID-19 will not negate an eventual full economic recovery, though could lead to a more protracted one, which should extend the associated outperformance of value stocks.

Figure 6 – 2020 – 2023E Earnings Growth (CAGR) is Faster Among Cheaper Stocks



Source: FactSet, Pzena analysis
 Full year 2023 earnings based on consensus estimates and pricing as of September 30, 2021.
 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.

The cheapest stocks are projected to grow slightly faster than growth stocks the next few years, while trading at a roughly 60% discount (Figure 7).

Figure 7 - 2023E Multiples

	US	Non-US
Growth Index	25.8x	19.5x
Value Index	16.2x	9.9x
Cheapest Quintile (P/N)	10.9x	7.1x

Source: FactSet, Pzena analysis
 Full year 2023 earnings based on consensus estimates and pricing as of September 30, 2021.
 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 – MAINTAIN FOCUS

Pro-value cycles have never happened in a straight line, and the current cycle is no different. Supply chain disruptions and COVID-19 variants may impact the timing of the recovery, but value stocks should continue to see earnings recover at a more rapid pace than the rest of the market over the next couple of years, as the economic recovery continues to take hold. We believe the ability to purchase high quality companies at low-teens earnings yields is what enduring value cycles are made of.

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