History provides a strong case for maintaining focus on fundamentals in the face of geopolitical shocks and macroeconomic concerns.

We commonly hear two questions at opposite ends of the value cycle: “Is value dead?” and “Is the value cycle over?” The psychology behind these questions is what drives enduring value cycles and creates the opportunity for long-term alpha. Not long after the pro-value cycle started in October 2020, we started hearing the latter question.

Recent concerns relate to the impact of supply chain issues, rising inflation, and, more recently, Russia’s invasion of Ukraine. Higher prices, particularly for energy, and concerns about a Fed-induced recession are leading to talk of stagflation, something markets have not seen in more than four decades. The range of outcomes has certainly widened, but we believe history and market fundamentals support the case for an enduring value cycle.

GEOPOLITICAL SHOCKS AND VALUE CYCLES

As Russia amassed troops on the Ukrainian border, the market turned down sharply, as investors fled to perceived safety. In the face of a humanitarian crisis and a geopolitical showdown unlike anything seen since the Cold War, the fears were understandable.

While the long-term impact of the Russian invasion remains uncertain, we can look to history to examine the impact of geopolitical shocks on markets. We reviewed 38 notable geopolitical shocks that took place over the past 85 years to see the impact on the broader market and on value stocks specifically. We found that market sell-offs following these shocks were generally short lived, typically lasting on average just a couple of weeks. Contrary to popular belief, there was no place to hide; cheap stocks performed essentially in line with expensive stocks. The market generally recovered over the next couple of months, as the shock either wound up being temporary or businesses adapted to the changing landscape. Additionally, the volatility created by fear-induced sell-offs often created opportunities for disciplined value investors. Finally, we didn’t find a pro-value cycle that ended due to a singular geopolitical shock.

Drawdowns on Geopolitical Shocks the Past 85 Years

Average Drawdown Duration (Days) [1]	14
Average Recovery (Days) [1]	57
Average Relative Return to Trough (Value vs. Growth Stocks) [2]	-0.03%

THE SPECTER OF STAGFLATION

Putting current concerns into historical context, this period is reminiscent of the stagflation period from 1973–1982. Recognizing no two periods are exactly alike, the similarities are striking. That period featured a regional conflict, leading to higher oil prices caused by the OPEC oil embargo. Inflation averaged 8.5%, and real GDP barely grew 2% per year. Despite three recessions in this period, the market returned an average of 8.2% per year, while value significantly outperformed at 18.9% per annum.

Of course, there is no way to predict how events will unfold. However, it is worth remembering that an investor in 1973, who happened to have perfect knowledge of future economic conditions, would most likely not have predicted the solid market returns that were realized over the next decade. That’s why it is important to focus on investing in deeply undervalued companies that have the market positions, business models, financial strength, and flexibility to thrive over the long term, through various economic conditions.

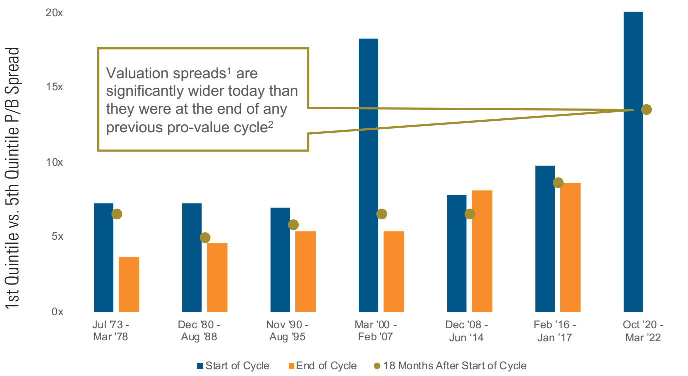
VALUE SPREADS SUPPORT AN ENDURING VALUE CYCLE

One common theme at the end of value cycles is the prevalence of narrow valuation spreads. This is important because as cheap stocks begin to outperform, disciplined value investors seek cheaper opportunities in other good businesses to replace fully valued holdings. Wide spreads indicate a rich opportunity set of cheap stocks for value investors to potentially rotate into, whereas narrow spreads indicate a smaller relative opportunity.

The current value cycle began 18 months ago when the first COVID-19 vaccine was announced. It accelerated as the Omicron wave subsided, and interest rates began to rise. Despite significant narrowing, spreads remain wider today than at any point historically other than the tech bubble. Impressively, spreads are more than twice as wide as they were at the same point during the post tech bubble value cycle (see Exhibit 1). These wide spreads provide the opportunity to take profits on holdings that have outperformed, and are approaching our estimate of fair value, and rotate into new, deeply undervalued opportunities that have lagged during the recovery (see Global Research Review, page 4).

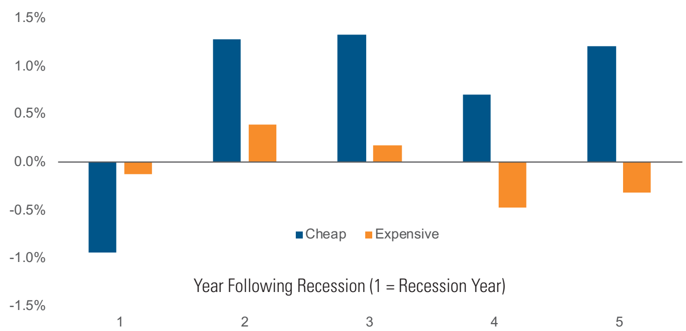
Source: Kenneth R. French, Pzena analysis. Table is based on 38 notable geopolitical shocks over the past 85 years.
[1] The US universe used is all NYSE, AMEX, and NASDAQ stocks defined by Kenneth R. French data library and calculated using cap-weighted returns.
[2] Value and Growth is defined as the cheapest and most expensive quintile of stocks based on book/price within the universe. To calculate the cohort of stocks for each quintile, we excluded the smallest 20% of the universe based on aggregate market capitalization to remove the small cap effect. Quintiles calculated using cumulative equal-weighted returns. Does not represent any specific Pzena product or service. Data as of March 31, 2022 and in US dollars.
Past performance is not indicative of future returns.

Exhibit 1: Narrowing of Spreads Through a Value Cycle



Source: Sanford C. Bernstein & Co., Pzena analysis
[1] Price to book spread between the cheapest and most expensive quintile within the ~1,000 largest US stock universe (equal-weighted data).
[2] 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. Here we define value as the equal-weighted returns of the cheapest quintile price to book within the ~1,000 largest US stock universe. The market represents the cap-weighted returns of the universe. Analysis does not represent any specific Pzena product or service. Data in US dollars through March 31, 2022. Past performance is not indicative of future returns.

Exhibit 2: Year-on-Year Operating Margin Change[1] Following the Past Three US Recessions[2]



Source: FactSet, National Bureau of Economic Research, Pzena analysis
[1] Average change in operating margins of the cheapest and most expensive stocks (based on price-to-book quintiles) within the Russell 1000 Index; all equal-weighted data.
[2] Recessions in 1990, 2001, and 2008 per NBER.

LONG POST-RECESSION RECOVERIES

As discussed in our third quarter 2020 newsletter (https://www.pzena.com/third-quarter-2020-commentary/), cheap stocks have delivered significant five-year alpha following the start of recessions, outperforming the market by 530 basis points annually on average. Following a recession, the long path of value outperformance mirrors the operating recovery of cheap stocks. Over the previous three recessions, we found that while margins on cheap stocks contracted by 100 basis points in the calendar year a recession begins, they improved by an aggregate 450 basis points over the following four years (Exhibit 2) before stabilizing or contracting. This compares favorably to expensive stocks, which see margins contract only slightly going into a recession but also see them contract further later in an economic recovery.

This occurs because companies react to recessions by cutting costs in response to lower expected revenue. As economies emerge from recessions and companies' top lines start to recover, revenue grows faster than costs, generating several years of expanding margins, often exceeding pre-recession levels. These results are more pronounced for cheap stocks, where company managements generally tend to cut costs the most.

The recession and recovery around COVID-19 have been similar to past economic cycles, both in timing and trajectory. Margins on cheap stocks plummeted quickly in 2020, as the world was in lockdown for a good part of the year. The recovery was just as rapid, resulting in 2021 margins that exceeded 2019's. These margins were achieved in the face of rising inflation, indicating, so far, that companies have been able to pass along higher input prices. For companies experiencing below-trend demand for their products and services, the prospect is quite good for continued earnings growth, as they benefit from operating leverage driven by revenue recovery.

CONCLUSION

It is certainly hard to ignore the daily news flow without imagining the possible negative implications to equities. It is also impossible to predict whether there will be temporary interruptions in the value cycle caused by some of these events. However, we believe the lesson from history is clear: In the face of geopolitical fears, investors should stay the course in value because the market's reaction typically doesn't last long, and the recovery is powerful and enduring. Even after a period of significant outperformance, we believe the outlook for value remains strong given the solid post-recession fundamentals for cheap stocks.

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