A Ripe Environment for Value Valuations

December 8, 2022

As investors who employ a bottom-up process when seeking quality companies, we're intrigued with the growing valuation discount between our portfolios and their respective indices. We find it compelling that today we can purchase a higher-quality portfolio for a discounted price relative to the index, creating an attractive entry point for our actively managed small- to mid-cap value strategies. But before we get to that, let's take a step back and look at how we got here.

What Drives Equity Prices: Monetary Policy, Earnings Trends, and Valuation

The first nine months of the year marked the fourth-worst start of any calendar year on record for small- and midcap indices. While softer-than-feared inflation data and the possibility for moderating interest-rate hikes drove the market to stage an impressive rally in October and November, we believe near-term market prices will continue to be driven by the outlook for monetary policy. There may be more pain ahead if the U.S. Federal Reserve (Fed) is forced to raise rates higher than the predicted terminal rate or hold rates higher for longer than the market is anticipating to combat inflation.

As bottom-up stock pickers, it's not our job to be short-term economic or market prognosticators; rather, we seek to identify mispriced securities that offer an attractive risk-to-reward profile. Therefore, during uncertain times like those we are in today, it's useful to remember what we believe drives equity prices over the longer term: monetary policy, earnings trends, and valuation.

Monetary Policy

We believe the stock market should ultimately stabilize when it becomes clear that the Fed is near the end of its current rate-hiking regime, and our best guess is that we are closer to the end of this cycle than the beginning.

The Fed ramped up its pace of rate hikes quickly in an effort to make up ground for its previous policy mistake (believing that inflation was transitory). We believe that the massive surge witnessed in M2 money growth during the pandemic is more akin to the post World War II era—in which money growth also surged, then cratered to help keep inflation from becoming ingrained—rather than the stagflation experienced in the 1970s.

For this reason, and as growth slows due to higher rates, we believe the Fed will ultimately achieve its stated mission of bringing inflation down, allowing policymakers to take their foot off the gas sometime in 2023. Whether rate cuts come thereafter is much less certain and will depend on how much damage a higher-interest-rate environment has caused to demand.

Perhaps the largest impact of monetary policy on our value indices isn't the Fed's current rate-hiking regime but rather its response to the Global Financial Crisis. Unfortunately, policymakers' decision to hold interest rates near zero for more than a decade has led to a proliferation of non-earning, zombie companies supported by free money.

We've always maintained that calculating a price-to-earnings (P/E) ratio for the small- to midcap indices is more art than science given the substantial weight of these non-earning constituents in the indices. However, the excess and speculation created by central bankers has driven the percentage of companies in the indices that lose money to grow over time, and the number of these companies remains elevated, particularly in the small- and small-mid-cap indices, representing 35% to 40% of index constituents.

If we continue to be in a higher-rate environment—in which central banks are not pumping liquidity into the system but rather removing it—quality-focused investors like us should benefit from a tailwind. Said another way, as value investors focused on earnings and cash flows, we welcome a more normalized period of monetary policy that no longer supports sky-high valuations and cheap debt, particularly for money-losing operations that have come to represent a sizable percentage of our investable universe.

Earnings Trends

Most, if not all, of the market's drawdown in 2022 has been a result of multiple compression, with very little coming from earnings revisions. In fact, equity multiple compression already exceeds that of an average recession, while earnings per share (EPS) revisions for 2022 and 2023 have held up better than feared.

Unfortunately, the aforementioned collapse of M2 money growth will likely translate into slowing or even contracting gross domestic product (GDP). This, in turn, could slow corporate revenues and hurt margins. While earnings thus far have been more resilient than many thought, it's important to remember the lagging effects of monetary policy. We may not feel the full EPS impact until mid- to late 2023.

It's clear to us that within our small- to mid-cap universe the market does not believe the earnings forecasts of these companies, and has already priced in a 30% to 40% decline in EPS. In our opinion, this equates to a very draconian outlook.

Given how fast the market has moved to punish these companies based on future predicted downward earnings revisions, we believe we may witness multiple expansion from here. Yes, earnings expectations are going to be reset lower, but in many cases the stocks are already reflecting this. When we are valuing companies today, we are valuing them on much more modest earnings estimates in the future. And because we are starting out at a very low level, as earnings estimates come down, the multiples themselves may expand.

We think the market is more than discounting a mild recession, which is our base case. Investors today seemingly have a recency bias—and for good reason, given that the last two recessions were the Global Financial Crisis and a pandemic—but if we experience a more traditional, garden-variety recession, the market low may have already been experienced.

Regardless, we've used the market's weakness to upgrade the quality of our portfolios' holdings, whose future earnings either may be more resilient than the market expects or are already pricing in a severe recession.

Valuation

During this period of economic uncertainty, we are comforted by the historically low valuation of our value

strategies' holdings, which trade at just high-single-digit estimated earnings for the next 12 months. This represents a significant discount relative to long-term historical averages. Said another way, at current valuations, we believe much of the bad news is already reflected in share prices, at least in the small- to mid-cap value universe.

What's more interesting to us as investors who employ a bottom-up process that seeks quality companies is the growing valuation gap between our portfolios and their respective indices. Typically, our portfolio's forward earnings multiples are in line with their respective indices but also possess higher returns on equity, superior margins, greater free-cash-flow generation, and less leverage (which we consider the characteristics of higher quality franchises). Today, one can purchase a higher-quality portfolio for a discounted price relative to the index. To us, this creates an attractive entry point for our actively managed small- to mid-cap value strategies.

Greg Czarnecki is a portfolio specialist for William Blair's small- to mid-cap value equity strategies.

Disclosure:

This content is for informational and educational purposes only and not intended as investment advice or a recommendation to buy or sell any security. Investment advice and recommendations can be provided only after careful consideration of an investor's objectives, guidelines, and restrictions.

Information and opinions expressed are those of the authors and may not reflect the opinions of other investment teams within William Blair Investment Management, LLC, or affiliates. Factual information has been taken from sources we believe to be reliable, but its accuracy, completeness or interpretation cannot be guaranteed. Information is current as of the date appearing in this material only and subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. This material may include estimates, outlooks, projections, and other forward-looking statements. Due to a variety of factors, actual events may differ significantly from those presented.

Investing involves risks, including the possible loss of principal. Equity securities may decline in value due to both real and perceived general market, economic, and industry conditions. The securities of smaller companies may be more volatile and less liquid than securities of larger companies. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks. These risks may be enhanced in emerging markets. Different investment styles may shift in and out of favor depending on market conditions. Individual securities may not perform as expected or a strategy used by the Adviser may fail to produce its intended result.

Investing in the bond market is subject to certain risks including market, interest rate, issuer, credit, and inflation risk. Rising interest rates generally cause bond prices to fall. High-yield, lower-rated, securities involve greater risk than higher-rated securities. Sovereign debt securities are subject to the risk that an entity may delay or refuse to pay interest or principal on its sovereign debt because of cash flow problems, insufficient foreign reserves, or political or other considerations. Derivatives may involve certain risks such as counterparty, liquidity, interest rate, market, credit, management, and the risk that a position could not be closed when most advantageous. Currency transactions are affected by fluctuations in exchange rates; currency exchange rates may fluctuate significantly over short periods of time. Diversification does not ensure against loss.

There can be no assurance that investment objectives will be met. Any investment or strategy mentioned herein may not be appropriate for every investor. References to specific companies are for illustrative purposes only and should not be construed as investment advice or a recommendation to buy or sell any security. Past performance is not indicative of future returns.

Copyright © 2020 William Blair & Company, L.L.C. "William Blair" is a registered trademark of William Blair & Company, L.L.C. No part of this material may be reproduced in any form, or referred to in any other publication, without express written consent.