Value stocks’ year-to-date outperformance has been so unexpected it made the front page of *The Wall Street Journal*. After underperforming by a cumulative 60% for an unprecedented 14 years, the Russell 1000 Value Index has managed to outperform the Russell 1000 Growth Index by 15% since last summer—that still leaves Russell Value more than 50% below Russell Growth. Since 2007, the Russell 1000 Value Index has had three brief runs of outperformance, averaging +12% outperformance over 11 months. Each of these rallies faded, giving way to new lows within months. Given this track record, it is no wonder most investors expect Value’s rally to run out of steam soon and Growth to re-establish its natural leadership.

We disagree. Value has historically outperformed over the long term with periodic downcyles (See Display 1). And we see this modest outperformance thus far as the beginning of a structural bull market for Value stocks after a record structural bear market. Before laying out our rationale, it is important to properly define Value. The traditional Fama-French definition (the cheapest third of stocks on price-to-book-value) or the definition used by many popular index providers (the cheapest half of stocks on price-to-book and a couple more metrics) are overly crude, as they conflate sector and capitalization with the “true” Value factor. We prefer to define Value as the cheapest quintile of stocks (more concentrated than the cheapest half) within each sector or industry, based on a composite measure of Value, and then construct a Value index by equal-weighting each stock to

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Display 1: Value has Historically Outperformed Over the Long Term with Periodic Downcyles

Index


The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results. See Disclosure section for index definitions.

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1 MSIM Global Multi-Asset team analysis; Bloomberg; Russell 1000 Growth and Russell 1000 Value Index; periods identified are August 8, 2006 to September 1, 2020, and from September 1, 2020 to April 19, 2021.

2 E.g. Russell; MSCI; S&P.
reduce idiosyncratic risk. This means that our definition of Value ("GMA Value"") includes tech stocks like Intel and Oracle but also consumer cyclical stocks like GM and Ford. The opposite of Value, which we call Anti-Value (rather than Growth, because not all expensive stocks are Growth stocks), is the most expensive quintile of stocks within each sector or industry. Anti-Value includes tech stocks like Nvidia and Paypal but also financials like American Express. We do agree with most Value detractors that price-to-book-value is an overly simplistic metric to define an entire style and only use it as one of six metrics in our valuation composite, along with free cash flow yield, and forward price-to-earnings ratios.

The historical record on Value, even using the simple Fama-French definition, is very strong both in the U.S. and outside the U.S. Value has outperformed by 3.5% per annum for the past 100 years in the U.S. and by 2.1% per annum over the past 50 years in 24 countries, according to Dimson, Marsh et al. It is true, however, that the past decade has put a dent in that long-term record. We would argue that a big part of that is comparing apples with oranges on a dated metric (i.e. comparing tech stocks with bank or energy stocks on price-to-book which is what Dimson, Marsh et al. do). We note that Value, as defined by GMA and described above, continued to modestly outperform from 2007 to 2017. But even using our definition, the following four years saw the biggest underperformance of Value since our data started in 1963 (See Display 2).

### Display 2: Despite Very Strong Long-Term Outperformance (+7.0% p.a.), GMA Value Also Got Hit Severely in 2017-2020

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<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>25%</td>
<td>12%</td>
<td>-39%</td>
<td>+86%</td>
<td>40%</td>
<td>-40%</td>
</tr>
<tr>
<td>Anti-Value</td>
<td>-72%</td>
<td>23%</td>
<td>+1092%</td>
<td>-26%</td>
<td>+103%</td>
<td>+25%</td>
</tr>
</tbody>
</table>


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Therefore, the big question before us is whether Value, properly defined, is doomed to continue underperforming Anti-Value—with the occasional rally (or at best keep up with Anti-Value if all the stars align)—or whether Value can resume its structural trend of outperformance. We lay out the case for the resumption of its structural uptrend (relative to Anti-Value stocks) below.

In trying to determine the path forward for Value stocks (relative to Anti-Value stocks), it is important to first understand why Value has underperformed so badly in the past decade, particularly in the past four years. We identify three drivers of underperformance:

- **High starting valuations for Value stocks 14 years ago:** historically, Value stocks (GMA definition) have, on average, traded at approximately 10x forward earnings, a 54% discount to Anti-Value stocks, which have on average traded at 22x. However, by 2007, after 234% outperformance over Anti-Value stocks post-Tech Bubble burst, Value stocks were trading at their highest relative valuations ever—only a 40% discount to Anti-Value stocks. From such a high valuation starting point, Value stocks (GMA definition) barely outperformed for the next 10 years until 2016. At that point, they had modestly derated to a 52% discount, slightly more expensive than normal (See Display 3), so performance should have been positive in the low single digits, clearly better than the subsequent -40% underperformance. Starting valuations were therefore a factor, though not THE factor, driving Value stocks’ recent underperformance.

- **“Low Nominals”:** the entire post-Global Financial Crisis period was characterized by what one keen Wall Street observer, Mike Goldstein of Empirical Research, has dubbed “Low Nominals”: low nominal economic growth (both real growth and inflation) and low interest rates (both market rates and policy rates).

  Compared the late 1990’s, when real U.S. economic growth averaged nearly 4.5% during the tech bubble, or to the 2000s, when GDP growth peaked at nearly 4% during the housing bubble, the 2010s saw real GDP growth struggle to average more than 2.5% before heading into the sharpest and deepest economic contraction in the history of the United States. Such an environment of low economic growth is difficult for Value companies because they tend to have lower margins, lower returns on capital, lower earnings growth, and higher debt. Low growth coupled with low inflation is an even tougher environment for such companies. Value companies have done much better in an environment of high real economic growth and higher inflation because the rising tide lifts all boats, particularly slow and heavy ones! High nominal GDP growth makes it easier for Value companies to generate profits growth and service their heavier debt loads. Faster growing and higher return on capital companies with higher valuations (i.e. Anti-Value stocks) don’t need higher economic growth or inflation to grow their profits. So the 2010s— with multiple deflationary shocks (2010 Greece, 2011-12 Italy and Spain government debt crises, 2015 China currency devaluation, 2016 Brexit, 2018 U.S.-China trade war) ending with the COVID maxi-recession —were the worst possible environment for Value stocks.

In addition to low nominal GDP growth hurting the profitability of Value stocks, the 2010s also saw generally

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1. Dimson, Marsh and Staunton, Global Investment Returns Yearbook 2018, Credit Suisse Research Institute 2018
declining market rates (even despite a modest Fed hiking cycle): the 10-year U.S. Treasury yield declined from a peak of nearly 4% in 2010 to a low of 0.50% in March 2020 and the Fed went from ZIRP (zero interest rate policy) and QE (quantitative easing) in the 2010s to more ZIRP and more QE in 2020 (after a brief detour to a 2.5% fed funds rate in 2018). The lowest interest rates in recorded history for the U.S. were a tremendous boon to faster-growing companies trading on very high multiples: the very long-duration of their cashflows (often very low or negative in the near term but expected to be very large in the future) made the valuations of these companies very sensitive to discount rates. Nearly zero is nearly the most favorable risk-free rate one can imagine for such long-duration stocks!

This “Low Nominals” regime thus simultaneously hurt Value companies’ earnings fundamentals (due to low nominal GDP growth) and boosted Anti-Value companies’ valuations (due to low nominal interest rates): a deadly combination for the performance of Value vs. Anti-Value stocks.

• Technological disruption had a powerful negative impact on the performance of Value stocks during the 2010s, and a positive impact on Anti-Value companies. Following the New Economy of the late 1990s, the 2000s were all about the revenge of the Old Economy with homebuilding and oil and metal extraction leading economic activity (and stock market performance) until those bubbles burst too. While speculators were focused on flipping houses, on drilling for oil, and on mining for metals, innovators were busy leveraging technology to disrupt and take over industries from media to retail and creating the foundations for natural monopolies. This technological disruption created winners and losers, with the winners rewarded with plentiful capital (and high valuations) from investors. An interesting dynamic is that winners kept on winning as the economy digitalized, with the ultimate unexpected outcome of the pandemic, which forced much of the planet to go virtual. Clearly some business models benefited, and others suffered tremendously. Within each industry, the disruptors grew faster and their stocks outperformed, while the disrupted saw falling sales, losses, bankruptcies, and severe stock underperformance. So, on top of “Low Nominals”, technological disruption picked up speed and reached a crescendo in the pandemic lockdowns, exacerbating the underperformance of Value stocks.

The preceding analysis makes clear why a bull market in Value could be starting: almost every one of the factors that drove the underperformance of Value appears to be reversing.

• Today’s starting point valuations for Value stocks are very attractive. Value stocks trade at nearly a 70% discount today, compared with 2007 when they traded at a 40% discount (See Display 3). Just to get back to the historical (54%) discount, Value stocks’ multiples would need to expand by 44%. From the low in September 2020, when they traded as low as a 74% discount, Value multiples have rallied 24%, about in line with their relative performance of 25%. Starting points matter and there have not been many times historically when Value stocks have been this cheap. The other one was February 2000: Value stocks were then trading at a 74% discount and outperformed by 156% in the next two and a half years.

<table>
<thead>
<tr>
<th>Display 3: Value at Nearly 70% Discount to Anti-Value, Compared to 54% Normally</th>
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<tbody>
<tr>
<td>GMA Value vs Anti-Value: Relative Forward P/E</td>
</tr>
<tr>
<td>Ratio</td>
</tr>
<tr>
<td>0.25</td>
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<tr>
<td>0.57</td>
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<tr>
<td>2015</td>
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<td>0.57</td>
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• After more than a decade of outperformance, most investors’ portfolios and most benchmarks are extremely heavily weighted in Anti-Value stocks and very lightly positioned in Value stocks. As of today, analysis by BofAML Research shows that active U.S. equity mutual funds are still -30% underweight the Value factor (relative to the Growth factor). Most investors have had to capitulate and sell low multiple stocks and buy high multiple ones in order to keep up with Growth’s growing weight in benchmarks. More prosaically, everyone just wants to own the winners. This indicates to us that positioning is extremely skewed, and that liquidity is likely to prove thin as the rotation in performance towards Value persists—there are simply a lot more potential sellers of Anti-Value and buyers for Value.

• “Low Nominals” giving way to, if not “High Nominals”, at least “Higher Nominals”. Unlike many investors, we view this current economic cycle as radically different than the last one, and likely to shift to an inflationary regime. The Global Financial Crisis can best be described as a balance sheet recession, with a housing bust and a banking sector crisis leading to massive household and bank deleveraging. Private sector debt (households, businesses and banks) collapsed by 57% of GDP over the 12 years that followed the onset of the crisis (See Display 4): no wonder economic growth and inflation subsequently disappointed. Yes, the Fed printed massive amounts of money, but no one spent it, as banks and...
households took 12 years to restore their balance sheets’ health.4 So easy money from the Fed did not lead to a credit cycle, and did not fuel growth or inflation (except in financial assets – the Fed created liquidity but could not control where it went).

Display 4: After the Global Financial Crisis, Private Sector Debt Collapsed by 57%
Private Sector Debt as a Share of GDP

This cycle is entirely different: there is no balance sheet recession, as the recession was not caused by economic imbalances, but rather by a public health crisis (which can be thought of as an extended natural disaster). Banks are healthy and most sectors of the economy are generally healthy. In addition, economic policymaking has radically changed on two fronts: (1) the Fed has modified its mandate, from controlling inflation to generating inflation. The Powell Fed is really a Reverse Volcker Fed. And, importantly (2) the federal government now acts as a partner of the Fed, and is willing and able to use the Fed’s liquidity to borrow and spend to generate demand in the economy. Fiscal policy has crossed the Rubicon just as the Fed did with unconventional monetary policy: it started with the pro-cyclical Trump tax cuts in 2018 (at a time when unemployment was at the lowest level in 50 years) and is continuing with President Biden’s radical government spending plans. Just as most of this March’s $1.8 trillion COVID-19 relief package was not relief but stimulus, most of the $4 trillion infrastructure package is not infrastructure but stimulus.5 In a similar way that the Global Financial Crisis legitimized unconventional monetary policy, the COVID-19 recession has legitimized radically expansive fiscal policy. And there appear to be no constraints on fiscal profligacy, neither political, nor financial.

After 40 years of disinflation, we think a regime shift towards inflation is extremely likely, given the absence of apparent economic imbalances and the confluence of unconventional monetary policy and radical fiscal policy. It is important to note that there is a huge difference between when the Fed is printing money for the government to borrow and spend, rather than printing money for banks to lend to households and corporates to borrow and spend. The latter makes deflation more likely because, if the household sector or the business sector becomes overindebted, they can run out of money to service their debt. This can cause a bust and retrenchment amidst deleveraging (i.e. the balance sheet recession previously mentioned). That’s deflationary. However, a government with a subservient central bank never runs out of money to service debt issued in its own currency. It’s simply that the cash it is paying as interest is worth less than it was previously as more of it gets printed (i.e. inflation). The eventual consequence of a private sector debt boom gone bad is usually deflation, but the consequence of a government debt boom is inflation. The private sector does not have a printing press!

What does all this mean for Value? It means that the disinflationary cycle of the past decade, with its numerous deflationary scares, is a lot less likely in this cycle as the current economic conditions (with no balance sheets to repair...yet) and policymaking trends are geared towards a more inflationary outcome. That means higher nominal growth, at least initially split between stronger real growth and higher inflation, and most likely higher nominal interest rates i.e. “Higher Nominals”. This should lead to better relative earnings prospects for Value stocks and higher discount rates for long-duration Anti-Value stocks, the exact opposite of what occurred in the past decade (See Display 5).

Display 5: Value’s Deep Discount to Normalize as “Low Nominals” End
Relative Valuation Multiple of Value Stocks Driven by Inflation Expectations

4 In practice, most of the expansion of Fed liquidity provided to the banking system did not go to expand credit to the private sector but ended up as bank “excess reserves” at the Fed! The liquidity was never recycled into the real economy due to households’ lack of appetite for taking on debt and the banks’ lack of appetite to extend loans to any but the most credit-worthy borrowers (caveat: the business sector after 3-4 years of deleveraging, took on more debt in the second half of the expansion but not enough to offset household deleveraging).

5 Includes the American Jobs Plan and American Families Plan
• Disruption, on the other hand, is likely to continue to be a headwind for Value companies. It is possible that the pace of disruption will slow in the U.S., given that the “installation phase” of the build-out of technological infrastructure (and access to it) is largely complete in the U.S. Almost everyone is already connected to the internet, already has a smartphone, a laptop, or PC, and stores most of their data on the cloud, and companies are a long way into digitizing their business processes. In addition, rather than simply benefit a minority of technology leaders, digitalization is likely to start benefiting more and more companies, including some of the lagging old-economy ones which populate Value portfolios. On the other hand, the “deployment phase” may only be partially complete with the use of digital tools and other disruptive technologies likely to continue to spread into, and disrupt, all industries rather than the most obvious ones. And digitalization in the rest of the world has a long way to go and could allow some emerging market countries and companies to leapfrog some stages of their economic development. Net-net, the jury is still out on whether technological disruption will continue at the same pace or slow, and whether it will continue to benefit some select “winners” or spread out to benefit more companies. But it is probably safe to assume it will continue to be at least a modest headwind to Value stocks.

Clearly, there are many risks to our base case of a secular Value bull market which could offset the very attractive valuation entry point. Some of the more worrisome scenarios follow:

• Despite all indications, fiscal probity returns as economists, politicians, and voters come to their senses and realize that fiscal stimulus should only be implemented in a countercyclical manner, i.e. when the economy is underemployed and the private sector is retrenching, and that economic booms call for saving. In this case, the likelihood of an overstimulated economy fueling a rise in above-target inflation is reduced and, after a transitory inflation spike, “Low Nominals” return.

• The Fed returns to its traditional mandate of maximum employment and 2% inflation, not FAIT (flexible average inflation targeting), not inequality, not climate change and importantly, not supporting federal government debt repayment (even at the cost of severe economic retrenchment). In this scenario, even if the government wanted to continue deficit spending, its ability to do so would be constrained by higher market interest rates and economic growth would be dependent on the private sector’s ability to increase its production in more efficient ways. This would be much less inflationary, making a continued “Low Nominals” environment more likely.

• China confronts a debt crisis. This is likely to occur eventually, as China’s debt build-up continues to outpace the economy’s productive capacity and its working age population continues to shrink.

• Technological disruption continues unabated, maintaining or even expanding the gap between technological winners and losers.

Overall, we believe a structural Value bull market (relative to Anti-Value) is likely to have risen from the ashes of the worst 10 to 14-year period of relative underperformance in the history of Value. Valuations for Value stocks have gone from above average to a near record low discount of 70%. More than 10 years of “Low Nominals”, a very tough environment for Value stocks, is likely to give way to a regime “Higher Nominals”, driven by unconventional monetary policy and radical fiscal expansion, leading initially to stronger growth but eventually to more inflation and higher interest rates. In this Higher Nominal regime, Value earnings will more easily beat market expectations, while Anti-Value multiples will come under pressure; the combination driving Value outperformance. Technological disruption will likely continue to be a headwind to Value as it has been in the past decade but unlikely at the same intensity. We have focused this report on U.S. Value but much of what we have described also applies to international and emerging markets which we will be focusing on in subsequent reports.

* Depending on the definition of Value
RISK CONSIDERATIONS

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, equity securities’ values fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed countries. Fixed-income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income.

Longer-term securities may be more sensitive to interest rate changes. Mortgage- and asset-backed securities (MBS and ABS) are sensitive to early prepayment risk and a higher risk of default and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks. Certain U.S. government securities purchased by the Portfolio, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the United States. It is possible that these issuers will not have the funds to meet their payment obligations in the future. The issuer or governmental authority that controls the repayment of sovereign debt may not be willing or able to repay the principal and/or pay interest when due in accordance with the terms of such obligations.

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Nondiversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. By investing in investment company securities, the portfolio is subject to the underlying risks of that investment company’s portfolio securities. In addition to the Portfolio’s fees and expenses, the Portfolio generally would bear its share of the investment company’s fees and expenses.

Subsidiary and Tax Risk. The Portfolio may seek to gain exposure to the commodity markets through investments in the Subsidiary or commodity index-linked structured notes. The Subsidiary is not registered under the 1940 Act and is not subject to all the investor protections of the 1940 Act. Historically, the Internal Revenue Service (“IRS”) has issued private letter rulings in which the IRS specifically concluded that income and gains from investments in commodity index-linked structured notes or a wholly-owned foreign subsidiary that invests in commodity-linked instruments are “qualifying income” for purposes of compliance with Subchapter M of the Internal Revenue Code of 1986, as amended (the “Code”). The Portfolio has not received such a private letter ruling, and is not able to rely on private letter rulings issued to other taxpayers. If the Portfolio failed to qualify as a regulated investment company, it would be subject to federal and state income tax on all of its taxable income at regular corporate tax rates with no deduction for any distributions paid to shareholders, which would significantly adversely affect the returns to, and could cause substantial losses for, Portfolio shareholders.
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The Russell 1000® Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000® Index is an index of approximately 1,000 of the largest U.S. companies based on a combination of market capitalization and current index membership.

The Russell 1000® Value Index is an index that measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The S&P 500 Total Return Index is an index that consists of 500 stocks chosen for market size, liquidity and industry group representation. The S&P Index is a market value weighted index with each stock’s weight proportionate to its market value. The S&P Index is one of the most widely used benchmarks of U.S. equity performance. The performance of the S&P Index does not account for any management fees; incentive compensation, commissions or other expenses that would be incurred pursuing such strategy. Total return provides investors with a price-plus-gross cash dividend return. Gross cash dividends are applied on the ex-date of the dividend.

The S&P GSCI® is a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. The returns are calculated on a fully collateralized basis with full reinvestment. The combination of these attributes provides investors with a representative and realistic picture of realizable returns attainable in the commodities markets. Individual components qualify for inclusion in the S&P GSCI® on the basis of liquidity and are weighted by their respective world production quantities.

The Sharpe ratio was developed by Nobel laureate William F. Sharpe and is used to help investors understand the return of an investment as compared to its risk. The ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk. Volatility is a measure of the price fluctuations of an asset or portfolio.

The MSCI U.S. Treasury Bond Current 10-Year Index is a one-security index comprising the most recently issued 10-year U.S. Treasury note or bond.

The MSCI USA Energy Index is designed to capture the large and mid cap segments of the US equity universe. All securities in the index are classified in the Energy sector as per the Global Industry Classification Standard (GICS®).

The MSCI USA Materials Index is designed to capture the large and mid cap segments of the US equity universe. All securities in the index are classified in the Materials sector as per the Global Industry Classification Standard (GICS®).

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Treasuries Inflation-Protected Securities, or TIPS, provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index.

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