Growth vs. Value: The Case for the Middle

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by Russ Koesterich

of BlackRock

Russ discusses the appeal of the middle area when choosing growth versus value stocks.

During the past week the cyclical/value trade suddenly flipped. After an unusual period of value leadership, tech stocks rallied while some of the more aggressive manifestations of the cyclical trade, such as materials, stalled. For investors exhausted by these seemingly fickle rotations back-and-forth, there may be a solution: Focus on the middle of the growth/value spectrum.

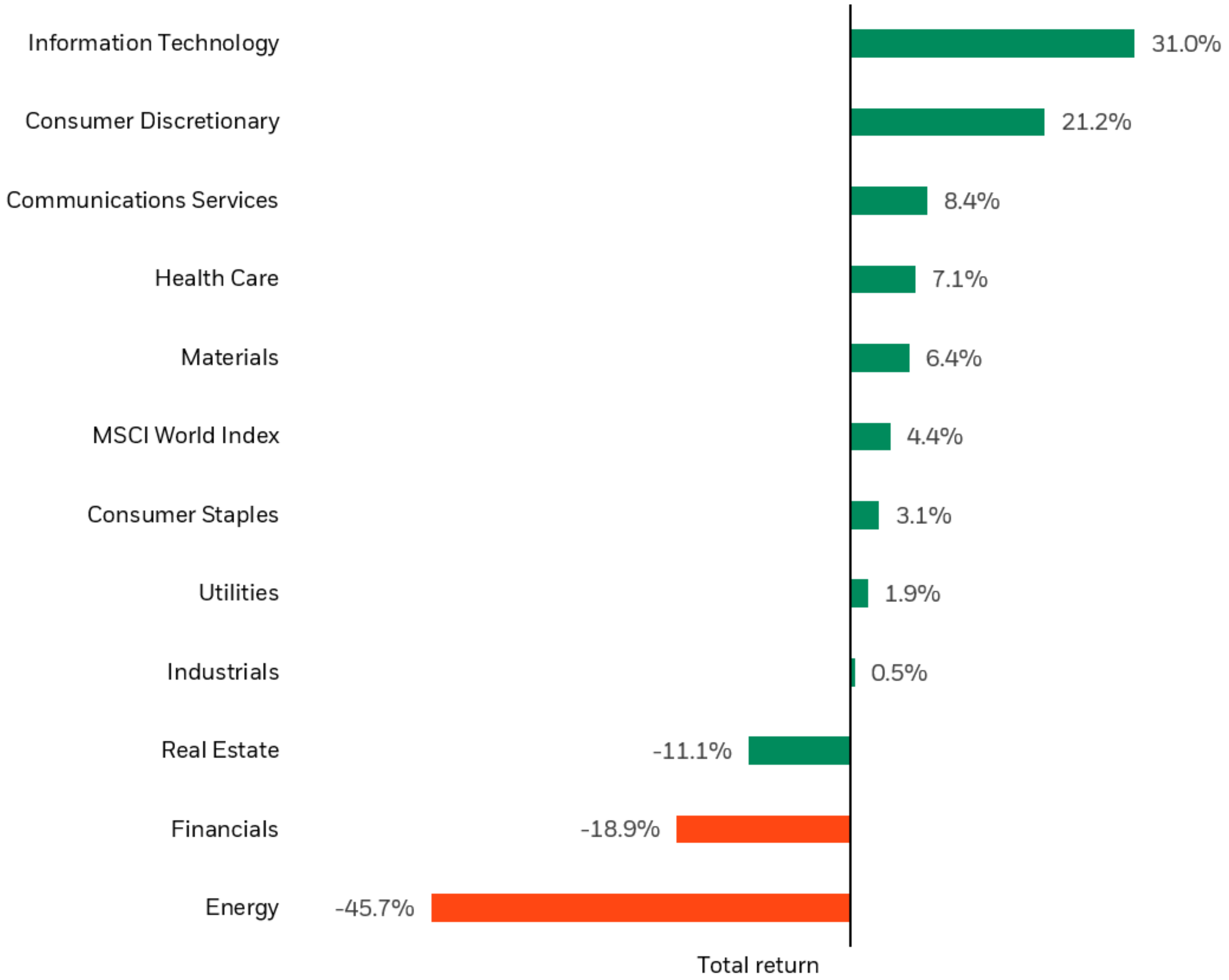
Rather than trying to exclusively time sudden shifts in growth versus value, a better strategy may be to focus on high quality companies for which the valuation is in sync with earnings, a style often referred to as “Growth at a Reasonable Price,” or GARP. Most of these names are neither pure growth or deep value but tend to fall in between.

No longer just a growth market

Looking at the past three months, U.S. growth continues to outperform. That said, there are a few nuances to note. The differential between value and growth has narrowed, at least compared to the earlier stages of the rally. It is also worth highlighting that parts of the cyclical space, which tends to be more tilted towards value, are doing particularly well. For example, industrial and material stocks are outperforming the broader market.

At the same time, many of the “deep value” names continue to struggle. Parts of value facing secular challenges, from big oil to financials, are still underperforming (see Chart 1). And while tech continues to dominate, many previous leaders have stalled, with several mega-cap internet names trading below their summer peaks.

Global sector performance - year to date



Source: Refinitiv DataStream, MSCI and BlackRock Investment Institute as of October 16, 2020.

Note: The bars show performance in U.S. Dollar terms year to date

Value is working...if you adjust for growth

The fact that some of the high-flying growth names have slowed after an epic run should not come as a surprise. Nor does it suggest that the growth rally is done. But it does imply that investors are increasingly searching for more reasonably priced growth themes.

Given this dynamic a successful strategy going forward may be to focus on companies for which valuation is in-line, or better yet, still cheap, relative to earnings growth. Research by the Global Allocation systematic team indicates that this strategy, often quantified through the P/E-to-growth or PEG ratio, has been working well even as most traditional valuation metrics, such as price-to-book, struggle.

Using this metric a few themes emerge. First, go global. While it is true that most of the top-earnings growers on an *absolute* basis are domiciled in the United States, this is not necessarily true when you adjust growth by *valuation*. On a PEG basis the best scoring names are evenly distributed across developed markets and EM Asia. Second, while there are several names in technology, specifically software, semiconductors and IT services, it is not an overly tech-centric list. Several cyclical industries, notably transport, chemicals and construction are well represented. For investors hesitant to overpay for stellar growth and unwilling to fish in the deep value pool, the space in between looks increasingly attractive.

Russ Koesterich, CFA, is a Portfolio Manager for BlackRock's Global Allocation Fund and is a regular contributor to Market Insights.