MUNRO

Comment

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Value investing and inflation

The era of quantitative easing programmes have had a distorting effect on markets since the 2008 financial crisis has given value investors a torrid time in the past decade. The near-constant sugar-rush of liquidity has served to de-link valuations from underlying fundamentals prompting a huge bias towards growth. While pockets of investors have been braced for a long-expected correction that has never really materialised, the recent sharp increase in inflation may constitute an inflection point. In inflationary periods and when interest rates rise, the time horizon for future discounting shrinks, leaving highly rated equities exposed.

Income-yielding shares have an inherent value-bias, owing to the types of company that pay steady dependable dividend. This provides a measure of inflation protection both in absolute terms and relative to nominal bonds.

The relationship between equity income, equity duration and value-bias

Mature companies whose valuation is a function of near-term earnings and dividend payments are known as "shorter duration equities" and typically have a value-bias. Valuations and growth rates may not be high, but the company's market value is underpinned by fundamentals of near-term earnings and dividends.

Less mature companies whose valuation is a function of future long-term growth – with or without dividends – are known as "longer duration equities" and typically have a growth bias. Valuations and growth rates may be high, and the company's market value is therefore highly sensitive to changes in assumption around growth rates, and also the discount rate at which future earnings (and potentially dividends) are discounted back. It is this sensitivity to discount rates that make growth-oriented stocks sensitive to inflation. The higher the discount rate, the less valuable in today's terms all that future growth looks.

The relationship between value and inflation

In addition to the conceptual framework that explains the potential for relative outperformance of value stocks during inflationary regimes, there is also empirical evidence.

In a study of the US market, BlackRock found that from 1927 to 2020, during inflationary regimes (CPI inflation above 4.4%), Value outperformed Growth by an annualised 7.4%p.a. on average. During periods of middling inflation (1.1% to 4.4%p.a, relative to today's 2% target), Value outperformed Growth by an annualised 4.0%p.a on average. During periods of low inflation (<1% pa), Value outperformed Growth by just 0.5%p.a. on average.

https://www.blackrock.com/us/individual/insights/value-stock-opportunity

Summary

If inflation proves less transitory and more persistent, there is a rationale for concentrating equity exposure in strategies with an inherent value bias because of their focus on dividend income.

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VT Munro Smart-Beta UK Fund
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