Portfolio considerations

Valuations, economy may favor value stocks

August 23, 2023

As measured by the Standard & Poor's 500 Index, U.S. stocks have risen more than 20% since they hit a trough in mid-October 2022[1]—a dismal year that brought the S&P 500's worst calendar-year decline since 2008 but just its second loss in 14 years. They've roughly doubled in value since the pandemic-induced low of March 2020 [1]. The extent and pace of the gains are enough to make the wary equity investor wonder: Where is there opportunity in the U.S. stock market?

Feedback

Once again, Vanguard research suggests opportunity in value stocks—shares marked by lower prices in relation to their enterprise book or accounting values, lower expected and historical growth rates, and relatively high dividend yields.

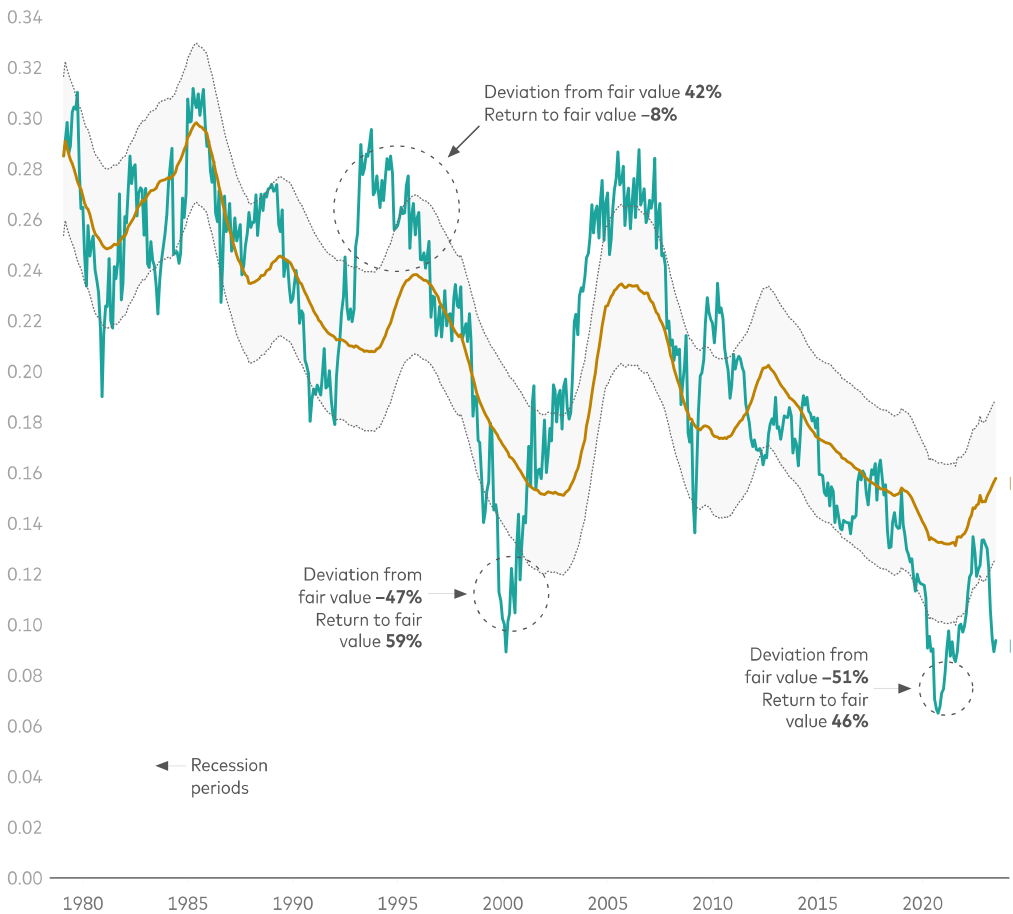
We've been here before—not long ago

"The value/growth relationship is at an extreme very similar to 2020," said **Kevin DiCiurcio**, CFA, head of the **Vanguard Capital Markets Model**® research team. "Now, as then, investors in aggregate are very enthusiastic about growth stocks—notably, technology shares—and seem to have limited interest in value stocks, including financial, industrial, and health care companies."

The interactive chart that follows presents our estimates of the fair value of value stocks relative to growth stocks.[2] When the historical, actual ratio exceeds the upper limit of our estimated fair-value range, the chance for market-beating returns appears to be larger in growth stocks. When that ratio is below the lower limit of the range, such opportunity appears to be larger in value stocks.

Value stocks appear depressed, even in the context of a long-running decline in their relative value

Value stocks' aggregate price/book ratio divided by growth stocks' aggregate price/book ratio



Notes: To assess the performance of investable value and growth portfolios, we constructed market-capitalization-weighted indexes of companies in the bottom and top thirds of the Russell 1000 Index, sorted by price/book ratios and reconstituted monthly. The valuation ratio is projected based on a vector error correction model (VECM) describing the statistical relationship between cointegrated time series. The VECM is a dynamic model of the first differences of the variables used in the cointegrating regression that includes a disequilibrium term to correct deviations from the long-term equilibrium. Monthly data begin with January 1979 and end with June 2023.

Sources: Vanguard (methodology and calculations, based on data from FactSet Research Systems) and the National Bureau of Economic Research (for U.S. recession dates).

The chart highlights the returns that value stocks recorded, relative to growth stocks, in the wake of a trio of their most extreme valuations.

- Following an overvaluation in 1993, value stocks underperformed growth stocks by a cumulative 8 percentage points on their way back to our predicted ratio (the median of our estimated fair-value range). It took three years to get there.
- An undervaluation near the peak of the tech bubble in 2000 preceded an instance of value outpacing growth by 59 percentage points before reaching fair value in about a year.
- In 2020, another undervaluation preceded a return advantage of 46 percentage points in about 20 months. Value stocks never quite got back to our median fair-value estimate before sagging again to a similar state of investor apathy.

It's well-known, as our chart suggests, that asset prices can stray meaningfully from perceived fair values for extended periods. However, as we explained in **research published in 2021** [11-page PDF], deviations from fair value and future relative returns share an inverse and statistically significant relationship over five- and 10-year periods.

Our outlook for value stocks—a solid relative performance edge

Since we issued our **2023 economic and market outlook** [61-page PDF], our forecast of the return advantage for U.S. value stocks over U.S. growth stocks has risen by more than 1 percentage point, to 3.8 percentage points, annualized, over a 10-year period.[3]

Our expectation for a performance edge for value reflects a rotation back to growth stocks this year. Indeed, following a rebound in the relative performance of value stocks in the latter stages of 2021 and 2022, value stocks have lagged growth stocks across the U.S. market's capitalization spectrum in 2023. The Russell 3000 Growth Index, for example, returned 32% year-to-date as of July 31—more than three times the 9% return of the Russell 3000 Value Index.

There may be an economic case for value stocks beyond valuations

Market performance across the dozen U.S. business cycles since 1980 suggests another potential reason for optimism on value, DiCiurcio said.

"On average, value has outperformed during economic recoveries, historically speaking," he said. "So, if you believe that the Federal Reserve may have engineered a soft landing—that we're going to sidestep a recession and that the economy's next move is an acceleration—the case for value is strengthened."

Historically, value has shined amid economic recoveries

Average monthly return advantage of value over growth across economic cycles

State of the economy	Value trading above fair value	Value trading below fair value	Value's average return advantage
Expansion	–0.06%	**0.09%**	0.00%
Slowdown	–0.54%	**0.43%**	–0.05%
Contraction	–0.28%	**–0.01%**	–0.12%
Recovery	**0.12%**	**0.34%**	**0.23%**

Notes: Economic states reflect The Conference Board Leading Economic Index (LEI). LEI above trend and increasing is expansion, above trend and declining is slowdown, below trend and declining is contraction, and below trend and increasing is recovery. The monthly data underlying the figures shown begin with February 1979 and end with June 2023.

Sources: Vanguard, based on data from the Conference Board.

Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Investors who can look past shorter-term market cycles may benefit in the long run

To be sure, the state of the business cycle alone is an unreliable signal of the relative returns between value and growth. As shown in the table, however, when value has traded below its fair value—as it is doing today—it has historically enjoyed a performance edge in all but contractionary economic phases. Even then its shortfall relative to growth has been a scant –0.01%.

Given relative valuations and economic conditions, an overweight to value stocks could help offset the **low broad-market returns we expect** over the next decade, DiCiurcio said.

As with any potential strategy to outperform, however, he added, "Investors should have above-average tolerance for risk, a long time horizon, and, perhaps most importantly, the patience to endure shifting economic conditions and potentially fast-moving changes in investor sentiment."

1 As of August 18, 2023.

2 To be clear, our outlook is for the style *factors*, or what might be termed "pure" value and growth portfolios. These differ from both the academic definitions of value and growth popularized by Eugene Fama and Kenneth French and style-specific market indexes that serve as benchmarks for many investment portfolios.

The academic definition of value includes selling short the most expensive stocks—a practice unlikely to be undertaken by the average investor. In a short sale, an investor borrows and then sells a stock in anticipation of its price declining. If the price does decline, the investor can repurchase the shares at a lower price and return them to the lender, thereby profiting. If the price rises, however, losses ensue. Regulations limit short sales.

Arguably, indexes sponsored by such firms as FTSE Russell do a good job of representing active managers' security selections. That doesn't make them ideal representations the style factors themselves. For example, roughly 30% of Russell 1000 Index constituents appear in both the growth and value indexes, while the remaining 70% are classified exclusively as growth or value. In our view, a stock thought to represent a style factor should—for analytical purposes, at least—represent only one style. In our model, a company can be deemed only value or growth in any given month, though its classification may vary over time.

3 In our 2023 outlook, our return forecasts for U.S. value and U.S. growth stocks appear in Figure II-9a. Our latest forecasts appear in our **economic and market update for August**. In absolute terms, our median forecast is for U.S. value stocks to return 5.6%, annualized, over the coming decade.

Related links:

- **Investor Pulse: Many expect strong returns to continue** (article, July 2023)
- **Value manager balances risk and reward in current market** (4:54 video, June 2023)
- **Value versus growth stocks: The coming reversal of fortunes** (11-page research PDF, April 2021)

Notes:

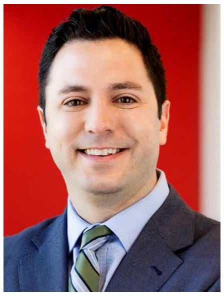
All investing is subject to risk, including possible loss of the money you invest.

Past performance does not guarantee future results.

There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income.

In a diversified portfolio, gains from some investments may help offset losses from others. However, diversification does not ensure a profit or protect against a loss.

Contributors



Kevin DiCiurcio, CFA

Vanguard Investment Strategist

Olga Lepigina

Vanguard Investment Analyst

Vanguard

Vanguard is the trusted name in investing. Since our founding in 1975, we've put investors first.

Learn more