As Value Stages a Comeback, Emphasize Quality

The growth vs. value debate—a topic investors revisit regularly—is often framed as a market timing exercise where an investor should choose one over the other, aiming to capitalize on a shift in leadership between the two distinct styles.

A prevailing narrative currently circulating in the financial media is that now may be an opportune time to favor value over growth amid a strengthening economic recovery and a "return to normal" driven by mass vaccinations, mitigating the economic harm caused by the COVID-19 pandemic.

Recent economic data support this view, as tremendous tailwinds exist for a strengthening recovery. This sets the stage for companies with cyclical operating leverage—those more typically found in value indexes—to potentially outperform companies driven by secular trends—those more typically found in growth indexes. However, value indexes have tended to have a lower-quality bias than their respective growth counterparts due to their construction methodology. Historically, higher-quality stocks have outperformed lower-quality stocks over multi-year periods, reinforcing the need to pursue value strategies that emphasize quality as part of their investment process.

Favorable Conditions for Value Outperformance

The worsening COVID-19 pandemic in March 2020 quickly upended the economy, narrowing the growth environment significantly and gave rise to the "stay-at-home economy." Outside of this small subset of benefactors, mainly within the technology sector, the larger investing climate remained extremely weak, and many value-oriented and cyclical sectors such as travel, leisure, and energy, experienced significant declines.

November 2020 marked a dramatic shift in the market environment. Positive news about multiple vaccine approvals—far earlier than investors expected—sparked a sharp rotation out of stay-at-home stocks and prompted a relief rally in companies and sectors that faced fierce headwinds at the height of the crisis—many of which are classified as part of the value universe.

U.S. monetary and fiscal stimulus has been aggressive in response to the pandemic—collectively exceeding 50% of U.S. gross domestic product (GDP). The Federal Reserve (Fed) has also reiterated, on numerous occasions, a willingness to allow inflation to exceed its 2% target, given the low inflation the economy experienced in recent years. Interest rates have moved higher in anticipation of broadening growth, improving unemployment, rising inflation, and GDP rebounding sharply.

These dynamics strongly suggest that significant tailwinds exist for the economic recovery to broaden, creating favorable conditions for companies with cyclical operating leverage—such as those more typically found in the value universe—to outperform companies driven more by secular trends. Consensus earnings expectations support this view, as the Russell 3000® Value Index is estimated to deliver significantly stronger growth than the Russell 3000® Growth Index this year.

YEAR-OVER-YEAR EARNINGS GROWTH ESTIMATES

	RUSSELL 3000® VALUE INDEX	RUSSELL 3000® GROWTH INDEX
2021	38.36%	21.30%
2022	14.93%	15.14%

Source: FactSet. As of April 15, 2021.

Investor concerns have surfaced about the Fed letting inflation run unabated, forcing the central bank to raise rates to counter overheating in the economy and stalling growth in the process. However, these concerns seem premature, as lingering high unemployment is likely to contain companies' labor costs—a major potential headwind that can undermine cyclical operating leverage. Additionally, many companies that benefit from a cyclical growth environment have recently suggested they have the pricing power to pass costs onto customers without negatively impacting demand.

Conditions for Cyclical Growers to Outperform Secular Growers

- **Strong GDP growth**
- **Interest rates/real yields moving higher**
- **Steepening yield curve**
- **Rising inflation**
- **Purchasing Managers' Index (PMI) rising**
- **Improving growth expectations**

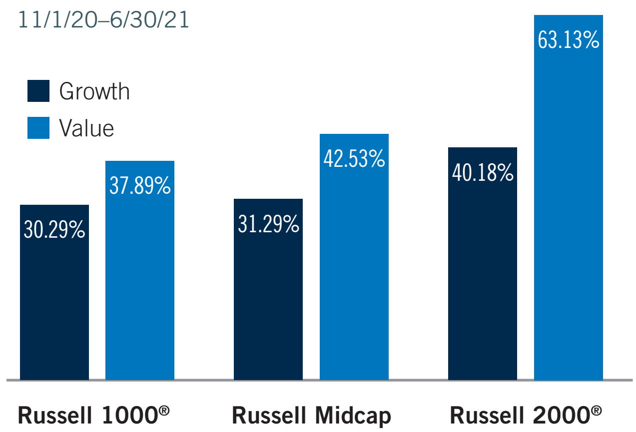
Understanding Benchmark Construction and the Need to Seek Quality

Russell value indexes across the market cap spectrum outperformed their respective growth counterpart by a wide margin in the months following the November vaccine news. This aligns with a classic early-stage recovery and reflects underlying differences in how value and growth indexes are constructed.

Russell value indexes rely heavily on price-to-book value in their construction methodology, making up 50% of the input calculation that determines weighting. The remaining 50% is split evenly between historical sales growth and future earnings estimates.

INDEX TOTAL RETURNS

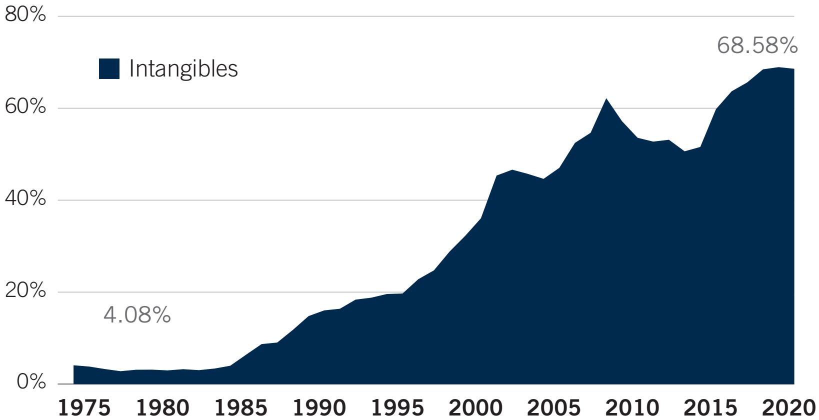
11/1/20–6/30/21



Past performance is not indicative of future results. Source: FactSet.

Outside of a small subset of the market, such as banks and other financials with readily marketable securities, book value is an increasingly irrelevant measure and often says very little about a company's true worth. The reason is that intangible assets have become a dominant aspect of the stock market's valuation in recent decades. Intangible assets, non-physical assets such as a company's brand value, patents, and proprietary datasets, are not counted toward book value but still contribute to cash flow. In 1985, less than 10% of the S&P 500® Index's value could be attributed to intangible assets. By the end of 2020, intangibles made up over two-thirds of the S&P 500's total value.

S&P 500® INDEX PERCENT OF BOOK VALUE FROM INTANGIBLES
12/31/74–12/31/20



Additionally, companies that return capital to investors through dividends and share repurchases are "penalized" in a value index heavily reliant on a price-to-book methodology. All else equal, returning capital to shareholders through dividends and share repurchases reduces book value and drives the price-to-book ratio higher. This gives the appearance that these companies may be overvalued relative to their peers. Moreover, if certain benchmark thresholds are met, consistent dividend payouts and share buybacks—which are supported by generating sustained cash flow and earnings—can lead to a company's removal from a value index.

Value managers develop certain philosophies about how they approach the world of equity investing. Yet, the industry has allowed third parties to define what those parameters should be through benchmark construction methodologies. Unfortunately, leading value benchmarks continue to follow a construction framework from over 30 years ago and have not adapted to the realities of today's investing climate.

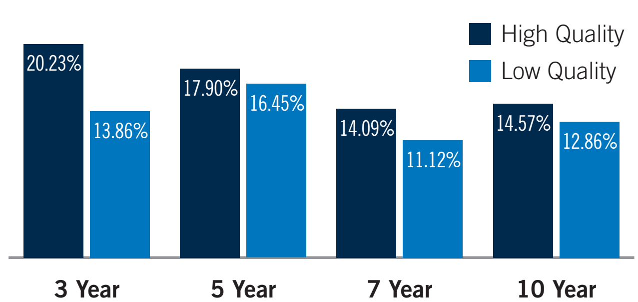
Relying on this outdated methodology has resulted in value indexes skewing lower-quality in terms of capital efficiency than their respective growth index counterparts. Despite similar long-term debt-to-capital ratios, the Russell 3000® Value Index underperforms the Russell 3000® Growth Index across quality measures, as illustrated in the below table.

	Return On Assets	Return On Equity	Return On Invested Capital	Long-term Debt-to-Capital
RUSSELL 3000® VALUE INDEX	4.53%	9.59%	5.69%	41.33%
RUSSELL 3000® GROWTH INDEX	10.29%	27.29%	13.64%	44.08%

Past performance is not indicative of future results. As of June 30, 2021. Source: FactSet.

While lower-quality value indexes have outperformed growth indexes with a higher-quality tilt in recent months, it is highly unlikely that long-term investment success could be built on a portfolio of lower-quality companies. As history has shown, higher-quality stocks have outperformed lower-quality stocks over multi-year periods, as illustrated in the chart. This reinforces the need to pursue value strategies that emphasize quality as part of their investment process. Virtus advocates for selecting quality-driven value managers that invest in companies generating consistent earnings, cash flow, and dividend payouts over the business cycle, which help promote financial stability, transparency, and confidence to investors.

HIGH QUALITY HAS OUTPERFORMED OVER TIME
Russell 3000® Index Quality Returns



Past performance is not indicative of future results. Data presented is as of June 30, 2021. Data is obtained from FactSet and is assumed to be reliable. High Quality is represented by S&P Quality Rankings of B+ and above. Low Quality is represented by S&P Quality Ranking of B and below.

Value equity portfolios emphasizing quality are available through Virtus affiliates Ceredex Value Advisors, Kayne Anderson Rudnick (KAR), and NFJ Investment Group.

With value equity investing roots tracing back to 1989, Ceredex Value Advisors has a strong history of identifying value across the equity markets. Ceredex's experienced investment team applies fundamental research to seek out compelling opportunities in undervalued companies with attractive upside potential.

Kayne Anderson Rudnick believes that superior risk-adjusted returns may be achieved through investment in high-quality companies with market dominance, excellent management, financial strength, and consistent growth, purchased at reasonable prices.

NFJ Investment Group is a global value equity manager with a rich heritage and deep roots in Dallas, Texas, dating to 1989. NFJ is unwavering in its commitment to investing at the intersection of value, quality, and shareholder yield, seeking to identify companies with low market expectations and the strongest prospects for returning capital to shareholders.

To learn more, visit virtus.com or call us at 800-243-4361.

INDEX DEFINITIONS: The **S&P 500® Index** is a market capitalization-weighted index that includes 500 of the largest U.S. companies. The **Russell 3000® Index** is a market capitalization-weighted index that measures the performance of the 3,000 largest U.S. companies. The **Russell 3000® Growth Index** is a market capitalization-weighted index of growth-oriented stocks of U.S. companies. The **Russell 3000® Value Index** is a market capitalization-weighted index of value-oriented stocks of U.S. companies. The **Russell 1000® Growth Index** is a market capitalization-weighted index of growth-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The **Russell 1000® Value Index** is a market capitalization-weighted index of value-oriented stocks of the 1,000 largest companies in the Russell Universe. The **Russell Midcap® Growth Index** is a market capitalization-weighted index of medium-capitalization, growth-oriented stocks of U.S. companies. The **Russell Midcap® Value Index** is a market capitalization-weighted index of medium-capitalization, value-oriented stocks of U.S. companies. The R**ussell 2000® Growth Index** is a market capitalization-weighted index of growth-oriented stocks of the smallest 2,000 companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The **Russell 2000® Value Index** is a market capitalization-weighted index of value-oriented stocks of the smallest 2,000 companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The indexes are calculated on a total return basis with dividends reinvested. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.

The commentary is the opinion of Ceredex Value Advisors, Kayne Anderson Rudnick, and NFJ Investment Group. This material has been prepared using sources of information generally believed to be reliable; however, its accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice or an offer of securities.

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