

UNDERSTANDING VALUE BENCHMARK CONSTRUCTION AND THE NEED TO SEEK QUALITY



Since the U.S. Food and Drug Administration rolled out emergency-use approval for COVID-19 vaccines, a shift in market leadership occurred from secular growth companies to those with high economic sensitivity that tend to comprise value indexes. From this point in November 2020, value indexes have consistently outperformed growth indexes.

Value outperforming growth aligns with a classic cyclical recovery and reflects underlying differences in how value and growth indexes are constructed. Value indexes tend to have a lower-quality bias than their respective growth counterparts due to their construction methodology placing a greater emphasis on price-to-book value—an increasingly irrelevant measure in recent decades.

Russell 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.

These inputs are standardized and combined to produce a composite value score (CVS). Generally, Russell considers companies with a higher CVS more appropriate for inclusion in their value indexes and a lower CVS better suited for their growth indexes.

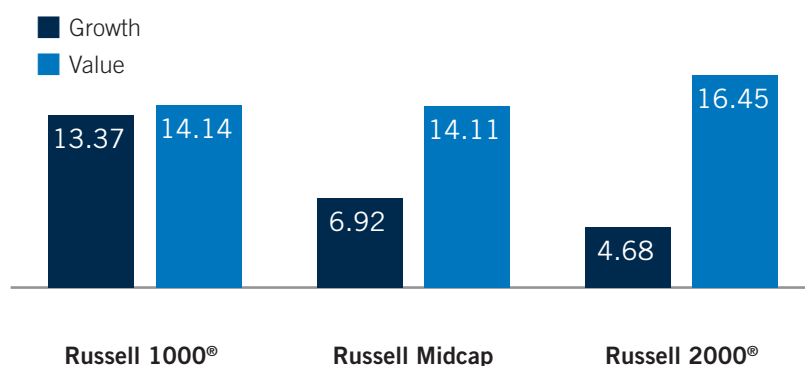
Outside of a small subset of the market, such as banks and other financials with readily marketable securities, book value is an increasingly irrelevant measure and often says very little about a company's true worth. The reason is that intangible assets have become a dominant aspect of the stock market's 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 2022, intangibles made up about two-thirds of the S&P 500's total value.

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.

INDEX TOTAL RETURNS (%)

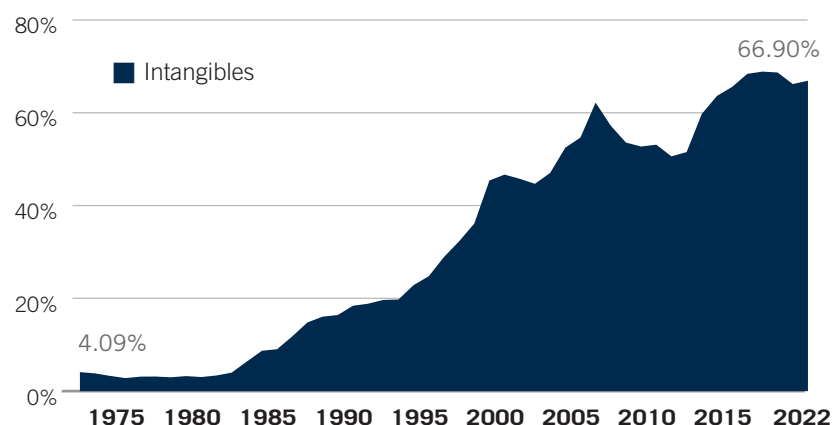
11/01/20–12/31/23



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

S&P 500® INDEX PERCENT OF BOOK VALUE FROM INTANGIBLES

12/31/74–12/31/22



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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.

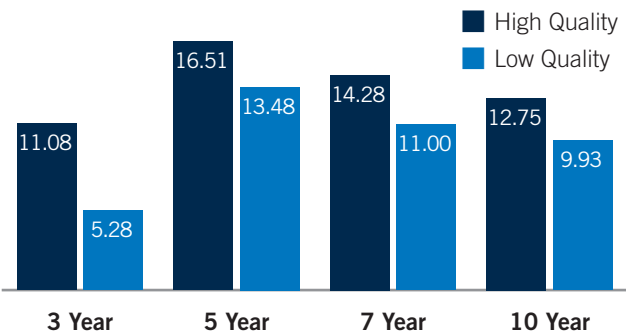
	Return on Assets	Return on Equity	Return on Invested Capital	Long-term Debt-to-Capital
RUSSELL 3000® VALUE INDEX	6.54%	15.05%	9.36%	39.96%
RUSSELL 3000® GROWTH INDEX	13.62%	25.71%	29.49%	41.70%

Past performance is not indicative of future results. As of December 31, 2023. Source: FactSet.

Historically, higher-quality stocks have outperformed lower-quality stocks over multi-year periods, reinforcing the need to pursue value strategies that emphasize quality in 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 December 31, 2023. High Quality = Russell 3000 Index companies with S&P Quality Rankings of B+ or above. Low Quality = Russell 3000 companies with S&P Quality Rankings of B or below, plus non-ranked Russell 3000 companies. Sources: S&P Global, FactSet, and FTSE Russell.

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.



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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 **Russell 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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All investments carry a certain degree of risk, including possible loss of principal.

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