Amundi ASSET MANAGEMENT | Smart Beta

Viewpoint

Looking for Value across Assets: Is mean-reversion dead?

Value investing has been subject to debate in recent years. Many papers have been published about either **the “death” or the “next revival” of Value investing, and Covid-19’s outbreak acted as a catalyst forcing investors to take sides.**

Indeed, on one hand, many claim for an unsuitable environment for Value, pointing out at multiple arguments such as technological revolution and disruption of competitors, low interest rates and low inflation affecting pricing power. In addition, the use of traditional valuation metrics has also been challenged, since for example these do not incorporate intangible assets such as R&D, patents or brand recognition. This has left many investors wondering whether they should or should not try harder on value investing.

On the other hand, believers in mean-reversion have not yet fully disappeared: some investors consider that post-Covid-19 economic and financial conditions indeed advocate for a major mean-reversion favouring value stocks.

Is mean-reversion simply dead across asset classes? Or has value investing in equity markets, that is one specific way to implement mean-reversion, just had recently a very hard time?

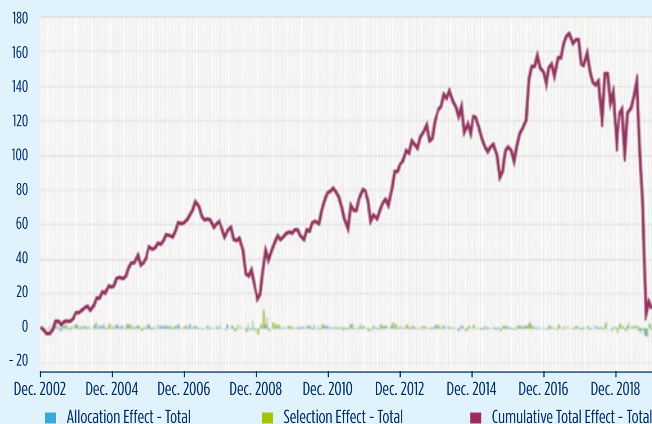
In this viewpoint, we compare value investing across equity and credit markets, with the objective of offering a perspective about mean-reversion across asset classes. At the end of the day, investors can play mean-reversion in various ways and across asset classes, and these offer different risk-return characteristics, face different market conditions and challenges.

We believe that looking at mean-reversion beyond only equity value investing will enrich the opportunity-set for active managers allocating across asset classes and risk factors.

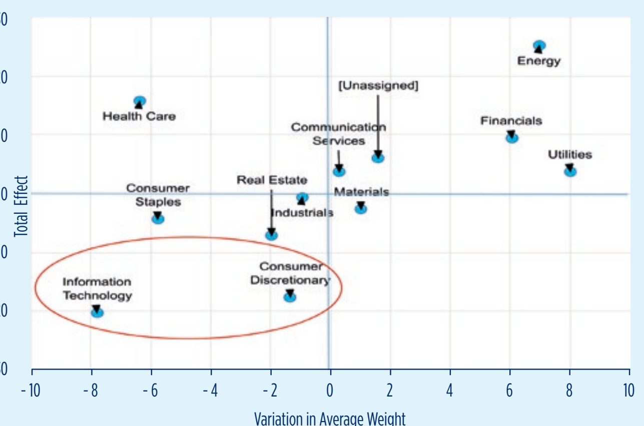
Equity Markets and the Value vs Growth Dilemma

Valuation dispersion reaching extreme limits and ultra-concentration within equity markets created a challenging environment for factor investing over the recent period. This has been particularly visible in the US market, amid the dominance of Tech giants such as Facebook, Amazon, Apple, Netflix, Tesla or Microsoft. In the specific case of Value factor in H1 this year, we estimate that 30% of the underperformance versus the MSCI USA index is due to the lack or clear underweight of these 6 stocks.

Looking at Value excess returns over the longer term, we can clearly observe an **inflexion point in 2017 followed by a massive acceleration linked to Covid-19’s outbreak while growth stocks stood out**. From a sector point of view, it is clear that a significant part of Value’s under-performance is explained by a lack of exposure to the Technology sector overall, and to some extent the Consumer Discretionary sector with Amazon.

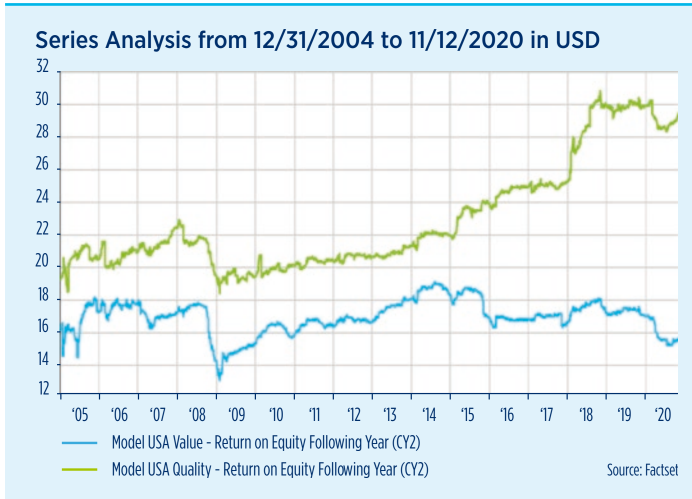


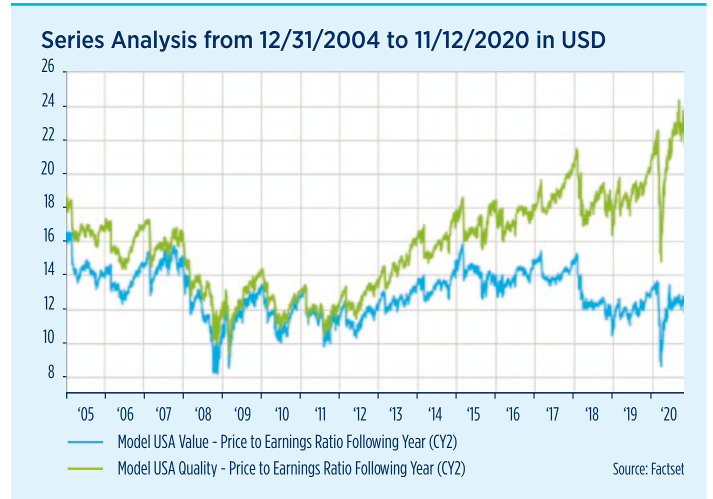
Sources: Factset, Amundi



Sources: Factset. Amundi

This said, it needs to be acknowledged that Value has also been negatively affected by its own issues. **The over-representation of disrupted sectors - linked to global digitalization or energetic transition – is key to explain Value companies' weak profitability dynamics relative to the rest of the market.** These contributed to widen the profitability gap versus Growth stocks, relative valuation (i.e. valuation dispersion) and relative performance, which recently reached unprecedented levels. Thus, it is hard to expect Value to mean-revert strongly without additional rationale (e.g. resurgence of inflationary pressures or disruption forces abating).



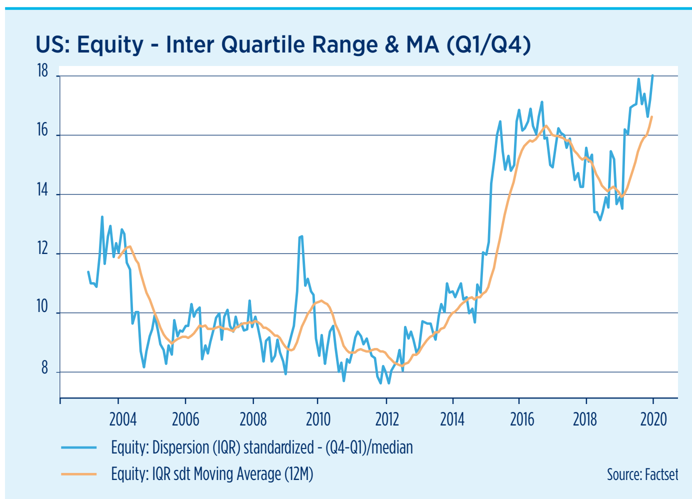


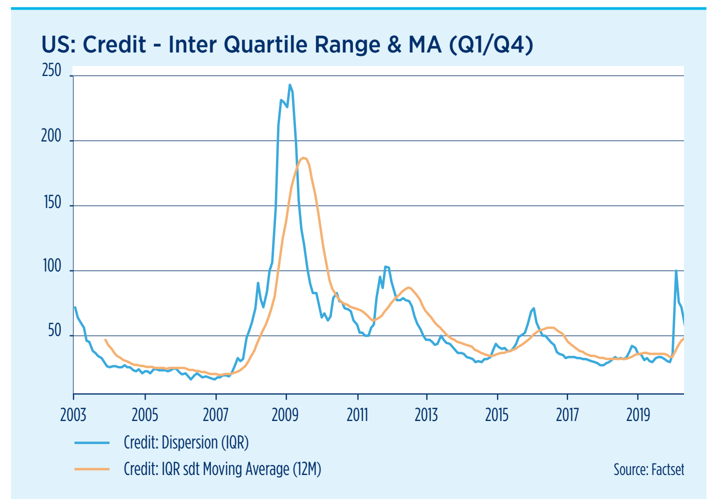
In addition, it is important to point out that most risk factors suffered from market concentration issues, especially in the US where the market structure is skewed towards growth-related sectors and a limited number of stocks. As the trend started to accelerate 3 years ago, it led to a growing re-correlation between Momentum and Growth factors - currently near 80% - while penalizing others.

The recent polarization of risk factors has had a negative impact on the behaviour of equity multi-factor portfolios, **which drove some investors to search for additional ways to capture mean-reversion beyond the equity space.** ■

Enlarging the Opportunity-Set to Credit Factors

Observing the historical behaviour of credit factors, we can see that valuation dispersion (as measured by the inter-quartile range between expensive vs cheap securities) in credit evolves differently than within equities. **While its overall dynamic differs, the frequency of mean reversion is higher in credit markets.** We show below the historical valuation dispersion within equity and credit in the US from 2003. It is obvious to see that capturing mean-reversion in US equity markets via value investing was a much more challenging task than doing the same in US credit.





There are different reasons that can explain the above. Firstly, playing value in credit markets tends to be more closely linked to the asset class beta and, as the credit market experienced upswings, mean-reversion was rewarded.

Secondly, the structure of the credit market is very different from equities. There are fewer super growth-disruptive oriented sectors and issuers (since these do not issue much debt) in the credit universe, and therefore this increases the odds of mean-reversion. ■

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Conclusion

Over the past few years Value factors experienced different performance patterns across asset classes.

While value investing in growth-oriented and concentrated markets like US stocks was particularly challenging, playing value in credit was a lot easier and performed quite well.

We believe **this builds the case for adopting a total portfolio approach (TPA), across asset classes, to invest in risk factors.**

As an example, we believe that building a diversified exposure to mean-reversion should be achieved not only via the equity value factor. This holds particularly true if we are searching for it in the US stock market, dominated by growth and disruptive stocks. Extending the search for mean-reversion to other geographical areas and other asset classes is key for success.

This will improve the robustness of the whole portfolio and **will create tactical opportunities for flexible managers, seeking to dynamically allocate across asset classes and risk factors**. In recent years, mean-reversion had to be harvested in the credit market and not so much in the equity space. Tactically, we believe that it makes sense to add more mean-reversion in the equity markets now, as spread compression in the credit market already went a long way. ■

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