Finding Value in Volatility

September 8, 2015

The recent bout of market volatility has no doubt been unnerving to most investors, but they may have to live with it for at least a little while longer, given continued near-term market uncertainties. Norm Boersma, chief investment officer of Templeton Global Equity Group, explains why his team doesn't see major cause for alarm amid the recent market correction—and why they think conditions look ripe for a value-oriented approach.

Until recently, some major global markets had gone an unusually long time without a meaningful correction. In recent months, investor uncertainty had gotten very elevated, and it is likely that many investors were waiting for a reason to sell following a protracted rally. The latest downturn in China's highly leveraged, speculation-prone market has provided that reason, sparking fears about broader-based emerging market instability and global growth headwinds, as evidenced by tumbling commodity prices. While the situation remains volatile, we would note that fundamentals in key major economies remain generally supportive, and we are still finding selectively attractive investment opportunities at the bottom-up level.

The US economy is still far from recession and recent corporate earnings reports have been largely positive. In Europe, eurozone manufacturing data has been holding steady, corporate earnings have been improving and credit demand has been picking up. In Asian and emerging markets, commodity producers are bearing the brunt of the downturn, but attractive values persist among well-capitalized, well-managed enterprises with good exposure to secular growth trends.

More broadly, we think recent selling pressure could mark a transition away from the market's growth-oriented phase. Since the global financial crisis, growth stocks have outperformed value stocks for an unusually long stretch; in fact, this period marks the longest duration of value underperformance on record.[1]

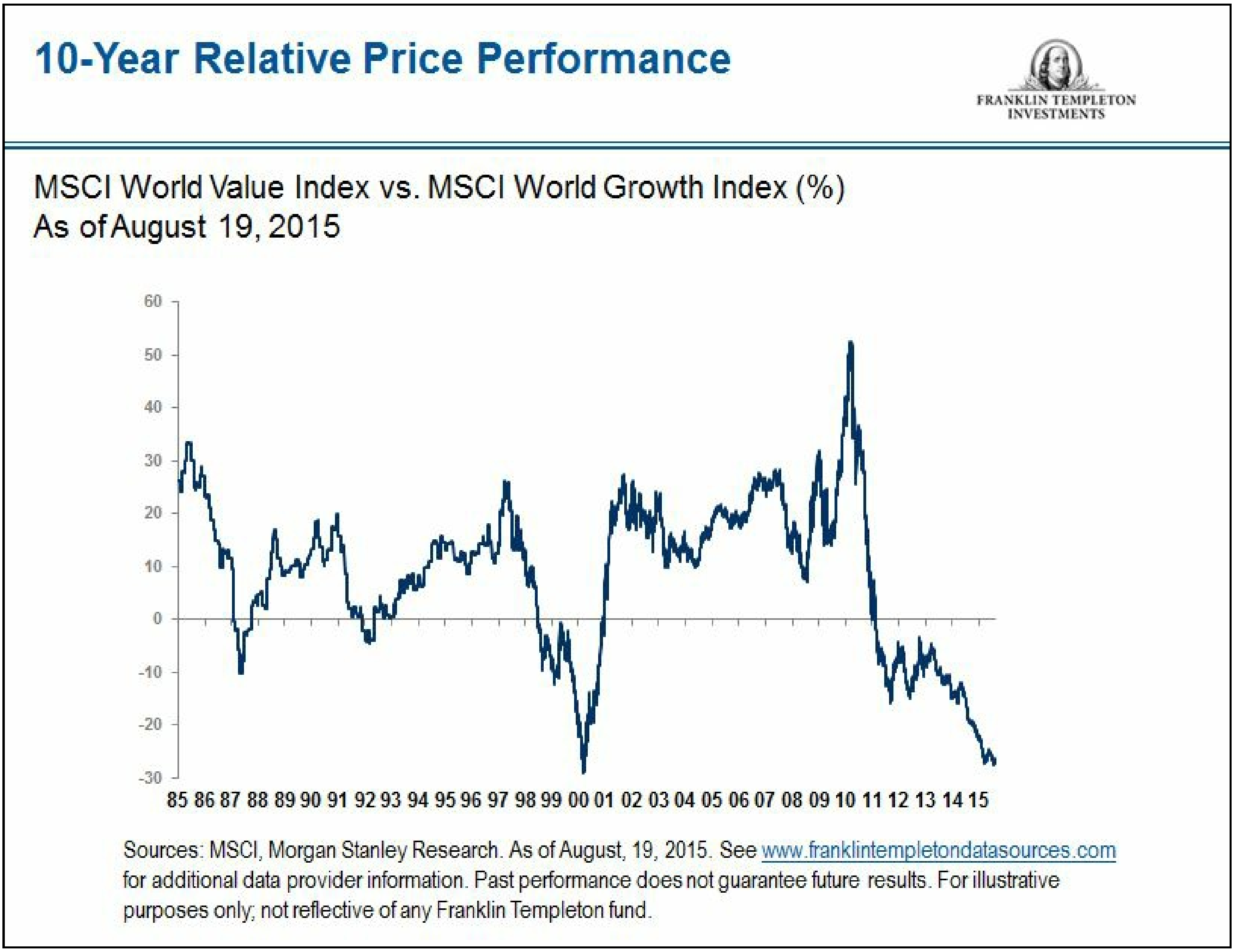
Historically, the outperformance of value has been associated with a rising interest-rate environment; as the US Federal Reserve Board (sometimes referred to as "the world's central bank" for the far-reaching impact of its policies) attempts to begin raising rates, we see a potential catalyst for a value recovery over our long-term investment horizon.

Adrift in the Value Doldrums

At Templeton, we see a strong case for value investing in today's challenging environment. Sir John Templeton once described his investment process as "search[ing] for areas that are unpopular, and then study[ing] to see if that unpopularity is permanent." There is no doubt that value investing today is deeply unpopular.

As the first chart below highlights, value as a style is plumbing the depths of its longest stretch of underperformance on record. Of equal interest to contrarian investors, the second chart suggests that value-oriented stocks look historically cheap relative to their growth-oriented peers. In fact, at a 75% discount to growth on price-to-tangible book value—two standard deviations below the average long-term level—value hasn't been this cheap relative to growth since the peak of the "dotcom" bubble.[2] But, is this unpopularity permanent? History would suggest no; value has always recovered and, over time, outperformed.[3] We are optimistic that any nascent change in market trends could be supportive over a long-term investment horizon for our team's value-oriented approach.

Additionally, we think of value as a forward-looking concept, as opposed to a static or backward-looking valuation multiple. This dynamic approach to value investing tends to distinguish our portfolios from an index-based approach, oftentimes giving us exposure to stocks that might traditionally be classified as "growth." Ultimately, we are not too preoccupied with style labels like "growth" and "value." Sir John Templeton cared far less about the rate of expected earnings growth than he did about the price he was paying for those future earnings.



Price-to-Tangible Book Value

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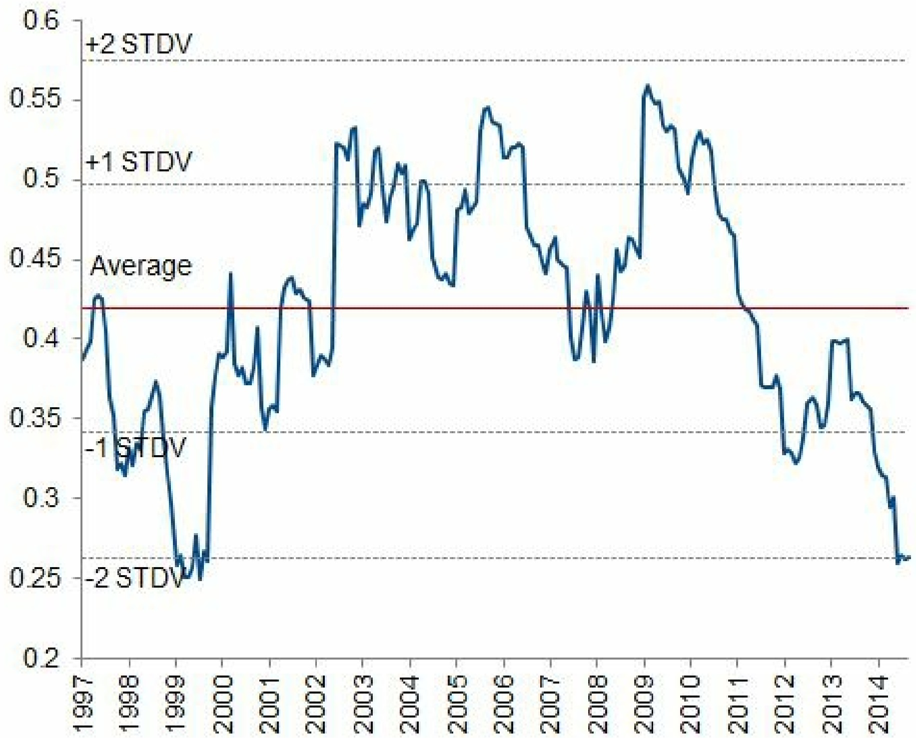
MSCI World Value Index vs. MSCI World Growth Index



Sources: MSCI, Bloomberg, See www.franklintempletondatasources.com for additional data provider information. Past performance does not guarantee future results. For illustrative purposes only; not reflective of any Franklin Templeton fund.

Volatility Creates Long-Term Value Opportunity

A value recovery is by no means the consensus expectation, and admittedly, current conditions appear outwardly hostile to value. So much industrial capacity was added to the global economy in this China-driven, debt-fueled, technology-enhanced business cycle that it is taking a long time for demand to recover to capacity-clearing levels. In our view, the ultimate impact of these forces is deflationary, and against the backdrop of falling yields and lower investment returns, investors have been willing to pay up for growth.

At some point, investors will probably pay too much for the perceived certainty of growth. Yet, the consensus appears to have accepted the current tepid economic environment as the new normal, affording a major scarcity premium to those companies that have demonstrated strong near-term revenue growth. We believe this historic growth premium is unsustainable.

To the extent extreme bearishness persists in the near term, its impact on global equities may be fairly indiscriminate, and we would expect our portfolios to weather some temporary volatility. Yet, as Sir John Templeton once advised: “To buy when others are despondently selling and to sell when others are avidly buying requires the greatest fortitude and pays the greatest ultimate reward.”

We will remain disciplined in our time-tested investment process and use despondent selling to create long-term value for our clients as opportunities arise. For patient investors, we believe the potential recovery in value represents *the* most attractive contrarian investment opportunity in today’s market.

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1. Sources: MSCI, Morgan Stanley Research. See www.franklintempletondatasources.com for additional data provider information. Past performance does not guarantee future results. For illustrative purposes only; not reflective of any Franklin Templeton fund.

2. Sources: MSCI, Bloomberg. See www.franklintempletondatasources.com for additional data provider information. Price-to-book value is a ratio used to compare a stock's market value to its book value. A stock with a low price-to-book value could be viewed as undervalued. Standard deviation is considered a measure of volatility, representing deviation of a set of data from a mean.

3. Past performance is no guarantee of future results.