FIRST QUADRANT

MARKET INSIGHT

Growth or Value in Uncertain Times? Why Not Both?

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While markets may not be "high risk" from a historical standpoint, investors have been shifting from optimistic to pessimistic on a regular basis. The rapid shifts in sentiment have been partly triggered by political issues, which are hard to predict, but there has been conflicting economic data, as well. Although global growth continues to be positive, manufacturing data has been weak, with the most recent Markit PMI indicating a manufacturing recession. Thus, we have some information pointing towards more resilient markets, where risk appetite tends to bounce back after shocks, and some towards fragile markets, where shocks can turn into bear markets.

For investors, this can be a bit of a quandary. We know that when times are good, and markets are resilient, investors tend to be forward-looking. They trust analysts' forecasts and participate in trades that are gaining momentum. But when markets become stressed investors turn to hard measures of value and stocks that hedge against downturns. Value measures are typically asset-based, like Price/Book, and have been popular since Graham & Dodd. However, when investors are forward-looking and markets are resilient, these measures do not do well, as the last few years have demonstrated.

So what's a value investor to do when caught between two market states? Do we go for protection and potentially miss out on the rally, or go for growth and possibly suffer if there is a negative shock? Our research has found that there are measures of value that can be helpful in both environments. These measures are more tied to the actual operations of the company, rather than accounting values. One very consistent measure is the cash flow yield, or the ratio of "Free Cash Flow" to Market Price. A high cash flow means that a company not only has enough income to finance long-term investments in the business, but also has a cushion for unexpected shocks. In other words, free cash flow is good for both growth in good times and protection in times of stress. Our research shows that in periods like 2018, when stocks with attractive asset-based value tend to do poorly, those with high free cash flow tend to do well.

The free cash flow yield illustrates why an investment strategy needs to consider both the market environment and the goals of market participants in that market environment. In resilient markets, investors look to the future and have little interest in measures based on current accounting values. But during times of uncertainty, investors want cold, hard facts and turn to traditional value characteristics. In between these states, you may want to consider a more flexible measure that looks both to the future and the present. The free cash flow yield is one such measure.

Past performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss.

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