JENNISON ASSOCIATES

PERSPECTIVES

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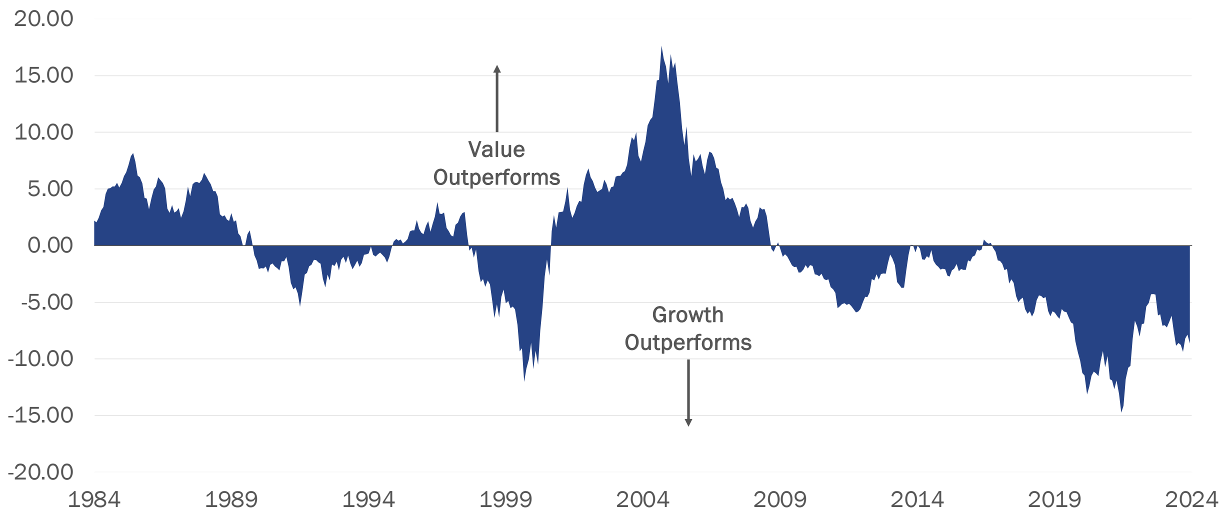
The Value Opportunity: Value Investing in Today's Environment

Growth equities have caught the imagination of investors in today's markets. After all, they have the tech savant leaders, nicknames—"FAANGS," "Magnificent Seven"—and, most importantly, extraordinary gains. Over the past decade, growth has strongly outperformed value on a consistent basis, averaging 16.1% annualized returns versus value's 9.1%.[1] Value has managed some pockets of outperformance, but these were short-lived exceptions (Exhibit 1). As of mid-2024, growth continued its dominance: the Magnificent Seven—Apple, Amazon, Nvidia, Netflix, Meta, Microsoft, and Tesla—accounted for more than a quarter of the S&P 500's market cap and its projected free cash flow.[2]

Exhibit 1: Growth Has Dominated Value Since 2008

Difference in Annualized Total Returns over 5-Year Rolling Periods: Russell 1000 Value vs. Russell 1000 Growth Indices



Data from May 31, 1984 through May 31, 2024. Past performance does not guarantee future results.

Source: Jennison, FTSE Russell

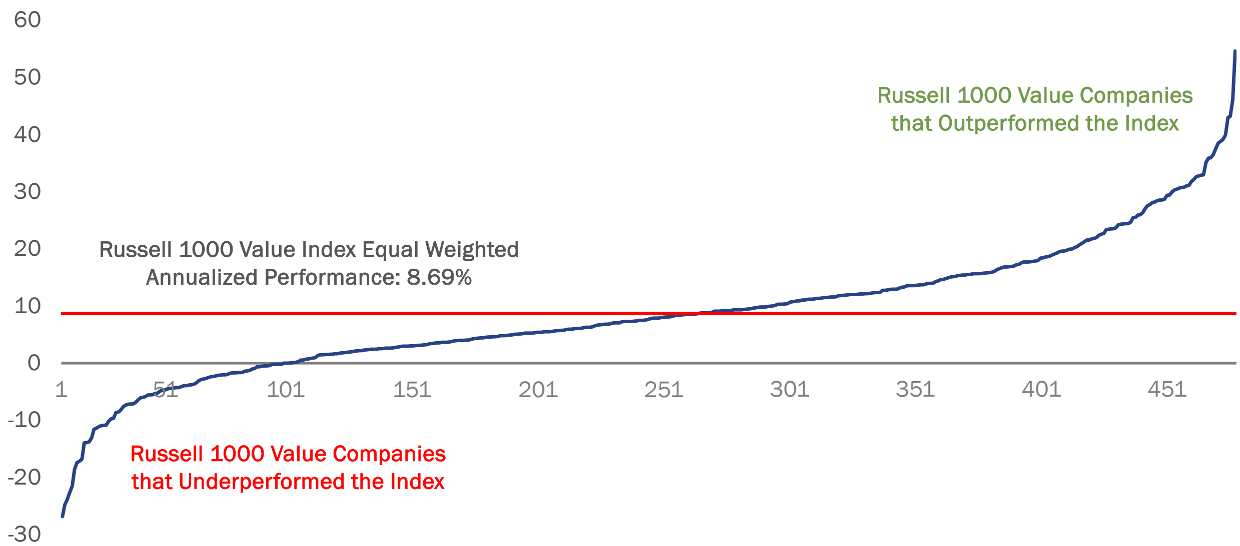
Nevertheless, we believe investors can benefit from value investing, especially in the current market environment. We are not suggesting that value-based indexes will inevitably overtake their growth counterparts, nor that the developments in technology have led to a growth bubble. We largely agree that the economy is undergoing fundamental, secular shifts that will impact virtually every industry. However, we also believe value strategies can be an effective way to access a broad set of investment opportunities.

A value-based investing approach—grounded in bottom-up, fundamental analysis—can help identify companies that are well led, innovative, offer growth potential, and are well priced. Value managers often identify opportunities overlooked by others. They can position themselves early, taking advantage of short-term price fluctuations to buy attractive companies that are undervalued on a long-term basis (i.e., time horizon arbitrage).

We believe this approach can be especially fruitful today when investors have been rewarding companies with promising fundamentals. Almost half of the companies in the Russell 1000 Value Index have outperformed the index on an equal-weighted basis since 2020 (Exhibit 2). This has given skilled value managers the opportunity to use a different approach to potentially achieve the same objective as their successful growth manager counterparts: long-term outperformance.

Exhibit 2: Fundamentally Strong Companies Have Been Rewarded

Russell 1000 Value Index Companies Performance Annualized (%)



Russell 1000 Value companies with more than $5 billion market capitalization (481 companies). Calculated on an equal-weighted basis annualized from December 2019 through May 2024. Past performance does not guarantee future results.

Source: Jennison, FTSE Russell

Multi-Faceted Approach to Value Investing

How should investors think about value exposure? There are many effective approaches to investing (be it growth or value). The characteristics listed below, in our view, may be effective and repeatable. We feel that applying a well-vetted investment process consistently over longer periods of time can potentially deliver attractive results.

Intrinsic Value

First, we believe an intrinsic value approach to assessing a company's valuation is critical.

When product or market innovations alter a company's Total Addressable Market (or TAM), an intrinsic value approach can capture the present value of those changed prospects for future free cash flow (FCF) growth. In contrast, a P/E or EV/FCF approach can miss these important aspects about a company.

A focus on intrinsic value gives skilled managers the ability, when they believe circumstances warrant, to hold a stock even when the P/E multiple on near-term earnings has expanded. This can be an opportunity for value managers to generate alpha.

Durability

Second, we believe durability (which we define as durability of earnings and FCF growth) is very important to identifying attractive investment opportunities. One of the key elements in assessing intrinsic value is estimating a business' terminal value, a measure which accounts for the long-term durability of a franchise's margin structure and FCF generation in the outyears. If product or market innovations alter a business' competitive positioning, the change in the franchise's durability is often concealed in a low (or high) P/E or EV/FCF ratio on near-term earnings. Some value managers may miss this in their pursuit of (so-called) "cheap stocks."

We believe a focus on durability can help managers better evaluate the impact disruptions have on terminal value and, therefore, intrinsic value. This, in turn, can improve the manager's ability to exit or avoid low P/E value traps, while simultaneously helping to increase its ability to stick with a winning stock whose valuation "looks expensive" on near-term earnings.

A Long-Term Horizon

Third, we believe patience is a key tenet of a successful investment process. Investors' perceptions of a company often fluctuate more widely than its underlying fundamentals, a short-term focus that can create rewarding investment opportunities. We believe the intrinsic value of a business will emerge and be recognized, and patience rewarded, when good managements execute on their plan over time.

Long-term investing also allows for the power of compounding to drive returns and can allow managers to limit the impact of short-term market swings. If an investment thesis remains intact, a manager may continue to hold a company until its intrinsic value is recognized.

Risk Management

Fourth, active investment management requires active risk management. Many managers follow most, if not all, traditional risk measures in portfolio management (e.g., beta, tracking error, factor exposures, standard deviation, etc.). However, we believe one of the most important risk measures can be derived from proprietary scenario analysis on holdings.

Some managers, for example, enhance their "margin of safety" by constructing upside and downside scenarios for each company. This allows them to calculate their risk/return exposure more precisely—e.g., managers may prefer companies with upside scenarios that offer roughly two times the gains as compared to the losses estimated in the downside scenario. The wider the range of potential outcomes in the scenarios, the larger the risk. The potential dispersion of outcomes for any individual stock, in our view, is an important element of risk that some value managers may ignore or underestimate.

In addition, the discipline from scenario analysis, particularly downside scenarios, can help limit so-called "value traps." If the downside price target (or the investment thesis) is violated for reasons that are not anticipated, or is much worse than initially believed, the manager can reassess the thesis and, if necessary, exit the position.

The team's judgment is essential. In the illustrative example below (Exhibit 3), the team entered a stock at a price below its valuation range (green arrow). Over the next two years, the company delivered results in line with expectations, which drove gains in the markets. After the company's position reached a large size in the portfolio, the team sold some of the position (Exhibit 3, first red arrow) to take profits and redeploy the cash in other opportunities. The team maintained its confidence in and exposure to the company, which was rewarded over the next several years as the stock enjoyed market success. The position grew to a large size and was trimmed again (second red arrow). Finally, after a positive run and a strong catalyst, the stock reached the team's price target, leading to a significant reduction in the position (third and final red arrow).

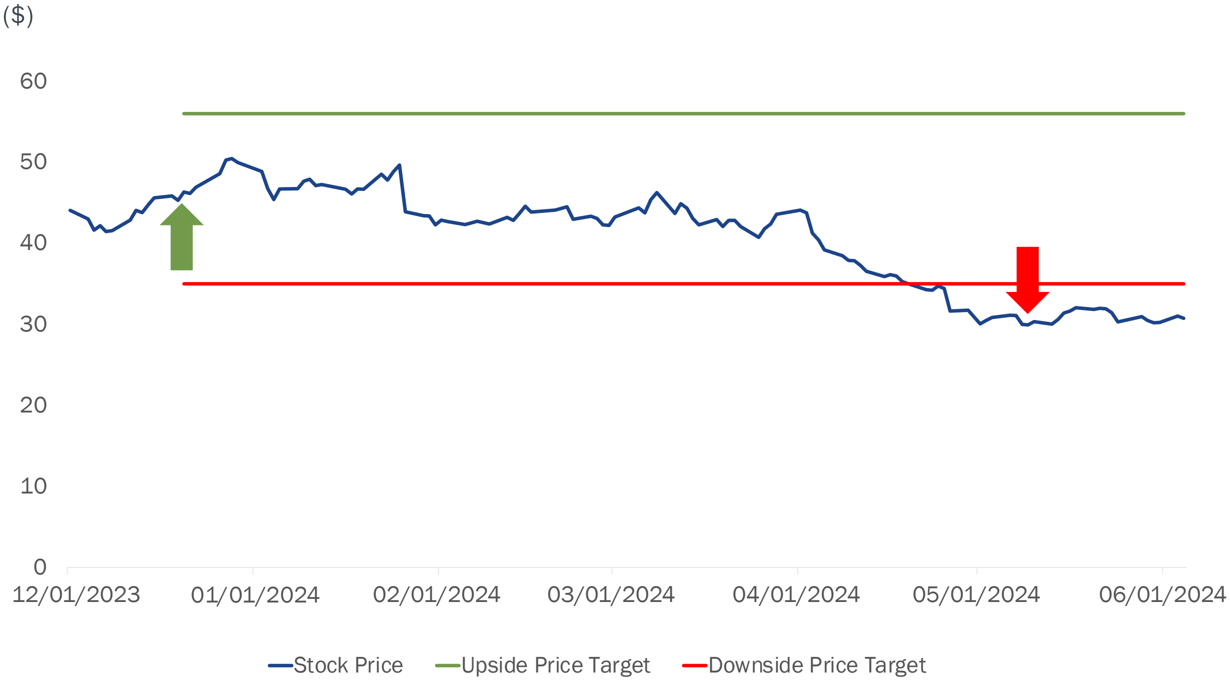
Exhibit 3: You Have to Know When to Hold'em. . .

Data from April 2019 through March 2024. Past performance does not guarantee future results.

Source: Jennison

It is not uncommon for a stock price to drift below the team's downside target. Sometimes—but not always—the downward movement triggers a sale. In one case, the team decided that the company's thesis was no longer valid and sold the position (Exhibit 4; red arrow). The team's sell discipline, in hindsight, was crucial to preventing additional losses in a company with deteriorating fundamentals.

Exhibit 4: . . . And When to Fold'em



Data from December 2023 through June 4, 2024. Past performance does not guarantee future results.

Source: Jennison

Strong Fundamentals Are Ultimately Rewarded

Fifth, much attention has been paid to the Magnificent Seven and how they have driven a majority of the S&P 500 Index returns in 2023 and so far in 2024. This performance has been impressive, but it misses a broader story: companies in the index that executed and grew their earnings and cashflow in-line with, or better than, expectations, also generated strong returns.

We believe a skilled, effective investment process that focuses on fundamentals can help identify higher quality companies. Disciplined execution of a solid investment process, particularly during volatile markets driven by short-term thinking, can help managers in the value space to find attractive companies that have been mispriced by the markets.

Exposure to Value Positioning

Sixth, during a "growth-led" market, some value managers' portfolios may have drifted into the core or blend style box. Style drift can negate the diversification that strategy is supposed to provide—especially when it is needed most during periods of volatility and uncertainty. In our experience, an intrinsic value approach has helped keep the portfolio in the upper right-hand corner of the value box.

It's important to note that indexes can migrate, or drift, across market caps and different styles of investing because of changes in the macroeconomic environment. Consequently, investors who are seeking consistent exposure to a specific value approach may be better served by a well-disciplined manager than a passive or a less-disciplined active approach.

Over the past several years, value equities (Russell 1000 Value Index) have on average trended smaller, while large cap stocks (S&P 500 Index) and growth equities (Russell 1000 Growth Index) have taken on more growth exposure, which is consistent with recent outperformance by technology-driven companies.[3] Note that the style drift in the S&P 500 Index to growth exposure makes value a potentially stronger diversifier.

An Important Investment Approach in Its Own Right

Large cap growth equities have largely deserved their extraordinary performance over the past decade. Many growth companies—especially in technology—have had visionary leaders and developed products that are innovative and meet the needs of customers. However, we believe investors are wrong to assume that value has little to contribute to today's market environment.

We believe value strategies help diversify a portfolio, and also identify important investment opportunities that a growth strategy, because of its focus, would understandably miss. A skilled value manager with a bottom-up, fundamental approach can also identify innovators at a relatively inexpensive price—which often happens prior to, or early in, a new product life cycle. This, in turn, offers investors exposure to the compounding returns that can drive long-term portfolio outperformance.

Endnotes

[1] Russell 1000 Growth Index versus the Russell 1000 Value Index through March 30, 2024.

[2] As of May 31, 2024

[3] Data from June 1, 2021–May 31, 2024; FTSE Russell, Standard and Poor's

Disclosures

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