Harris Associates
Oakmark Funds

Value vs. growth: Then and now - U.S. Equity market commentary 3Q23

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"There is no such thing as growth stocks or value stocks as Wall Street generally portrays them, as contrasting asset classes. Growth is part of the value equation."

-Warren Buffett

At Oakmark, we are long-term investors. We attempt to identify growing businesses that are managed to benefit their shareholders. We will purchase stock in those businesses only when priced substantially below our estimate of intrinsic value. After purchase, we patiently wait for the gap between stock price and intrinsic value to close.

In the decade ending in 2021, the Russell Growth 1000 Index doubled the performance of the Russell 1000 Value Index. That partially reversed last year when the Russell Value outperformed the Russell Growth by 22 percentage points. As a result, value investors thought we might have the wind at our backs for a while. But just as quickly, Russell Growth climbed back in 2023, outperforming the Russell Value Index by 24 percentage points, erasing Value's 2022 gains. This unusually large divergence has made growth versus value a popular discussion topic despite no agreement on what the terms mean. Let's look into our definition of value, and the opportunity we see today for price-sensitive investors.

Oakmark is value

Oakmark is known as a leading practitioner of value investing. Each Oakmark fund follows a value investing discipline and usually falls in Morningstar's Large Value category. But we often get asked, "Wait a minute, you say you're a value investor, how can you own XYZ?" And, of course, the question never refers to General Motors or Capital One, holdings trading near book value with single-digit P/E ratios. Instead, it is typically about stocks, like Alphabet, that are trading above the S&P 500 P/E ratio. We love the question because it provides us the opportunity to explain what value investing means to us.

History of value investing

Benjamin Graham, who co-authored *Security Analysis*[1] in 1934, is generally viewed as the father of value investing. In that book, Graham encouraged avoiding speculation by investing with a margin of safety, meaning paying such a low price that if you were only partially correct you weren't likely to lose money. Graham understood that owning a stock wasn't just a certificate; it was a fractional interest in a business. Further, business value was closely tied to shareholders' equity, or book value, which was a relatively stable number. Stock prices, however, generally correlated more to earnings than book value, so they were more volatile. He believed that investors could purchase depressed shares when earnings were low and then patiently wait for better times when the price would climb back to book value.

OPINION PIECE. PLEASE SEE ENDNOTES FOR IMPORTANT DISCLOSURES.

Nearly 90 years later, many still think of value investing as buying below book value and waiting for a reversion to the mean. In fact, Investopedia states that, “A price-to-book ratio under 1.0 typically indicates an undervalued stock.” Eugene Fama, professor at the University of Chicago, and Kenneth French, professor at Dartmouth College, showed that, on average, low price-to-book stocks performed well from 1963-1990.[2] Why did it work so well? The U.S. was primarily an industrial economy, and earnings were tightly tied to physical assets. Earnings rose during good times and fell during bad, but book value acted like an anchor that limited the swings. And just as a boat returns to its anchor when the wind dies down, stock prices usually returned to book value.

Growth investors paid little attention to book value, instead looking for growing earnings. Because companies with above-average earnings growth tended to sell at high price-to-book ratios, growth and value investors lived in separate worlds that rarely overlapped. Investors referred to a “growth versus value” continuum with cheap stocks that didn’t grow very much at one end and high-growth businesses that were very expensive at the other. Growth investors owned exciting businesses, but value investors got the last laugh because their boring stocks usually made more money.

The value of intangible assets

In 1988, Warren Buffett shocked his followers by purchasing Coca-Cola. It was an excellent business, the kind that was too expensive for value investors. But Buffett explained that accounting rules prevented Coca-Cola from putting its brand name on its balance sheet and noted that the company’s “most valuable asset is on the balance sheet at zero.” When he included an estimate of the company’s brand value, Buffett could see that he was buying Coca-Cola at less than its true business value.

In the 1990s, Oakmark applied that approach to other intangibles, such as R&D and customer acquisition costs. We adjusted financial statements to reflect the long-term benefit of spending that increased customers or developed new products. That showed us that some cable TV and biotechnology companies were cheap relative to their business value. Over the years, as the U.S. moved from an industrial economy to a knowledge economy, adjusting for intangibles—or, as we say, “income statement investing”—became necessary for more companies. By the early 2000s, value investors were lamenting the failure of low price-to-book investing. At Oakmark, we believed this was a failure of accounting principles, not value investing.

Growth can be cheap or expensive

The idea that value investing is limited to outdated, competitively disadvantaged companies selling at low P/E ratios couldn’t be further from our definition of value. In fact, one of my favorite questions from investors is, “What would you do if ‘value’ got expensive?” What they are really asking is how we would respond if below-average businesses sold at average prices. Well, then they wouldn’t be undervalued. But the better businesses that should be selling at higher P/E ratios would be. Buying great businesses at average prices is just as much value investing as buying average businesses at great prices.

It is simply inaccurate to position value as the opposite of growth. I like what Buffett said, "Growth is part of the value equation." Investors should pay somewhat more for faster growing businesses, though the premium is often more than we can justify. But when the market underprices growth, buying faster growing businesses is value investing.

So, how does Oakmark differ from growth investors? We are willing to pay premium multiples for faster growing businesses as evidenced by our holdings of companies like Alphabet, Amazon and Salesforce. But the big difference is how far into the future we are willing to project above-average growth. Our analysts model financial statements for the next two years and then apply a growth rate for the next five years, giving us a seven-year forecast. If a stock can't grow into a below-market P/E ratio in that time, we aren't likely to consider owning it. I can almost hear you asking, "What about the 'compounders' that we 'know' will keep growing well beyond seven years?" Yes, some will. But the growth graveyard is full of companies that early in my career were considered "compounders:" Pitney Bowes (mailing machines), Yellow Pages, newspapers, cable networks, landline phones, drug companies (before patent cliffs became so steep), TV and radio stations, mainframe computers, and yes, mutual fund managers, just to name a few. It's a humbling list, and it keeps us from using a dim crystal ball to justify the highest P/E stocks.

<u>The opportunity today</u>

This idea that, at the right price, growth can be a value is terribly confusing to those who treat growth as the opposite of value. The opposite of cheap isn't growth; it's expensive. So instead of looking at growth versus value, we look at low P/E versus high P/E. A convenient way is to rank order the S&P 500 by P/E ratio, comparing number 50 to number 450. Currently, the 50th lowest P/E stock sells just over 8 times earnings, and the 50th highest sells at 60. So, the highest priced stocks are about 7 times more expensive than the lowest priced. Over the 30-plus years we have data, the P/E ratio averages about 4, bouncing between 3 and 5. (So, if there are 50 stocks below 10 times earnings, there are 50 over 40.) It was meaningfully higher only one time—when it hit 9 times at the end of the internet and tech bubble in 2000.

When we compare the 50 lowest ranked companies by P/E ratio on the S&P 500 today to the ones that made that list in previous periods, we don't observe any decline in business quality. Therefore, considering both the relatively high price of the higher P/E companies and the solid business quality of the lower P/E companies—we believe that low P/E stocks today present a better hunting ground than they normally do. Last year we bought depressed stocks of high-growth businesses, such as Uber, at a double-digit free cash flow yield; Workday at a low price relative to sales; and Adobe at only a slightly higher than average P/E ratio. This year, after strong outperformance, we sold them and bought much lower P/E stocks. Here's a fun way to think of it: In 2022, we bought a share of Adobe for about three shares of CVS Health. (CVS was just under $100 and Adobe under $300). This year we sold Adobe to buy more than six shares of CVS. (Adobe increased to well over $400 and CVS fell to $70.) We thought Adobe was cheap when we bought it, despite it being a high-growth business, and that CVS was fully priced when we sold it, despite it having a below-average P/E ratio.

As Benjamin Graham said, “The intelligent investor is a realist who sells to optimists and buys from pessimists.” The optimists who buy exciting businesses regardless of price have been on quite a run, resulting in today’s unusually wide spread of P/E ratios. Just as we recommend that investors rebalance their exposure to stocks and bonds after periods of extreme performance—selling what went up to buy what went down—we think investors should do the same for investment styles. Following strong outperformance, selling some high P/E stocks to buy low P/E stocks might both reduce your risk and increase your expected return. That’s why the Oakmark Fund today looks more like a traditional value fund than it has in a long time.

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[1]Graham, Benjamin and Dodd, David L., "Security Analysis." Whittlesey House, McGraw-Hill Book Co. 1934.

[2]Fama, Eugene F., and Kenneth R. French. "The cross-section of expected stock returns." the Journal of Finance 47, no. 2 (1992): 427-465.

The securities mentioned above comprise the following preliminary percentages of the Oakmark Fund’s total net assets as of 09/30/2023: Adobe 0%, Alphabet Cl A 3.5%, Amazon.com 1.7%, Capital One Financial 2.7%, Coca-Cola 0%, CVS Health 1.0% General Motors 2.1%, Pitney Bowes 0%, Salesforce 1.7%, Uber 0%, Workday 0% and Yellow Pages 0%. **Portfolio holdings are subject to change without notice and are not intended as recommendations of individual stocks.**

The securities mentioned above comprise the following preliminary percentages of the Oakmark Select Fund’s total net assets as of 09/30/2023: Adobe 0%, Alphabet Cl A 8.7%, Amazon 0%, Capital One Financial 5.7%, Coca-Cola 0%, CVS Health 0%, General Motors 0%, Pitney Bowes 0%, Salesforce 4.9%, Uber 0%, Workday 0% and Yellow Pages 0%. **Portfolio holdings are subject to change without notice and are not intended as recommendations of individual stocks.**

The securities mentioned above comprise the following preliminary percentages of the Oakmark Global Select Fund’s total net assets as of 09/30/2023: Adobe 0%, Alphabet Cl A 8.2%, Amazon.com 3.2%, Capital One Financial 4.7%, Coca-Cola 0%, CVS Health 0%, General Motors 0%, Pitney Bowes 0%, Salesforce 0%, Uber 0%, Workday 0% and Yellow Pages 0%. **Portfolio holdings are subject to change without notice and are not intended as recommendations of individual stocks.**

To obtain a full list of the most recent quarter-end holdings, please visit our website at www.oakmark.com or call 1-800-OAKMARK (625-6275).

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The price to earnings ratio ("P/E") compares a company's current share price to its per-share earnings. It may also be known as the "price multiple" or "earnings multiple", and gives a general indication of how expensive or cheap a stock is. Investors should not base investment decisions on any single attribute or characteristic data point.

The Price to Book Ratio is a stock's capitalization divided by its book value.

Morningstar: Large-value funds invest in stocks of big U.S. companies that are less expensive or growing more slowly than other large-cap stocks. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large-cap. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value, and cash flow).

The S&P 500 Total Return Index is a float-adjusted, capitalization-weighted index of 500 U.S. large-capitalization stocks representing all major industries. It is a widely recognized index of broad, U.S. equity market performance. Returns reflect the reinvestment of dividends. This index is unmanaged and investors cannot invest directly in this index.

Russell 1000® Growth Index is an unmanaged index that measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000® companies with higher price-to-book ratios and higher forecasted growth values. This index is unmanaged and investors cannot invest directly in this index.

The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000® companies with lower price-to-book ratios and lower expected growth values. This index is unmanaged and investors cannot invest directly in this index.

The Oakmark Funds' portfolios tend to be invested in a relatively small number of stocks. As a result, the appreciation or depreciation of any one security held by the Fund will have a greater impact on the Fund's net asset value than it would if the Fund invested in a larger number of securities. Although that strategy has the potential to generate attractive returns over time, it also increases the Fund's volatility.

Because the Oakmark Select Fund is non-diversified, the performance of each holding will have a greater impact on the Fund's total return, and may make the Fund's returns more volatile than a more diversified fund.

Oakmark Select Fund: The stocks of medium-sized companies tend to be more volatile than those of large companies and have underperformed the stocks of small and large companies during some periods.

Because the Oakmark Global Select Fund is non-diversified, the performance of each holding will have a greater impact on the Fund's total return, and may make the Fund's returns more volatile than a more diversified fund.

Investing in foreign securities presents risks that in some ways may be greater than U.S. investments. Those risks include: currency fluctuation; different regulation, accounting standards, trading practices and levels of available information; generally higher transaction costs; and political risks.

Investing in value stocks presents the risk that value stocks may fall out of favor with investors and underperform growth stocks during given periods.

All information provided is as of 09/30/2023 unless otherwise specified.

Before investing in any Oakmark Fund, you should carefully consider the Fund's investment objectives, risks, management fees and other expenses. This and other important information is contained in a Fund's prospectus and summary prospectus. Please read the prospectus and summary prospectus carefully before investing. For more information, please visit Oakmark.com or call 1-800-OAKMARK (1-800-625-6275).

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