WEALTH SEPTEMBER 17, 2019 / 1:13 AM / 2 DAYS AGO

U.S. value fund managers betting shift to value stocks won't last

David Randall

6 MIN READ

NEW YORK (Reuters) - The massive U.S. market rotation into value stocks over the last two weeks is finally giving value fund managers a reason to be hopeful after years of underperformance.

FILE PHOTO: Traders work on the floor at the New York Stock Exchange (NYSE) in New York, U.S., September 9, 2019. REUTERS/Brendan McDermid

Yet portfolio managers from firms such as Hillman Funds, Artisan Partners and Eaton Vance say that they are taking the rally in value stocks - so called because they trade at cheaper valuations than the rapidly expanding companies in the growth stock category - to sell some of their best performers and move into companies that are further out of favor. The move is based on views that the market's shift to value stocks will not last.

Among the companies that value funds are unloading are energy stocks, which surged 2.2% on Monday after an attack on Saudi Arabian crude facilities knocked out 5% of the world's supply.

"I'm a little skeptical that this has legs," said Aaron Dunn, co-director of value equity at Eaton Vance, noting that a sell-side firm his fund works with told him that they were seeing few buy orders from long-only funds and getting more of their business from quantitative-based strategies. "This is more of a momentum reversal and the valuations aren't that compelling anymore."

Bank of America Merrill Lynch and JPMorgan argue that the U.S. rotation into value - which has also been seen in Europe - may run further. Yet investors like Dunn argue that the move into value is fleeting.

Dunn said he continues to focus on companies like business jet company Textron Inc (TXT.N) and hot water heater manufacturer A.O. Smith Corp (AOS.N), which have posted weak results lately but have better long-term prospects.

MARKET SHIFT

Perceived improvement in U.S.-China trade negotiations and better-than-expected U.S. economic data helped ease investor concern about an impending recession, lifting bond yields and sparking the market rotation into value stocks, according to research from Goldman Sachs. At the same time, the rotation has pushed momentum stocks like plant-based meat company Beyond Meat Inc (BYND.O) and restaurant chain Chipotle Mexican Grill Inc (CMG.N) into their worst two-week return since 2009.

"These catalysts released the potential energy created by investor crowding" while also propping up beaten-down small-cap stocks, according to a note from the firm.

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At the same time, the steep increase in the yield of the benchmark 10-year Treasury note - whose jump from 1.45% at the beginning of September to 1.85% on Monday was the largest two-week gain since November 2016 - is helping boost the shares of financial companies that reap higher profits from interest rates, said Jonathan Golub, chief U.S. equity strategist at Credit Suisse Securities.

"This looks more like a reprieve for value than a longer-term trend," he said. "The real question for value is, 'Do you believe that interest rates will continue to go higher when all indications are that the economy will remain sluggish for the remainder of the year?'"

Mark Hillman, whose 25% gain in his Hillman Fund puts it among the top-performing large-cap value funds tracked by Morningstar this year, said the recent market rotation is sending many value stocks closer to their fair market value.

He is focusing on companies that look like they remain significantly undervalued, such as retailer Nordstrom Inc (JWN.N) and food company Kraft Heinz Co (KHC.O).

"We still think there is plenty of opportunity in this space," he said.

Thomas Reynolds, a portfolio manager of the Artisan Value Equity fund, said the underperformance of large technology and communications companies suggests investors are moving out of the most-crowded trades.

"People have been looking at these huge tech companies with strong balance sheets almost as a safety play," he said.

Any shift away from that mindset could continue to help companies like brokerage firm E Trade Financial Corp (ETFC.O), which is up more than 9% since the start of the month, he said.

"There are lots of companies out there that the market has ignored because their stories have not been perfect," he said.

The surge in value stocks could help push the broad stock market to new highs as investor fears of an imminent recession ease, said Charles Lemonides, founder of hedge-fund ValueWorks LLC, who has been moving into shares of companies like United Natural Foods Inc (UNFI.N) and Transocean Ltd (RIGN.S).

The benchmark S&P 500 is about 1.2% below its record high of 3,027.98.

"The advance has finally broadened out and the old narrow leadership has come down in price," said Lemonides, adding that he believes the S&P 500 will soon trade above 3,300. "As a group value stocks will likely be stable, and the exciting names will be 20 percent higher and still be below their old highs."

Reporting by David Randall; Editing by Jennifer Ablan and Dan Grebler

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