Commentary

October 2016

BARROW STREET
ADVISORS

# Looking Ahead to 2017:
# Will Value Lead Growth?

Principals Nicholas Chermayeff, Robert Greenhill Jr. and David Bechtel provide their current perspective on their investment approach, merger and acquisition activity and a potential market leadership shift.

## 1 With Barrow's focus on Quality and Value in stock selection, what have been the challenges of this approach over the past three years?

At Barrow, we focus on searching for high quality, stable businesses that typically possess the following business characteristics:

- **Strong top line growth,** as the market should reprice the stock higher as the company grows
- **High returns on capital and ample cash flow,** enabling companies to reinvest cash to fuel growth
- **Low debt levels,** as low leverage generally makes companies resilient to future economic challenges
- **Management teams with a high degree of ownership,** as they tend to be highly motivated and well-aligned with investors' interests

We seek to purchase these companies at what we believe are attractive discounts to their intrinsic values. This timeless investment philosophy can run counter to short-term market rallies. Investors may be influenced by macroeconomic and global geopolitical factors as well as the extreme intervention of central bank policies. These extrinsic forces may have little to do with the quality and value of an individual company.

While macro events present a challenge, we remain patient and focused on the intrinsic value and quality of the company.

Our conviction has been occasionally tested, but we believe our patience and diligence will be rewarded over the long term.

## 2 Merger and acquisition (M&A) activity has historically been an important driver of stock performance. Would you please discuss the current level of activity?

Overall, M&A volume and dollar value have declined on a year-to-date basis in 2016 compared to historical periods. While M&A activity tends to be cyclical, the slowdown takes the wind out of the market as fewer buyers are willing to pay premiums for publicly traded stocks.

Regardless of the slowdown in transactions, we anticipate M&A activity will continue to be robust. Private equity funds currently have $1.3 trillion in cash—an all-time annual high since 2000—and a significant portion of that "dry powder" can be spent on buyouts. With an unrealized $2.8 trillion portfolio value, private equity has a significant market presence with respect to M&A activity.

We take a private equity approach to investing, and therefore, can spot attractive entry levels in companies that later get identified as M&A targets. One recent example includes German chemical company Lanxess purchase of U.S.-based Chemtura (CHMT) at a 19% premium to the stock's closing price at the time of announcement.

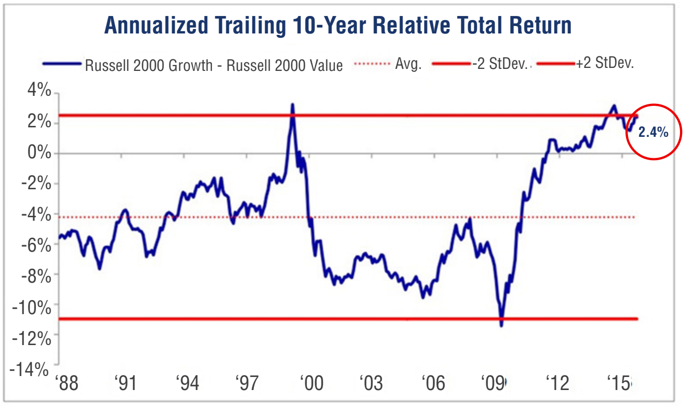
BARROW STREET ADVISORS

## 3 With growth stocks outperforming value stocks for multiple years in a row, what might indicate a market leadership shift?

Returns of growth and value stocks have historically been cyclical, with consecutive years of outperformance by growth stocks followed by strong periods of performance by value stocks. As shown in the charts below, large- and small-cap value appear poised to outperform growth companies, as the difference between the trailing 10-year returns of growth and value stocks in both the small and large cap market have hit a 15-year peak. To Barrow, we believe this peak period of underperformance by value stocks indicates a bright future ahead for value investors.

**LARGE-CAP GROWTH VS. VALUE**


**SMALL-CAP GROWTH VS. VALUE**




Source: Strategas Research Partners

## Important Information

**Performance data quoted represents past performance; past performance does not guarantee future results.**

The **Russell 1000 Growth Index** is an unmanaged index that measures the performance of companies in the Russell 1000 Index considered to have a greater than average growth orientation. The **Russell 1000 Value Index** is an unmanaged index that measures the performance of companies in the Russell 1000 Index considered to have less than average growth orientation. The **Russell 2000 Growth Index** is a capitalization weighted broad based index of 2,000 small capitalization US stocks considered to have a greater than average growth orientation. The **Russell 2000 Value Index** is an unmanaged index that measures the performance of companies in the Russell 2000 Index with lower price-to-book ratios and lower forecasted growth values. It is not possible to invest directly in indexes which are unmanaged and do not incur fees and charges. Market indices are included in this report only as context reflecting general market results during the period and should not be considered a comparable benchmark.

This commentary is distributed for general informational purposes only and is not intended to constitute legal, tax, accounting or investment advice. Any opinions expressed in this commentary are Barrow Street Advisors’ current opinions and do not necessarily reflect the opinions of any of its affiliates. Furthermore, all opinions are current only as of the date hereof and are subject to change without notice. Barrow Street Advisors does not have any obligation to provide revised opinions in the event of changed circumstances. All investment strategies and investments involve risk of loss and nothing within this commentary should be construed as a guarantee of any specific outcome or profit.