MFS® White Paper

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Re-framing Growth and Value through an Active Lens

Shifting perspectives moving forward

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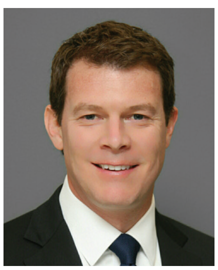

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We have been in a period of historic outperformance of growth versus value. As a result, many investors are wondering whether value is dead and growth will continue to dominate, or if not, when value will start to outperform.

The relative performance differential started to widen about five years ago as secular shifts and innovation provided meaningful tailwinds for companies in more growth-oriented sectors such as information technology while disproportionately negatively affecting those in more value-oriented sectors such as energy, consumer discretionary and financials. These trends have meaningfully accelerated in 2020 with the onset of COVID-19 pandemic, which has resulted in a global recession, declining interest rates and enormous fiscal stimulus. As of October 30th, 2020, we have witnessed the widest magnitude of relative performance between the style benchmarks in more than 40 years (since 1979), surpassing levels reached during the technology bubble boom and bust. While historically the large-cap-style benchmarks have been reasonable proxies for the underlying investment-style performance, today we believe there are a number of factors investors may want to take into consideration when thinking about their investment exposures.

We offer in this piece a holistic view, examining both growth and value from a benchmark and style/factor perspective. We start with a historical perspective of growth and value performance before offering observations on the current environment. From there we take a closer look at benchmarks versus styles/factors, with a discussion on some of the underlying drivers of growth's relative outperformance, which in many cases has been amplified by the pandemic. Finally, we suggest clients consider steering the growth-versus-value discussion away from using the Large Cap US and Global Style benchmarks and toward such factors as the primary metric of growth and value investment performance. We believe that the construction of the large-cap benchmarks and the increased concentration in a handful of names globally leaves the respective growth (and even core) benchmarks with a higher level of risk than many investors realize.

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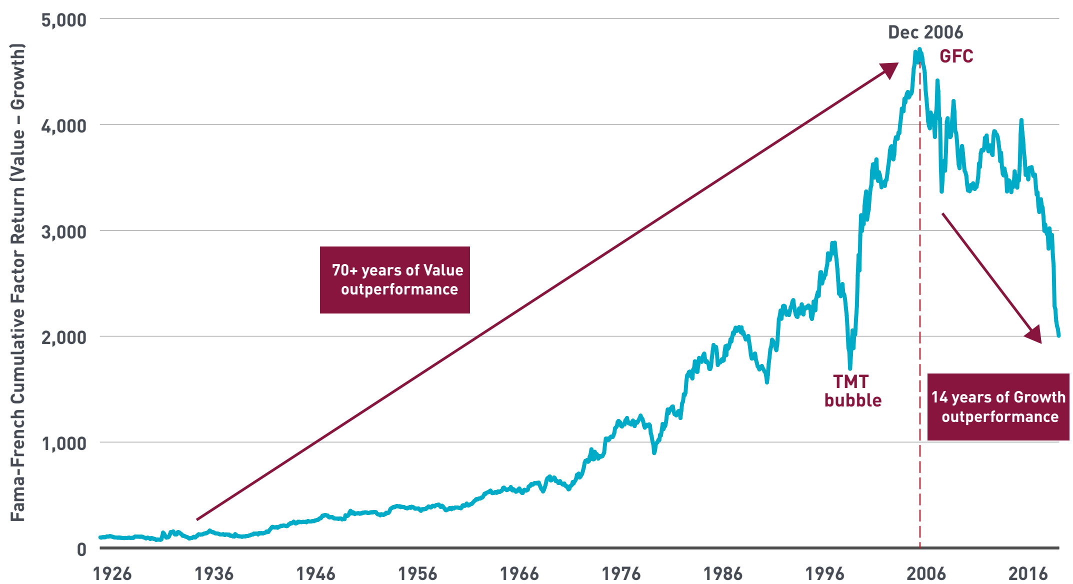
Style rotation is common

Historically, style rotation is actually quite commonplace when viewed through the lens of both factors and benchmarks.

From a factor perspective, looking over the period from June 1926 through 30 September 2020, value has outperformed most of the time. To be sure, there were periods from 1926 through 2006 when growth outperformed value, exhibiting the cyclical patterns that have continued into this century. In the wake of the GFC, this long-term trend reversed and growth has since dominated value, particularly in the most recent period. While growth has outperformed only 14 years, a shorter duration than prior periods of value's outperformance, its magnitude has been significant.

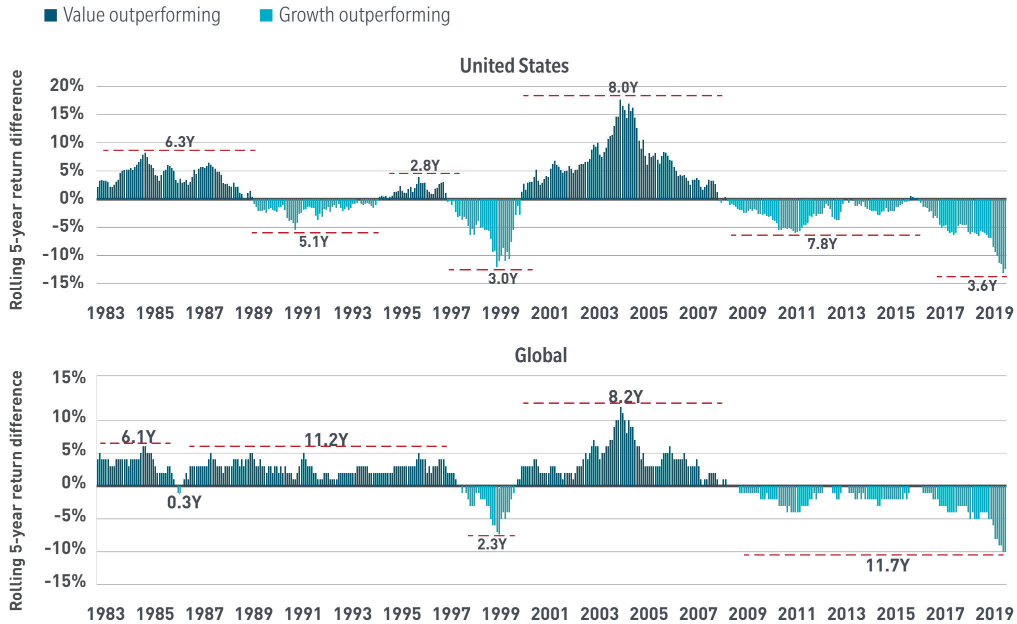
Exhibit 1: Recent growth leadership follows long period of value outperformance



Source: Fama-French factor returns for the US. Chart shows the cumulative High Minus Low (HML) factor return from June 1926 to August 2020 (June 1926=100) defined as the average return on the Small Value and Big Value portfolios minus the average return on the Small Growth and Big Growth portfolios. https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

From a benchmark perspective, since the late 1970s, the MSCI World Value has outperformed MSCI World Growth more often, while the Russell 1000® Growth has outperformed the Russell 1000® Value more than 50% of the time. More recently, the outperformance of large-cap growth benchmarks has been much more pronounced and of greater duration than during previous periods, nearly offsetting the strong outperformance of value stocks from the end of the dot-com era to the beginning of the global financial crisis.

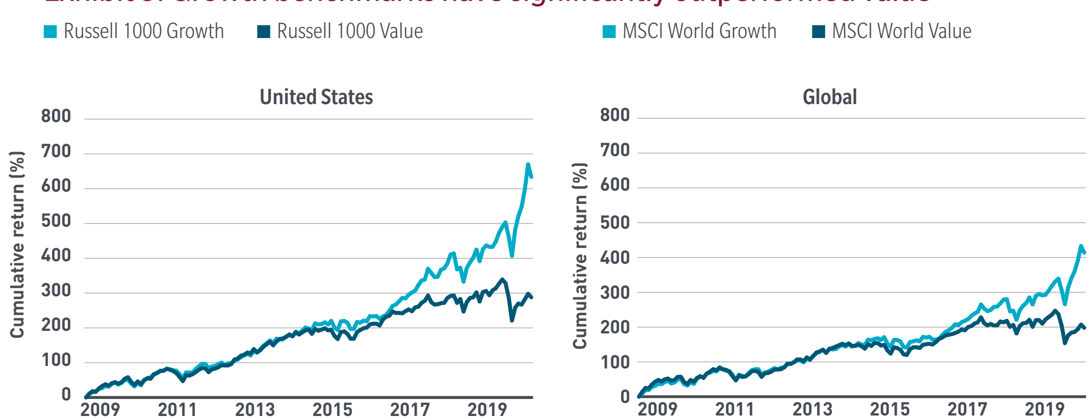
Exhibit 2: Benchmark style leadership has also been cyclical



Source: FactSet SPAR. Monthly data as of 29 December 1978 to 30 September 2020. Total returns (gross) in USD. Calculations show rolling 5-year annualized return differences between Russell 1000 Value and Russell 1000 Growth in the top chart and for MSCI World Value and MSCI World Growth in the bottom chart. **MSCI World Value and MSCI World Growth indices were launched on 8 December 1997. Any prior data is back-tested. Russell style indices were launched on 1 January 1987. Prior data is back-tested.** Charts note duration of leadership by growth or value style when leadership lasts longer than 4 months.

While the cumulative outperformance of these benchmarks has favored growth over value since the end of the GFC, it is worth noting that most of the outperformance has occurred since late 2016 and much of it can be attributed to a handful of mega-cap tech companies in the large-cap growth universe, commonly referred to as the FAANGM stocks (Facebook, Amazon, Apple, Netflix, Google and Microsoft). Notably, since the pandemic hit in early 2020, we have witnessed a tremendous acceleration in the outperformance of growth benchmarks.

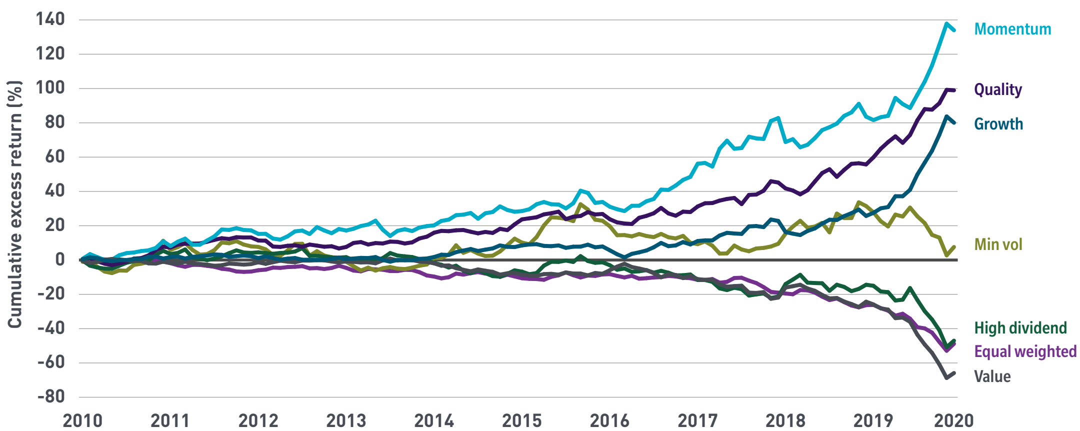
Exhibit 3: Growth benchmarks have significantly outperformed value



Source: Factset SPAR. Monthly data as of 31 March 2009 to 30 September 2020. Data series show cumulative total returns (gross, USD) for US style indices: Russell 1000 Value, Russell 1000 Growth; and Global style indices: MSCI World Value, MSCI World Growth.

Similar to what we observed with the benchmarks, from a style or factor performance perspective, the outperformance of growth and momentum over value factors has largely taken place since late 2016, accelerating in 2020 after the pandemic hit. Prior to the end of 2016, the relative performance of growth and value factors was much more aligned.

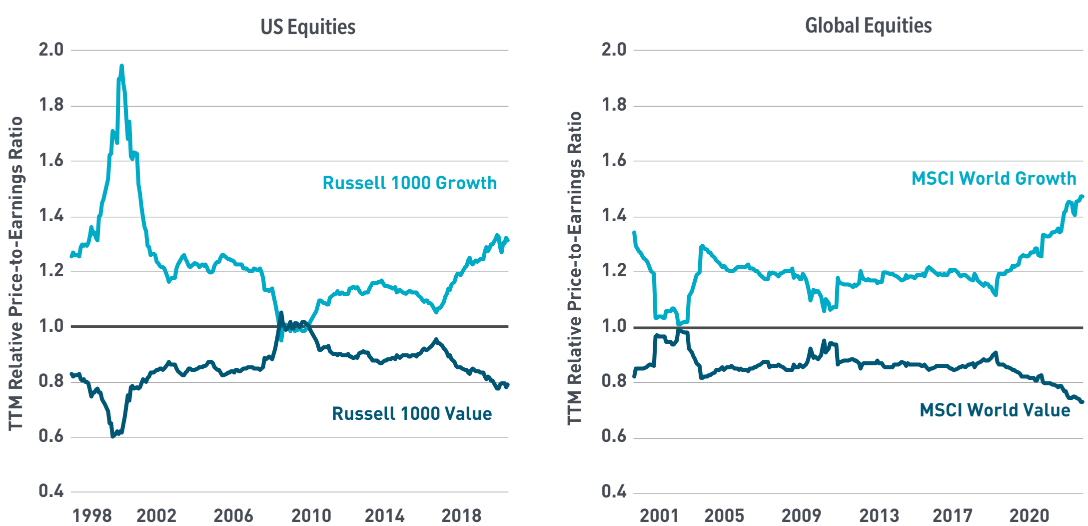
Exhibit 4: Momentum has dominated value over last decade



Source: FactSet SPAR and MSCI Global. Daily data as of 30 September 2010 to 30 September 2020. Figures show the excess cumulative return between each MSCI World style index and the broader MSCI World Index based on gross total return in USD.

All of this has resulted in increasingly wide valuation spreads between the growth and value indices. While valuations in the US have not surpassed the extreme levels reached during the tech bubble, they have widened out significantly more recently. Globally, however, valuations spreads are as wide as they have ever been.

Exhibit 5: Valuation spread between growth and value has increased



Source: FactSet. Data shows trailing twelve month (TTM) price-to-earnings ratio for respective indices. LHS: Monthly data as of 30 January 1998 to 30 September 2020 for Russell 1000 Growth and Russell 1000 Value relative to Russell 1000. RHS: Monthly data as of 31 January 2001 to 30 September 2020 for MSCI World Growth and MSCI World Value relative to

Where do we go from here?

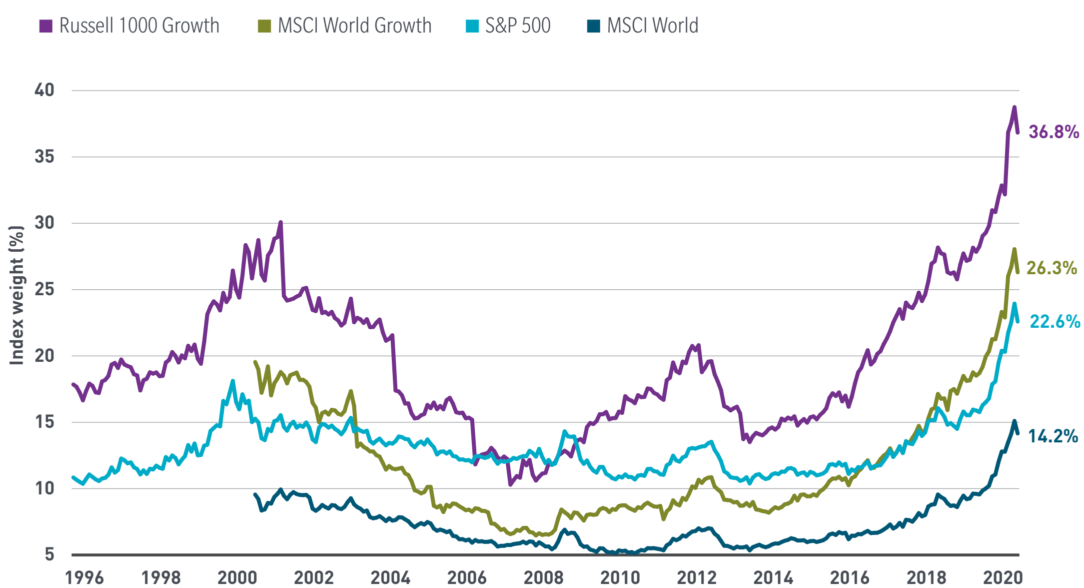
How one thinks about what the future holds for growth and value may depend on how one defines those styles. Historically, the style indices (Russell 1000® Growth and Russell 1000® Value or MSCI World Growth or MSCI World Value) have been reasonably good proxies for measuring the underlying investment style performance. More recently, however, index concentration, the increasing importance of intangible assets and sector allocations have all had a major influence on benchmark performance.

Benchmark concentration has meaningfully increased, and this has performance and risk implications moving forward. Looked at in a historical context, concentration in the Russell 1000® Growth/MSCI World Growth and the S&P 500/MSCI World are at all-time high levels, exceeding the previous peak reached during the dot-com era. This increased concentration of the growth and core benchmarks has been driven by Microsoft, Apple, Amazon.com, Alphabet and Facebook, which account for nearly 40% of the Russell 1000® Growth. The overall performance of the benchmarks is increasingly tied to these five companies rather than to growth as an investment discipline.

Index concentration, the increasing importance of intangible assets and sector allocations have all had a major influence on benchmark performance.

One of the primary reasons investors buy mutual funds is diversification. Therefore, in the United States, there are rules that must be met for registered mutual funds to market themselves as diversified investment vehicles. This never-before-seen level of concentration in the Russell 1000® Growth currently breaches the SEC diversification rules. If the Russell 1000® Growth ETF were a mutual fund, it would have to be classified as a nondiversified fund so investors could be made aware of the concentration risk they would be assuming. This is one of the most immediate risks investors in passive vehicles face today, sometimes unknowingly.

Exhibit 6: Index concentration has reached extreme levels



Source: FactSet Portfolio Analysis. Chart shows the weight of the top 5 companies based on monthly data from 31 January 2000 to 30 September 2020. Weights of different share classes are consolidated as part of the parent company's weight. The top-5 companies as of 30 September 2020 for Russell 1000 Growth, S&P 500, MSCI World and MSCI World Growth are as follows: Apple, Microsoft, Amazon, Alphabet, Facebook. The information included above as well as individual companies and/or securities mentioned should not be construed as investment advice, a recommendation to buy or sell or an indication of trading intent on behalf of any MFS product.

Another significant factor in the construction of style benchmarks is the reliance on price/book as the primary metric used to measure valuation so that companies may be categorized as growth or value.[1] Traditional book value measures company assets minus liabilities, but ignores many of the resources that are most important to companies today (*i.e.*, intangible assets). According to data compiled by Aon, intangible assets currently comprise approximately 85% of assets on company balance sheets, making price/book valuation metrics less helpful in fully capturing the value of many companies. Traditional book value makes sense in an economy composed of factories, farms and shopping malls but less so in an economy driven by intangibles like patents, licensing agreements, proprietary data, brand value and network effects. In addition, price/book does not capture the risk inherent in increased financial leverage. Importantly, with leverage ratios for the Russell 1000® Value, as measured by Net Debt/EBITDA, sitting near the highest levels seen in the past 25 years, the downside risks for some companies may be far greater than many assume.

Traditional book value makes sense in an economy composed of factories, farms and shopping malls but less so in an economy driven by intangibles like patents, licensing agreements, proprietary data, brand value and network effects.

The reliance on price/book in index construction methodologies has also led to some significant biases in sector positioning across the growth and value benchmarks. Most notably, as of 30 September technology represented nearly 45% of the Russell 1000® Growth and 34% of the MSCI World Growth benchmarks but less than 10% of the value benchmarks. This overweight to technology stocks has been a significant driver of the outperformance of growth over value more recently and is likely to be an important factor in future relative performance trends. Many of these businesses have benefited from exposure to strong end markets that are experiencing secular tailwinds. These include areas like cloud computing, e-commerce and digital payments, to name a few. Conversely, on the value side, this index methodology has led to larger exposures to financials, which have faced headwinds that may persevere — including lower interest rates and higher regulation — negatively affecting performance.

What has driven growth's outperformance?

A number of factors have contributed to growth's recent outperformance.

- As global GDP growth rates have slowed down, fewer companies have been able to sustain high levels of growth. Therefore, it makes sense that investors would be willing to pay a premium for a scarce asset.
- A lower-interest-rate environment benefits long duration assets. All else being equal, as rates go down, valuations for companies that can sustain higher-than-average growth rates should increase. Following dramatic actions by the US Federal Reserve that injected liquidity into the market following the global financial crisis, and then again in 2020 to provide liquidity support to offset economic disruption from COVID, the central bank's balance sheet ballooned. With higher levels of debt, future growth is likely to be lower, further supporting growth equities.
- Ownership of the largest stocks, many of which are in the Information technology sector, has increased to the highest levels seen since 1997, when data first began to be tracked, surpassing prior peaks reached during the tech bubble. In addition, retail investor participation in the market, facilitated by platforms like Robin Hood, has increased significantly, which is also likely contributing to the crowding that we are seeing in the largest companies. Individual investors have been notoriously momentum-oriented, and it is a question of how sustainable these trends will be. Further, investors have gravitated toward companies that are larger and more profitable. These trends have accelerated in 2020 as many of these companies have been benefiting from strong business trends through the COVID period. The trends have also contributed to the Russell 1000® Growth's significant outperformance in 2020.
- In sharp contrast to the tech bubble period, the increased valuations for growth companies today are supported by much higher levels of profitability and returns.

Valuations matter

As we have seen in prior periods — be it the Nifty Fifty era in the seventies or the tech bubble in the late nineties — growth at any price is not a sustainable investment strategy. It never ends well. As valuation premiums extend, the level of risk increases commensurately. Determining the right premium to pay for growth is a critical task. History has demonstrated that it is rare for companies to be able to sustain high rates of growth for long periods of time. Figuring out which companies are able to do this and what is the correct price to pay will be a vital determinant for continued alpha generation for growth investors moving forward.

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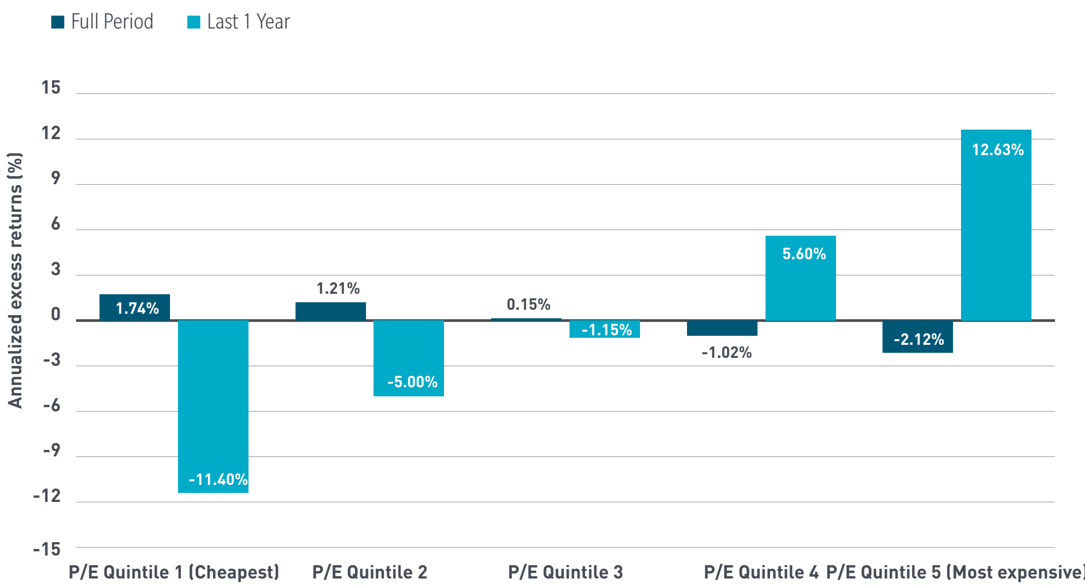
At the same time that growth has experienced the tailwinds noted above, valuation as a factor has not worked. Historically the cheapest stocks have outperformed while the most expensive ones have relatively underperformed. But over the past year the most expensive stocks have trounced the least expensive decisively. This has magnified the relative performance differential between growth and value, when we look at it through both a benchmark and a style lens.

Exhibit 7: Valuations matter in the long run

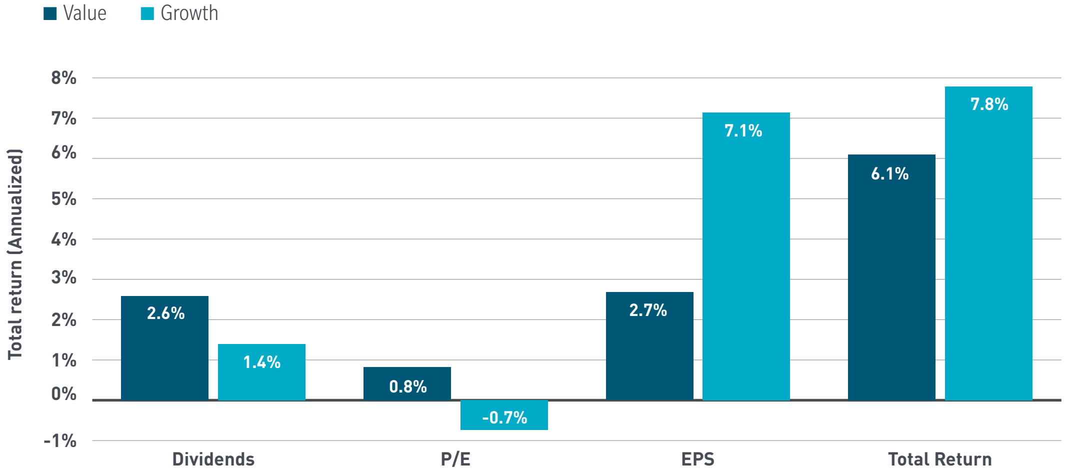


Source: Style Analytics. **"Full Period"** data from 28 February 1995 to 30 September 2020. **"Last 1 Year"** data from 31 October 2019 to 30 September 2020. The exhibit above is intended to illustrate factor performance trends in the market, and not intended to represent factor performance in MFS' quantitative models or investment portfolios. The style performance data are hypothetical returns calculated by Style Analytics based on stock returns within the Style Analytics global equity universe for MSCI All-Country World Index (ACWI). The universe consists of approximately 2,800 of the largest stocks globally, based on equal-weighting each stock at each month-end. For the factor, in this case earnings yield (E/P), stocks with available factor value data are sorted by their factor value within each country and GICS sector, and then grouped into equal-weighted quintiles at the end of each month. The earnings yield factor is defined as annual earnings (adjusted for amortizations of intangibles, extraordinary charges and credits) per share divided by the share price. This factor measures the worth of a company's shares according to the company's ability to support each share with after tax earnings. The universe is reconstructed and returns are calculated each month, and the monthly returns are linked geometrically into cumulative returns. The returns of the hypothetical factor quintile portfolios relative to the universe are displayed in the exhibit. While the data are based on sources believed to be reliable, MFS does not represent that it is accurate or complete and should not be relied on as such or be the basis for an investment decision. As discussed, the factor

Decomposing equity returns over the past 20 years clearly shows that earnings are an important driver of long-term stock price performance, especially for growth stocks. It also shows that while earnings matter for value stocks, returns from dividends are equally important, accounting for nearly 50% of their total return. Over the past decade, equity market returns have averaged over 13% per year.[2] In such a strong absolute return environment, the impact of dividend income has been muted, contributing to the relative underperformance of value.

Exhibit 8: Over the long term, earnings matter

Decomposition of returns



Source: FactSet Market Aggregates. Monthly data as of 31 December 1999 to 30 September 2020. Value = Russell 1000 Value Index. Growth = Russell 1000Growth Index. Price-to-earnings (P/E) and earnings-per-share (EPS) are trailing-twelve-

What could spark value's return to favor?

- **The absence of bad news may in fact be great news for value stocks.** Financials are a large part of the value universe, and sentiment around these stocks has been terrible. Banks in particular have faced numerous headwinds since exiting the GFC — increased regulatory pressures, deleveraging, declining rates and more recently, concerns about the potential for more credit losses. However, at this point, valuations are inexpensive and generally reflect these challenges and bank balance sheets are as strong as they have ever been.
- **Concerns about the sustainability of today's fastest growing companies.** Today, some of the fastest growing companies are trading at valuations which reflect expectations that a high level of growth will be sustained for a very long time. Should investors begin to become concerned about where these companies are in their maturity cycle, an acceleration of the deglobalization trend or increased regulatory scrutiny, questions about the sustainability of that growth could cause those investors to refocus their attention on companies trading at lower valuations outside the tech sector.
- **Evolution of the sector exposures in the value universe may result in reduced headwinds.** Some of the most challenged areas within the value universe, such as energy, have declined to such low levels that further headwinds from here will be significantly less impactful than they have been over the past decade.

What could cause growth to continue to outperform value?

- **The scarcity value of growth companies in a low-growth environment is persisting or increasing.** The case for the continued outperformance of the growth asset class comes back to the importance of earnings and the ability to generate earnings growth in a low-growth world. Businesses with pricing power that do not rely on underlying GDP to drive unit growth, or some external factor such as interest rates or commodity prices to drive earnings, will likely continue to elicit strong interest from investors and demand premium valuations. This pricing power can be found in many companies that reside in the growth asset class today. Technology companies in particular, given their exposure to long-term structural growth areas, such as cloud computing, e-commerce, digital payments and artificial intelligence (AI), appear well positioned for years to come. The massive barriers to entry, differentiated product and services and intellectual property that many of these firms possess should help support the continued outperformance of growth stocks.

Rising risks amid a wide range of potential outcomes

Equities will continue to be an important component of investors' portfolios, whether the ultimate long- term goal is retirement savings, college education funding or something else. The expectation that the return environment will be more muted moving forward is now broadly accepted.

While passive ownership has been viewed by many as a way to reduce risks over the past decade, it may in fact be far riskier than many may realize in the current environment. Looking ahead to the remainder of this new decade, the range of potential outcomes is wider than any other period we can remember, so uncertainty is high. Whether one is focused on growth or value, the benchmark idiosyncrasies discussed have resulted in meaningful increases in concentration risk, valuation risk, leverage risk, sustainability risks and business risk for passive investors invested in the large-cap-style benchmarks. The level of uncertainty is high, however, in our view, the opportunity for active managers to add long-term value for clients has rarely been greater. The ability to assess the long-term potential for companies to add value and thrive in many different environments — whether as a growth or value investor — while carefully considering risks — including those that haven't yet presented themselves — will be critical in ensuring that portfolios are well-positioned to deliver strong risk adjusted returns moving forward. We believe MFS is well positioned to deliver on our mission of creating value for clients by allocating capital responsibly. Given where we are in the cycle and in this challenging environment, the opportunity to do so has never been greater.

Endnotes

[1] FTSE Russell uses book-to-price, IBES forecast medium-term growth and historical sales-per-share growth. R1G includes companies with higher price-to-book ratios and higher forecast growth values. R1V includes companies with lower price-to-book ratios and lower expected growth values. MSCI uses five variables to define the growth style benchmark: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend, long-term historical sales-per-share growth trend and three variables to define the value style benchmark: book value to price, 12-month forward earnings to price and dividend yield.

[2] Average annual return of the S&P 500 from 9/30/10 through 9/30/20.