WILL VALUE INVESTING MAKE A COMEBACK?

Value is underperforming

According to some measures, Value is underperforming as an investment style relative to Growth. For example, the S&P Developed Broad Market Value Index underperformed its Growth counterpart by 1.1% p.a. over the last 10 years to the end of March 2016. This contrasts with the academic evidence that, in the long run, Value outperforms Growth. Indeed the S&P Broad Market indices show that Value outperformed Growth by around 1% p.a. over the last 20 years.

Part of the reason why Value is currently underperforming Growth is because Value stocks in general have moved to more discounted valuation levels, thus dragging down the returns of Value stocks compared to Growth. The current valuation difference between Value and Growth is now high by historical standards and this has previously been associated with higher future returns for Value compared to Growth.

The Value Spread

A common valuation measure is the book-to-market (BtM) ratio. The BtM ratio, favoured by academics, is simply the inverse of the price-to-book ratio, favoured by practitioners. A stock with a high BtM ratio is usually defined as Value whereas a stock with a low BtM ratio is generally regarded as Growth. To compare the valuation of Value versus Growth stocks, we can look at the difference between the weighted average BtM ratio of a portfolio of Value stocks and a portfolio of Growth stocks – which is commonly referred to as the *value spread*.

Research shows that the future relative performance of Value versus Growth (let's call it VMG for Value-minus-Growth) partly depends on the difference between their respective BtM levels i.e. the value spread. If the value spread is very high (as it was during the Tech bubble) then we might expect the future return of VMG to be higher.[1]

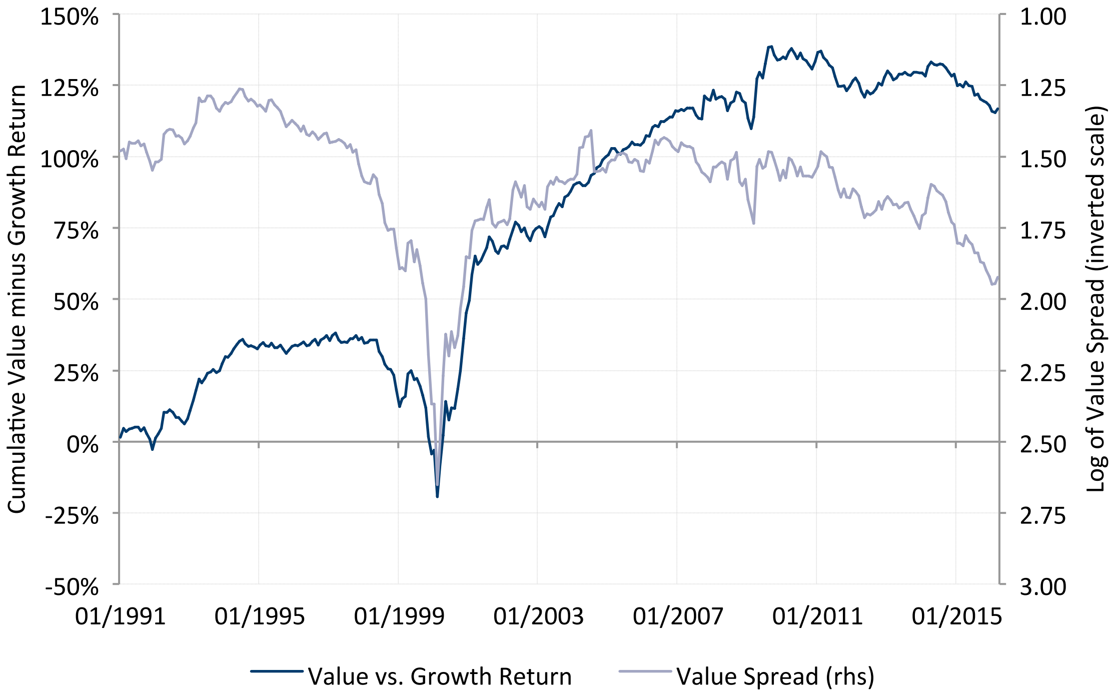
The Value Premium and the Value Spread

In Figure 1, we show a chart of the cumulative return of VMG and the value spread (using an inverted scale) across global developed market equities. Here Value (Growth) stocks are defined as the top (bottom) 30 percent by market value of stocks ranked by BtM in each country.

As Figure 1 shows, VMG tends to drift upwards, reflecting the well-known return premium of Value over Growth. However, there is a strong relationship between changes in the value spread and the realized return of VMG. In fact shifts in the relative valuation of Value versus Growth account for around two thirds of the risk of the VMG factor. VMG trends down when the value spread increases and vice versa. The value spread was at its widest at the peak of the Tech boom reflecting the excessive valuation levels of Growth stocks at the time.

[1] Academic studies on this topic include: Asness et al (2000). "Style Timing: Value versus Growth." *Journal of Portfolio Management,* 26, pp. 50-60; and Cohen et al (2003). "The Value Spread." *Journal of Finance* 58 (2), pp. 609-641.

Figure 1: The Value Premium vs. the Value Spread



Source: Style Research

The usefulness of this analysis depends on two assumptions however. The first assumption is that the high spread in the valuation between Value and Growth mean reverts in the "long run". Guessing when that will occur is probably futile. Recall that many investors incorrectly thought that the valuation of Growth stocks was already excessive at the end of 1998. However they continued to outperform Value stocks by around 50% before the Tech boom finally reversed. The second assumption is that the valuation level won't be significantly affected due to a change in fundamentals. For example, a stock trading at a high BtM level could suffer impairment to its balance sheet due to subsequent losses or write-downs. Conversely, a stock trading at a high price-to-earnings ratio could experience significant growth in earnings allowing the fundamentals to catch up with the price.

It is much more difficult than it may appear to use the value spread as a signal to time when Value will outperform Growth. Given the long run premium to Value, investors are generally better off sticking with an overweight to Value and riding through those periods when the value spread widens. In general, as Figure 1 shows, Value tends to outperform Growth.

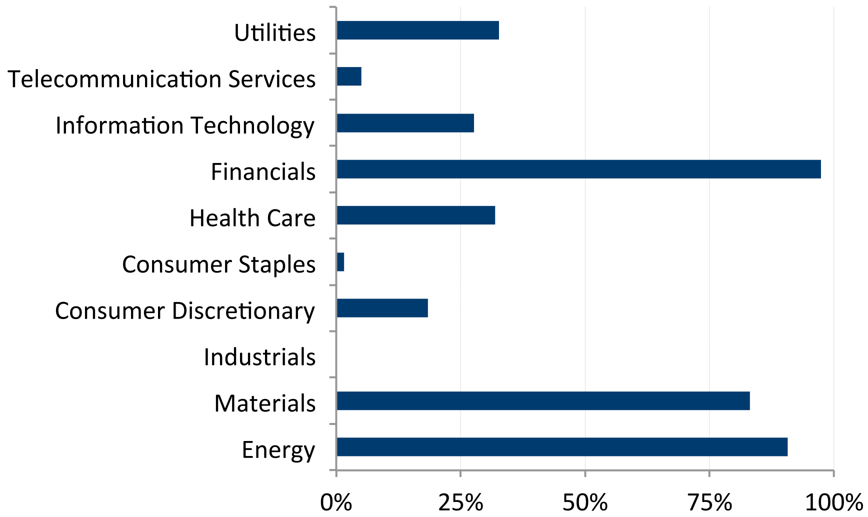
However there are periods when it underperforms, and those periods are closely tracked by changes in the value spread.

Sector Valuation Levels

Similar to the analysis above on the valuation levels of Value and Growth as investment styles, we can examine current sector valuation levels and put them into their historical context.

Figure 2 shows the percentile rank of the current BtM ratio of each global sector relative to its own history over the last 10 years. If we look at those sectors that currently have high allocations in the Value segment – Energy, Financials and Materials – we can see why Value is out of favour. Each of these sectors is currently valued at depressed levels. There are obvious and widely reported reasons why investors are concerned about the prospects for companies in these sectors. Banks have not properly recovered from the Financial Crisis and profits may continue to be impaired due to loan losses, regulatory costs and the effect of low interest rates under Quantitative Easing. A lack of demand from China is having a large negative impact on Materials and Energy, and the latter is also impacted by a glut in oil supply and a move to cleaner energy sources etc.

Figure 2: Percentile Ranks of Global Sector Book-to-Market Ratios at 31 March 2016 versus 10-Year History



Source: GSI, Factset

By contrast, defensive sectors such as Telecommunications and Consumer Staples have been driven to very high valuations relative to their history. The latter appears to reflect a defensive stance on the part of investors and may also be partly due to a herding of institutional investors into smart beta strategies that emphasise low risk stocks.[2]

Conclusion

In the past, a high valuation spread between Value and Growth stocks has contributed to a higher subsequent relative return for the Value style. For global developed markets as a whole, that spread is now in the top 7% of its range over the last 20 years – a period that includes the Tech bubble. The last time the spread was this high at a global level was around the end of 2000, after which Value outperformed Growth by 3.2% p.a. for 10 years. For those with patience, investors will be rewarded for sticking with Value in the longer run.

[2] A recent analysis by RAFI supports this – see Arnott et al. 2016 "How smart beta can go horribly wrong", Research Affiliates.