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Is there still value in Value?

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Just as a batsman whips out a cover drive to find the boundary at Lord's, value investing has long been the trusted arrow in the discerning investor's quiver to deliver stellar returns. Its followers, like Mr. Buffet, have reached rock star status. However, value seems to have hit a bad wicket. Since the Global Financial Crisis (GFC), value has suffered one of its longest drawdowns against other style factors, most notably growth. Calls for the death of value have been growing. So, let's explore the arguments against value, seeking answers to why it has underperformed and whether these outcries have been premature.

Value investing involves buying securities that appear underpriced relative to some fundamental anchor, typically a measure of intrinsic value linked to financial statements such as Book to Price (B/P), Price to Earnings (P/E) or Price to Cash Flow (P/CF). Fama & French[1] cemented value as an investment strategy in their seminal paper documenting the outperformance of HML (High Minus Low) stocks. In short, they established the existence of a premium when following a strategy that involves going long high B/P (cheap) equities and short low B/P (expensive) equities. However, since 2007 developed market growth equities have outperformed its value counterpart by more than 3.5% annually. If the value premium exists, why has it performed so badly over this period?

One argument is that value has become a crowded trade, and any premium has been arbitraged away. The thinking goes that everyone knows the value premium exists, and therefore enough capital has flowed to this strategy to increase asset prices (i.e., valuation multiples) of value stocks and reduce the future returns from this cohort. This argument is however easily refuted as valuation spreads – the difference in valuations between growth and value – have widened considerably.

A further diagnosis of value's ails relates to the low interest rate regime that persisted over much of the past 15 years. Low interest rates are said to benefit growth stocks as they are more exposed to duration risk due to their outsized expected future earnings. However, this alone does not suffice, as value stocks normally have greater debt burdens and would benefit from lower rates. Furthermore, there has been no meaningful relationship between interest rate levels or changes in rates and that of the value premium.

A further criticism of value relates to its inability to capture the rise of intangible assets in a transformed economy dominated by services and knowledge. Financial reporting requirements are more adept at accounting book value for capital invested in brick-and-mortar industries than for intangible assets. Investments into R&D, human capital and customer relationships are fully expensed, reducing book value immediately, despite long-term future returns. An approach that adjusts book value by capitalizing investment in intangibles would have outperformed normal HML strategies by 2.2% per annum from 2007 to 2020. Although this criticism has merit, even an intangible asset-adjusted value strategy would have still underperformed against growth.

If none of the above, with a minor exception of the intangible asset's argument, have caused value's slump, what has? The root cause seems to lie with relative valuations of value and growth stocks. The returns on the value factor can be split into three components: migration, profitability, and revaluation. Migration refers to stock level mean reversion in value stocks, while profitability captures the relative performance of companies on an income yield basis.

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02 September 2024

Each year some value stocks rerate and migrate into neutral or growth portfolios, providing returns to the strategy. Growth stocks are normally more profitable and growing faster, hence their justified higher multiples. Migration benefits value strategies whilst profitability benefits growth strategies. The last component is revaluation. This component captures the return from a change in valuation spreads between growth and value stocks.

In their research, Arnott et al[2] show that migration and profitability have remained largely unchanged when comparing returns from value portfolios before 2007 and after. Value stocks are still rerating into neutral or growth, and this return still more than offsets the profitability of growth stocks, although the premium has slightly diminished. The main culprit in value's underperformance is revaluation. Value stocks have become considerably cheaper relative to growth, being 3.2 times cheaper now measured on B/P, compared to 1.7 in 2007. The current gap is amongst its widest in history, comparable with the dotcom bubble. It seems that the prices have strayed precariously far from fundamentals.

What does this mean for value in the future? For value to be declared dead, the spread should increase indefinitely. Given the drawdowns in revaluation experienced to date, this seems unlikely. Even if revaluations do not meaningly revert but remain steady, the impact of migration over profitability still holds – in essence value still exists.

There is reason for optimism when looking at value's future. Although value has yet to see the light again in the US, there has been a glimmer of hope in international markets. Value strategies for developed markets excluding the US have outperformed growth since the depth of COVID-19. The principles encapsulating the strategy are still sound, and it is coming off a very low base. Overreliance on narrow definitions of value should be cautioned, but after its tough slog, value's next innings might be one of its finest to come.

Sources: [1]Fama, Eugene F. and French, Kenneth R., The Anatomy of Value and Growth Stock Returns (August 2007). [2]Arnott, R. D., Harvey, C. R., Kalesnik, V., & Linnainmaa, J. T. (2021). Reports of Value's Death May Be Greatly Exaggerated. Financial Analysts Journal. Unless stated all data is sourced Bloomberg Finance L.P., August 2024.

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