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Is cheap always cheerful?

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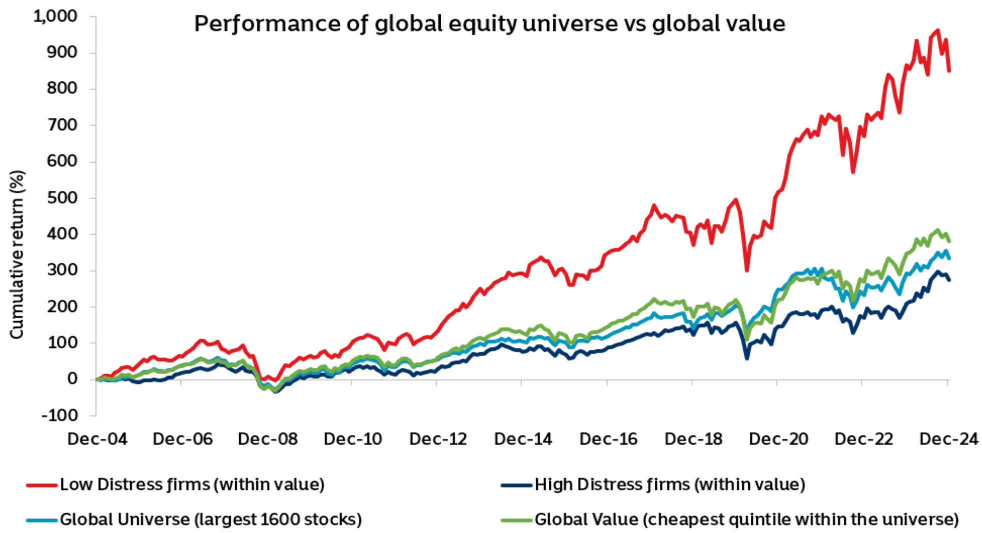
Chart of the Week



Source: FactSet as at December 2024

What this chart shows

Much has been said regarding the rewards of Value investing, essentially buying securities at discount to their intrinsic value. Over the longer term, this strategy has proven to be successful. There are many ways investors can do this, but typically it involves buying securities that are cheap based on certain metrics such as Price to Book (PB) or Price to Earnings (PE) ratios.

However, it is also widely accepted that investing in this space carries significant risks, and certain risks are worth avoiding. In this chart, we show a basket of global value stocks, defined as the cheapest quintile based on their price to book ratio. We then rank this cohort of stocks by their level of financial distress using a broad-based indicator, namely the Altman Z-score. This is a numerical measure that aims to calculate the probability of a business going bankrupt, making it a useful gauge of the state of financial distress in the firm.

The chart illustrates that investing in the cheapest quintile of securities has historically paid off over the long term, with global value outperforming the broader global universe. However, taking on additional risk by purchasing securities with higher distress risks is not well rewarded, as they tend to underperform. Therefore, if one's portfolio is skewed towards more distressed names, its performance is likely to be mediocre over time.

Why this is important

We often hear the term "value trap" and questions like "does value still work?". This analysis demonstrates that, while the value premium over the long term is positive, investors are more likely to be adequately compensated if they avoid the riskiest areas, which typically have a much higher risk of bankruptcy.

This also highlights the risk of accessing value stocks passively through funds and/or Exchange Traded Funds (ETFs), which tend to invest indiscriminately across the whole spectrum of cheaply traded securities, including those with higher levels of financial distress. The key takeaway is that investing in value stocks does not come without risk. We believe the best way to capture the value premium is via third-party active managers who have the required skills and expertise to carefully navigate these risks. Such managers can potentially enhance returns significantly by identifying businesses that are undervalued but exhibit lower financial distress, minimizing the risks inherent in this space.

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Important notes