Is Value Investing “dead”?

29/08/18 |Chad Slater, Morphic Asset Management

Tech stocks and growth investing have profited from 30 golden years. So is this the end of value investing?

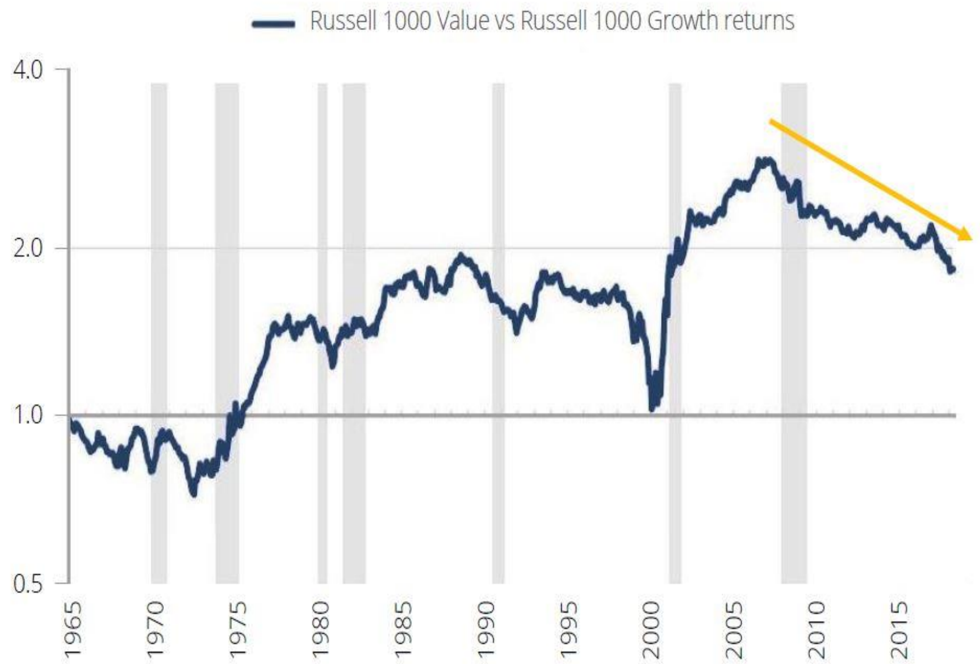
GROWTH INVESTING’S GOLDEN YEARS

In case you have been completely detached from stock markets, technology stocks (called FAANG, which stands for **F**acebook, **A**pple, **A**mazon, **N**etflix and **G**oogle) and growth investing are all the rage again. Every cycle has its poster child – in the “noughties”, it was Emerging Markets and mining stocks and this one is turning out to be San Francisco all over again. For those old enough to remember, it is as if the Tech bubble of 1999 never really left…

One of the accepted tenets of investing had been that value investing – a style popularised by Ben Graham and arguably perfected under Warren Buffett, where investors buy unloved cheaper stocks – rewarded its adherents with superior performance through time for accepting the pain of social isolation that comes with buying unloved and discarded businesses whilst others laugh at you.

And this was indeed true for many years. **Figure 1** below shows the returns of value investing in the US compared to following a growth style (where investors pay more for stocks growing swiftly) back to 1965. But since 2007, this recent period of value investing lagging growth has been so severe that value investing has given back all its gains since 2002 and now we are back to where it was in 1988.

FIGURE 1 – VALUE INVESTING VS GROWTH RETURNS IN THE US BETWEEN 1965 AND JUNE 2018



Source: OSAM

There's patience and there's patience – more than 30 years of no excess returns to value is the longest on record and should make one at least consider whether the model is broken.

O'Shaughnessy Asset Management out of the USA, a value adherent like us, with a similarly open model of publishing their thoughts did an excellent walkthrough of the dimensions of value and growth investing – which I will draw on heavily here.

Firstly, it dispelled some myths about the current value underperformance period. One myth espoused by value adherents is that we are just in another Tech bubble and the underperformance is due to these FAANG stocks outperforming.

However, when OSAM went through each listed sector (**Figure 2**), they found, somewhat remarkably, that growth investing had outperformed value in every sector in the USA since 2010!

FIGURE 2 – GROWTH OUTPERFORMANCE PER SECTOR SINCE 2010

Sector	Total Performance Effect (%) Growth over Value (2010 - June 2018)
Energy	17.44
Consumer Discretionary	13.97
Information Technology	13.19
Financials	8.71
Industrials	4.21
Consumer Staples	4.17
Utilities	3.49
Health Care	2.17
Real Estate	1.93
Materials	0.83
Telecommunication Services	0.27

Source: OSAM

This is not just a "tech bubble" story. Something else is going on amongst the listed companies of the world (which we will return to later).

So how did you make money out of value investing strategies (i.e. why did markets reward you for this style of investing previously)?

OSAM used the Russell 1000 as their starting point – an index similar to the All Ordinaries – except it comes as a "value" and a "growth" form. **Figure 3** below shows a decomposition of returns from 1965 to 2010.

FIGURE 3 – RUSSELL 1000's SOURCES OF RETURN BETWEEN 1965 AND 2010

Index	Return Source	June 1965 - June 2010
R1000 Value	Holding Period EPS Growth	7.01%
	Multiple Expansion that Got Rebalanced Out of the Index	3.18%
	Multiple Expansion that Stayed in the Index	0.06%
R1000 Growth	Holding Period EPS Growth	16.25%
	Multiple Expansion that Got Rebalanced Out of the Index	-7.65%
	Multiple Expansion that Stayed in the Index	-0.46%

Source: OSAM

Firstly, one can notice that growth companies do in fact grow faster than value stocks. That is, they are better businesses.

But investors are not the founders and thus they must acquire it (the shares) on the stock market. The price they buy and sell at reflects what others think the business is worth: *investors trade in the perception of businesses.*

Value investors make money not because value stocks are fast growing or great, but *because value stocks aren't as bad as people thought they were, so they re-rate (higher P/E) as opposed to growth stocks which aren't as good as people hoped they were and they de-rate.*

So 7% EPS +3% re-rating = 10% is > than 16% – 7% = 9% return for growth stocks. Whilst this may not seem like a lot, this average 1% per year adds up to large numbers over long periods of time.

Now compare this to the table for the period since 2010 (**Figure 4**). What is noticeable is that growth in earnings (business growth) is largely in line for the first table for the growth stocks, and whilst the de-rating has moderated, what jumps out is the collapse in earnings growth in value stocks – from 7.0% to 1.8%. The only reason value stocks haven't fallen behind more is the market has re-rated them, hoping that this lacklustre earnings growth will pass.

FIGURE 4 – RUSSELL 1000's SOURCES OF RETURN BETWEEN SINCE 2010

Index	Return Source	June 1965 - June 2010	June 2010 - April 2018
R1000 Value	Holding Period EPS Growth	7.01%	1.76%
	Multiple Expansion that Got Rebalanced Out of the Index	3.18%	8.28%
	Multiple Expansion that Stayed in the Index	0.06%	3.46%
R1000 Growth	Holding Period EPS Growth	16.25%	17.65%
	Multiple Expansion that Got Rebalanced Out of the Index	-7.65%	-5.77%
	Multiple Expansion that Stayed in the Index	-0.46%	5.05%

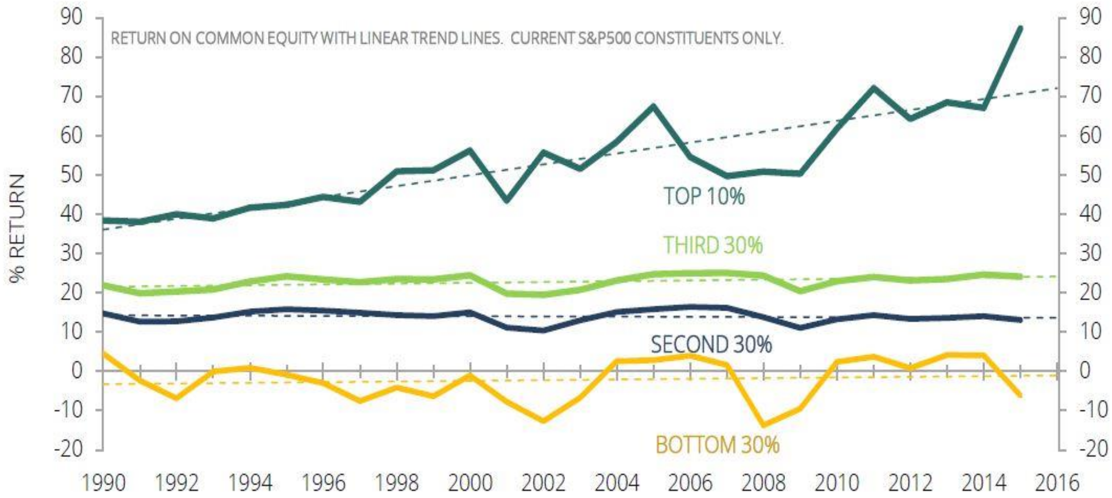
Source: OSAM

Like it or not, something really is different for the value stocks in their real-world operations – they are not delivering the EPS growth they used to.

SO, WHAT'S HAPPENING?

Minack Advisors' principal, Gerard Minack who also sits on the Board of Directors at Morphic, has a chart that graphically represents what is taking place. **Figure 5** represents Returns on Equity (RoE) split for the USA by groups from best to worst. Over long sweeps of history, the spreads were relatively constant. This is because, over time, new competitors would emerge and compete away incumbents' higher returns, poor business would consolidate and raise prices and so on. Schumpeter's "creative destruction".

FIGURE 5 – S&P500 Return on Equity by Company Rank



Source: Minack Advisors

We can see that "good businesses" are pulling away from the pack, leaving scraps for the rest and death for the bottom (where value investors often look). If we link back to the FAANG technology stocks, newer industry entrants have tended to become monopolists very quickly – think how many internet browsers you use; car apps; travel websites etc. These have all been called "platform companies" and they don't seem to suffer from the dis-economies of scale older businesses had.

So how could things return to normal? 100 years of data says value has always found a way to come back. If I am to speculate, it could be regulation. The monopolist of the "oil age" of the 1900's – Standard Oil – was broken up by new regulations and never really recovered. The same fate may await Amazon and Facebook, destroying their platform model. President Trump certainly has Amazon in his sights.

Though relying on regulation for value investing to work again could be a long wait. This is a real challenge for value investors like ourselves. If the companies we are buying are cheap, but they are no longer growing their earnings, then total stock returns will struggle to keep up.

WHAT CAN VALUE INVESTORS DO?

Whilst we started with Sir John Templeton's wise words counselling against thinking things are different, sometimes the world does change and one needs to be open to that possibility as well.

"Adapting" to this world for a value investor can mean a few differing things.

Firstly, “long winters” (like the current one for value investors) have occurred before and are often the hallmark for strong future returns as pessimism has taken root in the valuation, baking low returns in. This low valuation is present today.

Secondly, “adapting” is key. Value is just one factor in an investment process. Important, yes, as it tells you that you are not over-paying, but there are other signals that can be used. One is “momentum” or trend. Large investment house AQR has produced a plethora of data analysisshowing how adding trend signals to a value-based investment process can enhance returns dramatically.

Thirdly, stay out “junk”. Now, one investor’s trash is another’s treasure, but research has shown that avoiding the cheapest stocks with bad characteristics in value stocks, say the bottom of the **Figure 5**above, effectively enhances returns for value investors. In **Figure 6**, looking at the rankings from “Quality” to “Junk” of businesses, one can see that avoiding the value destroyed by the weakest businesses is more important than choosing the highest quality.

FIGURE 6 – “QUALITY” TO “JUNK” COMPANIES’ RETURNS

Source: OSAM

Or as OSAM puts it: “avoiding junk is more useful than buying quality.”

Now this is interesting for a long-only manager, but for Morphic who can short-sell “junk” stocks to profit from their fall, this insight adds another way to profit, particularly when value is struggling as a style. Shorting “junk value” is a promising area of focus.

Some sectors and industries, like banks, have unique data which may help us better identify junk and Morphic has specially focused on these data sets in choosing some of the US regional bank stocks we have owned over the years.

In short, there are a number of insights from academia and industry participants that show how a value-based investor can navigate to survive this more challenging period.

Or to finish with words from the other end of the investing spectrum, Paul Tudor Jones, the renown hedge fund trader:

"You adapt, evolve, compete, or die."