

Small Value: Still Flatlining

“Of expectation fails, and most oft there where most it promises and oft it hits where hope is coldest, and despair most sits.” - William Shakespeare

From Bespoke:

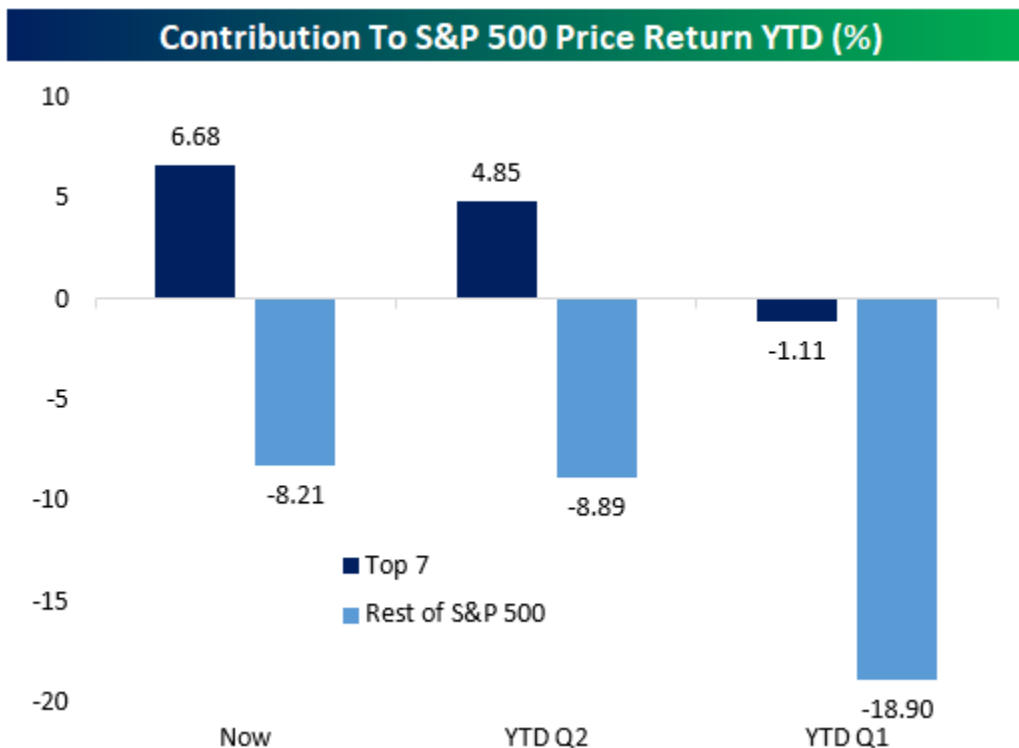
Big Winners Driving The Market In 2020

Tue, Jul 14, 2020

So far this year, the US equity market has been a story of big winners...and then the other 99% of the market.

Seven S&P 500 stocks stand out in terms of contribution, with the “Big Five” tech or tech adjacent names (AAPL, AMZN, FB, GOOG, MSFT) and two others that get a bit less discussion (NFLX, NVDA) each accounting for at least a +0.3 percentage point impact on the overall index performance this year. On average, these top seven are up 45% YTD, versus an 11% decline for the rest of the index. That’s why the equal-weighted S&P 500 is underperforming so badly: the majority of stocks are way, way behind a furious rally in some of the biggest names.

Currently, the top seven stocks by contribution have added 6.7% to the index in 2020, which itself is still down a bit over 1% on the year. That means that the rest of the stocks in the index have cost the S&P 500 over 8% in 2020.



From Verdad on June 22nd:

Where There Is Room to Run

“Fortune favors the bold” says an ancient Latin proverb. The progeny of Rome now offers investors an opportunity to buy profitable, cash-generative businesses at historic discounts.

By Brian Chingono

In recent weeks, markets have gyrated based on news related to coronavirus and its effect on the global economy. Two weeks ago, we wrote about the relatively modest volatility in Japanese equities due to the country’s full employment and near absence of default of risk. Today, we cover how the pandemic’s risks have been priced into other developed markets in Europe and the United States.

The figure below tracks the year-to-date performance of \$100 invested into the MSCI Large Growth Index and the MSCI Small Value Index at the end of 2019. This analysis is applied separately for Europe and the US, but the broad conclusions are the same: the darlings of the market—large growth stocks—now trade as if coronavirus never happened, whereas small value stocks are now priced at an even steeper discount relative to the end of 2019.

Figure 1: Year-to-Date MSCI Index Performance (June 2020)



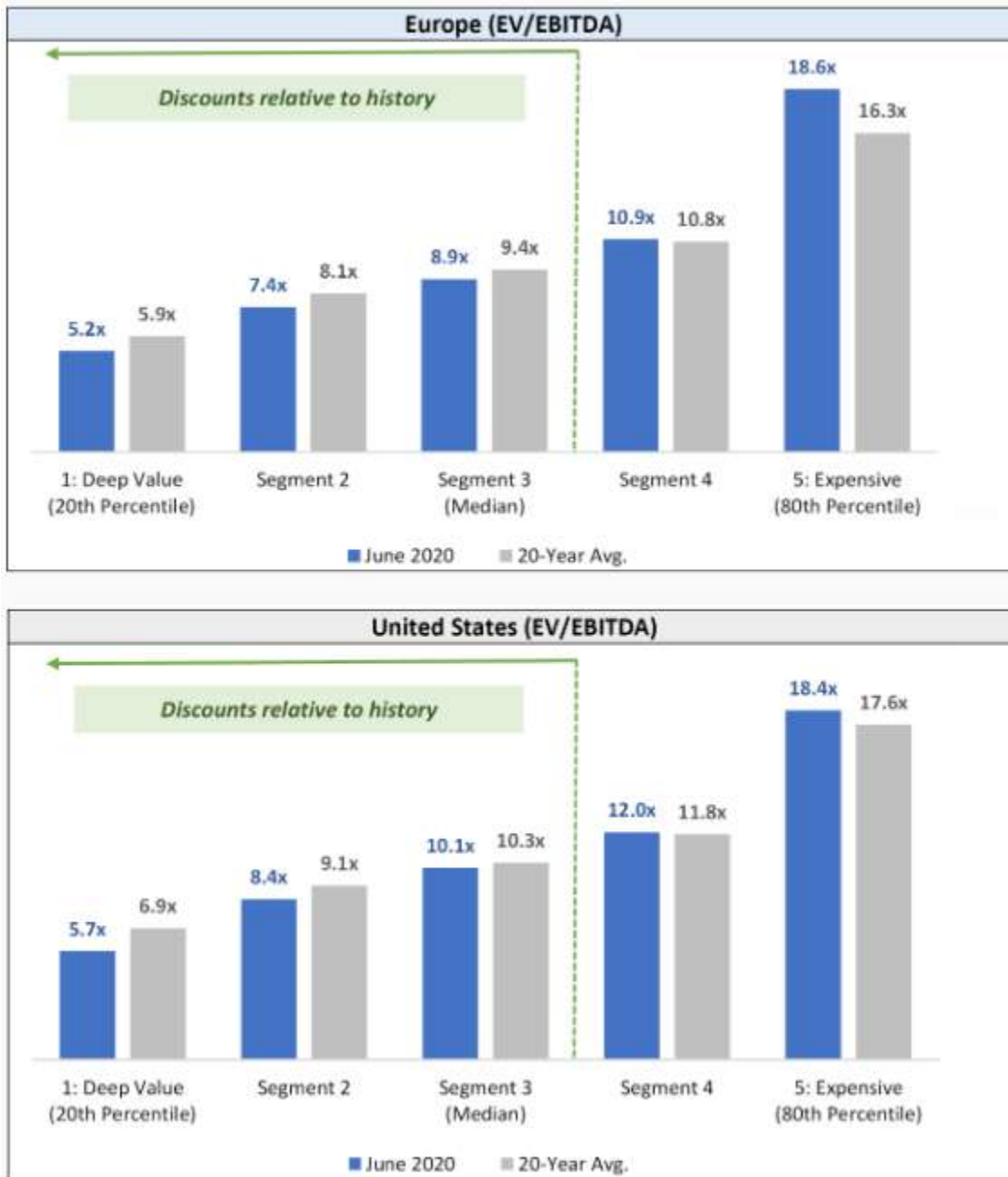
Source: MSCI. Data as of June 19, 2020.

To put today’s valuations into historical perspective, we sorted all European and US stocks into five valuation segments. The first segment (deep value) represents the cheapest 20% of stocks in the market. And the fifth segment, consisting of companies more expensive than 80% of the market, represents the most loved growth stocks. Based on this segmentation of the market into five price buckets, we compared the valuation of each segment today against its average valuation over the past 20 years.

In both Europe and the US, the cheapest stocks in the market now trade at significant discounts relative to their long-term averages. The cheapest segment of European stocks—where Verdad selects the vast majority of its European portfolio companies—now trades at 5.2x EV/EBITDA; a 13% discount relative to this segment’s average valuation of 5.9x over the past 20 years. The cheapest segment of US stocks trades at 5.7x EV/EBITDA today; a 17% discount relative to this segment’s average valuation of 6.9x over the past 20 years.

On the other hand, the most expensive stocks now trade at a premium relative to their historical averages in both Europe and the US.

Figure 2: Current Valuations by Market Segment vs. Historical Averages (June 2020)



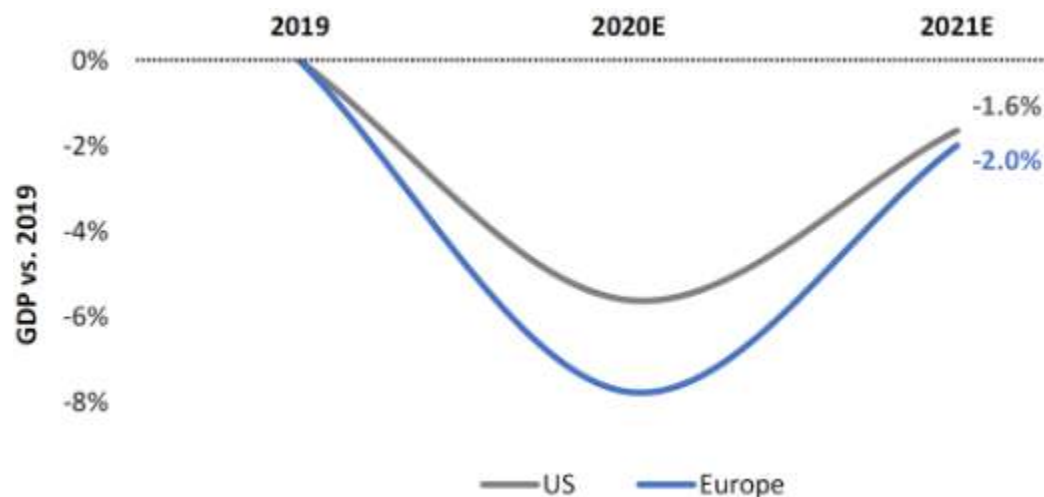
Sources: Capital IQ and Verdad research. Segments 2, 3, and 4 are the 40th, 50th, and 60th percentiles respectively.

The market today is a tale of two cities. Growth stocks are trading at very rich valuations as their prices have shrugged off any economic effects of coronavirus, whereas value stocks are trading at deeply discounted valuations that reflect significant fear about the pandemic's economic impact.

Europe is a more extreme case with cheaper valuations than the US in four out of the five market segments shown above. So why are European stocks systematically cheaper than US equities? It does not appear to be because of higher default risk; European stocks have a lower debt-to-income ratio of 1.8x Net Debt/EBITDA

versus 2.4x Net Debt/EBITDA for US stocks. The answer seems to be related to expectations of future economic growth. As evidenced by the projections below, economists expect a relatively sharper contraction of GDP in Europe compared to the US over the next two years. Relative to 2019 levels, economic output in Europe is expected to be 2% lower at the end of 2021, versus 1.6% lower in the US.

Figure 3: GDP Forecasts Relative to 2019



Sources: Eurostat and Congressional Budget Office (May 2020).

These gloomy expectations are already reflected in the prices of value stocks today, but apparently not in the prices of growth stocks. That is why fear and pessimism create opportunities for value investors—particularly those who focus on buying profitable, cash-generative businesses. We have written extensively about how crises create opportunities, based on evidence from eight market crises since 1970. When we add European returns to our prior research on crisis investing in the US, we find similar results. In both the US and Europe, quantitative factors like value, profitability and investment return substantially more after the start of an economic crisis like the one we are currently experiencing in the US and Europe.

The figure below summarizes factor premiums before and after each of the eight market crises that have occurred since 1970. European data begins in 1990, so the Europe sample includes five crises. Over the two years after the start of a crisis, investors receive significantly higher compensation for holding stocks that are cheap, profitable, and conservative in their spending (i.e. cash flow generative).

Crises have a way of forcing people to acknowledge reality. Doing the things that should work over the long run—buying cheap companies that are profitable and generating cash—has historically been amply rewarded in the years following a market crisis. But capturing those return premiums requires a certain amount of boldness in leaning toward uncertainty as opposed to running away from it. We believe that today, Europe offers a historic opportunity for long-term investors to buy deeply discounted companies that exhibit healthy profits and solid cash generation.

Figure 4: US and Europe Factor Premiums Before and After Crises (1963—2017)



Source: Ken French data library. US data begins in 1963 and includes eight crises. European data begins in 1990 and includes five crises. All crises are defined as events when the high yield spread exceeds 6%.

on June 29th:

Asset Allocation Beyond the Zero Bound

Japan has had zero rates for 20 years. Here is what seems to have mattered for investment outcomes.

By: Nick Schmitz and Greg Obenshain

We appear to be entering a period of prolonged low interest rates across most major developed markets. US and European investors are wrestling with how to adapt to this “new normal”—and how their asset allocation decisions should shift in a zero-rate environment.

Japanese investors, however, have dealt with these conditions for over 20 years since the initiation of the Zero Interest Rate Policy (ZIRP). Japan dropped rates to zero in February of 1999, and Japanese government bonds have been at around a 1% yield ever since. Zero rates aren’t a new normal; they’re just normal in Japan.

Japan thus provides an interesting case study for how different assets performed in a zero-rate environment and which asset allocation decisions made the most sense in our view. Below we show Japanese domestic asset class returns since ZIRP began.

Figure 1: Japanese Domestic Asset Class Returns Post ZIRP (2/26/1999 to 2/26/2020)

	Stocks				Bonds		Other	
	Small Value	Large Value	Large Growth	Small Growth	JGBs	Corporate Debt	Commodities	Real Estate
Return	7.1%	4.0%	0.8%	3.6%	2.1%	1.5%	0.4%	5.2%
Annual Volatility	20.8%	21.6%	36.1%	25.3%	1.7%	1.4%	30.0%	31.5%
Sharpe	0.34	0.18	0.02	0.14	1.22	1.06	0.01	0.17
Max Drawdown	-53%	-54%	-80%	-63%	-4%	-2%	-77%	-73%

Source: MSCI and Bloomberg. MSCI Factor indexes for stocks, Bloomberg Barclays Japan Treasury Index and S&P Japan Corporate Bond Index for bonds, and MSCI commodity producers and REIT indexes as rough proxies for commodities and real estate. Annualized total returns in Yen.

In terms of absolute performance, small value stocks and real estate were the best performing investments. Large growth stocks and commodities were the worst performing investments. Bonds, large value stocks, and small growth stocks performed in between.

The outperformance of small value stocks and real estate was a sharp reversal of prior trends. Both had significantly lagged the equity market in the 1990s. Small value stocks were out of favor as investors chased large growth stocks during the technology bubble, and real estate was still reeling from the major collapse in real estate prices that began in 1990.

Despite major concerns over Japan's debt/GDP levels and bond yields starting at 1.4%, Japanese bonds returned 1–2% over the period with almost no volatility, negative correlation to equities, and a Sharpe Ratio greater than one. Commodities, the only asset which does not produce cash flow, returned basically zero real returns over this period during which there was no inflation in Japan.

Only bonds and foreign exchange markets offered meaningful diversification benefits to equities, with real estate and commodities returns highly correlated to the stock market.

Figure 2: Correlation Matrix (Domestic, Yen Denominated)

	Stocks	Comm.	Real Estate	Bonds	USD/JPY
Stocks	1.00	0.89	0.77	-0.51	-0.30
Commodities		1.00	0.81	-0.59	-0.28
Real Estate			1.00	-0.42	-0.39
Bonds				1.00	0.16
USD/JPY					1.00

Source: Capital IQ. For simplicity, small value used for stocks, and JGBs used for bonds.

In a zero-rate environment, it would have been easy to declare the death of bonds as a diversifying tool. But while measly yields correctly portended low returns from bonds, they did not mean that bonds lost their role as effective diversifiers. In fact, the negative correlation of Japanese government bonds with Japanese equities was stronger than the same relationship in the United States over this period. ...

The performance of Japanese banks was also quite interesting. As shown below, Japanese bank stocks did horribly, as banks found themselves stuck with massive portfolios of zombie loans at the start of the period and were unable to make much money in a zero-rate environment.

Figure 3: Stock Returns of Japanese Banks vs. Equity Indices Since 1995



Source: Capital IQ

What’s perhaps most interesting about the performance of these different asset classes is that they were nearly perfectly predicted by the yields of the different asset classes in 1999. Below are the cash yields on each asset class at the start of the period and the subsequent 20-year returns.

Figure 4: Cash Yields in 1999 and Subsequent 20-Year Annualized Returns

	Stocks				Bonds		Other	
	Small Value	Large Value	Large Growth	Small Growth	JGBs	Corporate Debt	Commodities	Real Estate
Cash Yield	8.2%	4.3%	1.6%	1.5%	1.4%	1.4%	0.0%	5.0%
Return (JPY)	7.1%	4.0%	0.8%	3.6%	2.1%	1.5%	0.4%	5.2%

Source: Capital IQ. Stock yields in Feb 1999 are calculated from the unlevered FCF yields on all listed stocks above/below \$2bn in market cap for large/small stocks respectively. Value is the 20th and growth the 80th percentile breakpoint within those two universes. Bonds use the bond yield. Real estate yield is the Japanese cap rate from ARES, which is about the same as the J-REIT cap rate from Sumitomo Mitsui Trust Research Institute.

In retrospect, with basically zero GDP growth and zero inflation, we might expect entry yields to dominate outcomes over such long horizons. And it is remarkable to us how highly correlated the returns were with the yields at entry. Apart from Japanese banks and Japanese bond returns, there was no clear relationship between any of the asset classes’ relative performance that we could attribute to the prolonged zero-interest environment. Instead, entry valuations were highly predictive of actual outcomes in our view.

At the start of the period, bonds were very expensive at 1.4% yields. Real estate had become much cheaper, which is an understatement coming out of the 1989 asset bubble, when the small plot of land around the Imperial Palace in Tokyo was famously estimated to be worth more than all of the land in the state of California. Value and growth stocks were pushed to opposite historical extremes of the valuation spectrum at the end of the 2000 dot-com bubble. Some things were historically very expensive, and some things were historically pretty cheap in 1999. Lower expectations seemed to lead to higher returns on long horizons.

Many investors rely on historical returns and correlations of broad asset classes to determine asset allocation and form the basis for estimating expected future returns. But researchers have found and reaffirmed that, while practitioners typically use only 60 to 120 months of data to estimate optimal portfolio allocations, in reality, one would need 3,000 months to draw valid statistical inferences on 25 different assets and 6,000 months to draw valid statistical inferences with 50 assets to choose from. “The severity of estimation error is startling,” they conclude. However, they also found that “using information about the cross-sectional characteristics of assets, rather than just statistical information about the moments of asset returns, does lead to an improvement in Sharpe ratios.”

Perhaps the most significant conclusion to draw from Japan’s experience during ZIRP therefore is not about the special impact of a low-rate environment. As we see it, interest rates were relevant in predicting bond returns and the poor performance of bank stocks, but other asset classes were better predicted by relying on entry valuations and yields.

From Morningstar:

Small Value Stocks: Peril and Opportunity

Their fates lie at the heart of today’s economic debate.

John Rekenthaler

Jun 15, 2020

Small value stocks are today’s barometer. The main concern entering the New Millennium was whether technology stocks had become too richly priced. Approaching the global financial crisis, the question was whether all banks would implode. For those questions, small value stocks could offer few answers. However, their fortunes are irrevocably linked with today’s key questions. Will the recession be brief, or will it persist? When it does conclude, will the economy look as it did before?

Economically Exposed

A glance at the characteristics of Morningstar’s Small Value index explains the importance of the initial query. These companies are *vulnerable*. Even at peak conditions, most small value firms are relatively unprofitable. Nor are they financially robust, recording an average grade of C+ on Morningstar’s Financial Health measure (the market norm being B+). These problems might be manageable if their revenues were recession-resistant. Unfortunately, they are not. Almost 60% of the Small Value Index’s companies operate cyclical businesses.

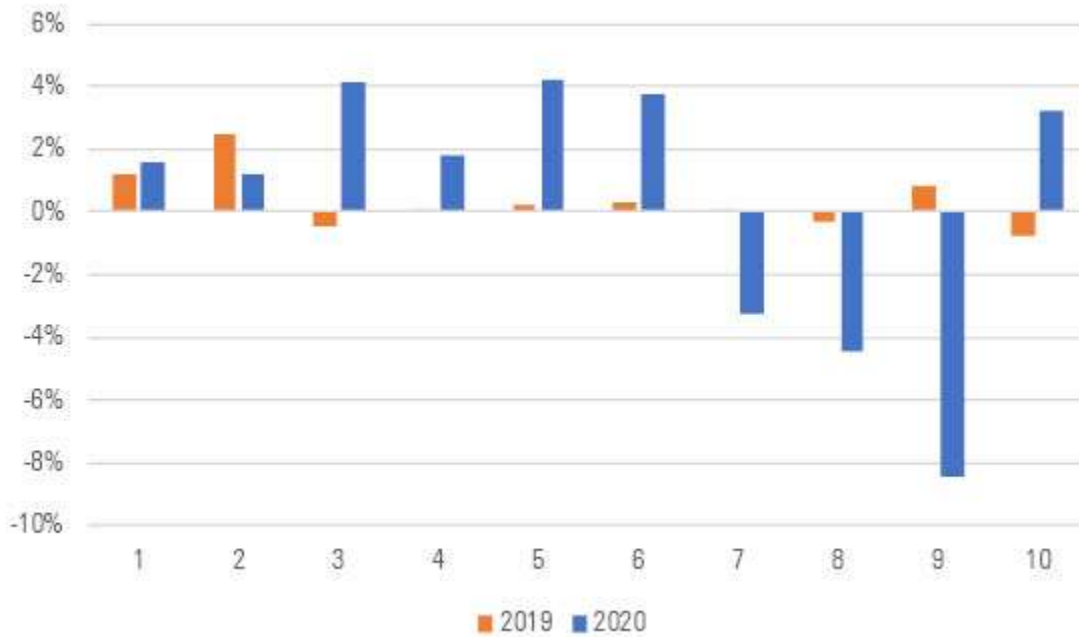
Another indication of economic sensitivity: Morningstar’s Economic Moat score, which sorts stocks into three buckets. Those companies judged by Morningstar’s equity analysts to be well positioned against competition receive a “wide moat” designation, those believed to possess some defenses are marked as “narrow moat,” and those bereft of protection have “no moat.” No company in the Small Value index qualifies as having a wide moat. Just under 40% of those receiving scores (not all stocks are graded) have no moat, as opposed to 10% for the overall market.

Besides a rapid recovery, small value companies seek a return to normalcy. Some forecast that the experience with COVID-19 will forever alter American habits, as high-tech applications replace brick-and-mortar locations. Shopping will continue to move online; office spaces will become virtual; business travel will be curtailed. That is splendid news for companies on the cutting edge. Few such firms, however, exist within the

small value group. In general, its constituents occupy traditional industries. For example, most of the nation's REITs are classified as small value.

That investors have not reached a consensus on either the length of the recession, or the extent to which old-line industries will recover, is demonstrated by small value stocks' performances, which have been exceedingly volatile. Consider the daily returns of Morningstar's Small Value index during the first 10 trading days of June 2020, as opposed to 12 months before.

Exhibit 1: Small Value Volatility Is Way Up (Daily Returns for Morningstar Small Value Index, Now versus One Year Ago)



Source: Morningstar Direct

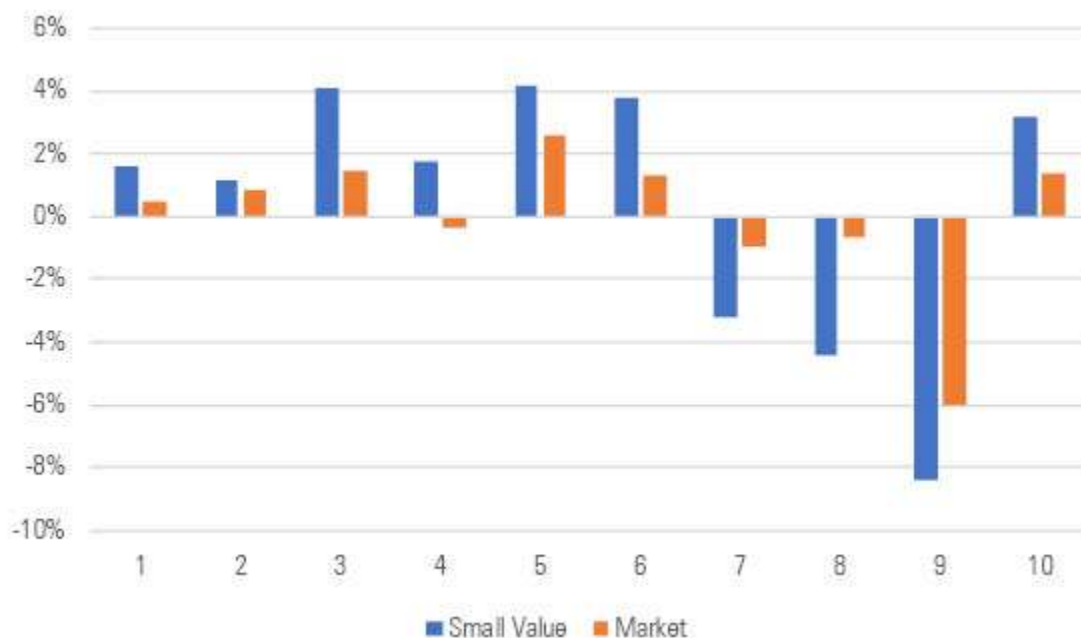
Those results are so far apart that they seem to come from different asset classes. To be sure, some of this year's additional volatility owes to changing circumstances; all stock performances are unsettled. But small value has become the riskiest U.S. stock-market sector, by a wide margin. Compare its daily totals with those of the overall market, once again over June's first 10 trading days.

Trading Places

To an extent, this behavior puzzles me. As I have indicated, the economics make sense. What I do not understand is how these stock-market gyrations occur in practice. Frequently, large companies are traded in baskets, through futures contracts or exchange-traded funds. Such transactions can spur sharp, rapid price changes across an assembly of stocks, since a single transaction affects the whole group.

However, smaller firms are not typically traded in batches, at least not through investment vehicles. The leading general small-company ETF possesses \$40 billion, while the top small value ETF controls \$12 billion. Those figures are relatively modest. Neither do small-company futures attract great attention. Without these mechanisms to accelerate the effects of trading, it would seem difficult to push the small value index by several percentage points, within a single day. Yet such movements have become commonplace.

Exhibit 2: Riskier Than the Overall Market (Daily Returns for Morningstar Small Value Index and Morningstar Market Index)



Source: Morningstar Analysts

I suspect that the answer to the trading mystery is twofold. First, because most small value stocks are deeply illiquid, even modest buying or selling pressure can send them skidding across the pricing ice. Second, the shortage of trading mechanisms hampers attempts at arbitrage. That is, bargain-hunters who stabilize prices during declines may do so only for a few selected holdings, rather than support the entire group through a futures or ETF transaction.

The Gamble

Regardless of the details, the big picture is apparent: Small value stocks are as volatile (if not more so) as they ever have been, mainly because of fundamental reasons. Trading peculiarities may be exaggerating the movements, but the underlying concern about the long-term future of small value companies is widespread, and it doesn't seem to be going away anytime soon.

In uncertainty lies opportunity. Small value issues have sharply lagged other equities, returning 1.5% annualized over the past five years versus the overall market's gain of 9.8%. Much of that shortfall owes to diminished investor expectations. Should the economic news favor small value companies, with a short recession leading to a conventional recovery, then small value stocks could perform very well indeed, supported by both the economic bounce and higher investor sentiment.

Against that proposition rests the very real possibility that the coronavirus pandemic will linger, thereby permanently changing consumer habits and business practices. As always, opportunity is accompanied by peril. At least in this case, though, the investment positions are clear. Those who hold small value stocks should have no illusions about which conditions will help their investments--and which will not.

John Rekenhaller has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John is quick to point out that while Morningstar typically agrees with the views of the Rekenhaller Report, his views are his own.