The Value of Size

On Friday the S&P 500 made a new all-time high. Nothing new there, but so did the Russell 2000, the most widely quoted index for Small Caps, whose previous high stretched all the way back to August 31, 2018. Value stocks are also showing signs of life. From Friday's WSJ:

STREETWISE | By James Mackintosh

Value Shares Receive A Shot in the Arm

Is it finally time to buy back into the shares of unloved and cheap companies? On Monday, these "value" stocks beat expensive growth stocks by the widest margin of any single day since the 1930s, as vaccine progress improved the prospects of the beaten-up losers of lockdown such as airlines and cruise lines.

The question investors face is whether Monday's extraordinary move marks the end of a grim decade-and-a-half for value, or is just another false dawn amid the gloom.

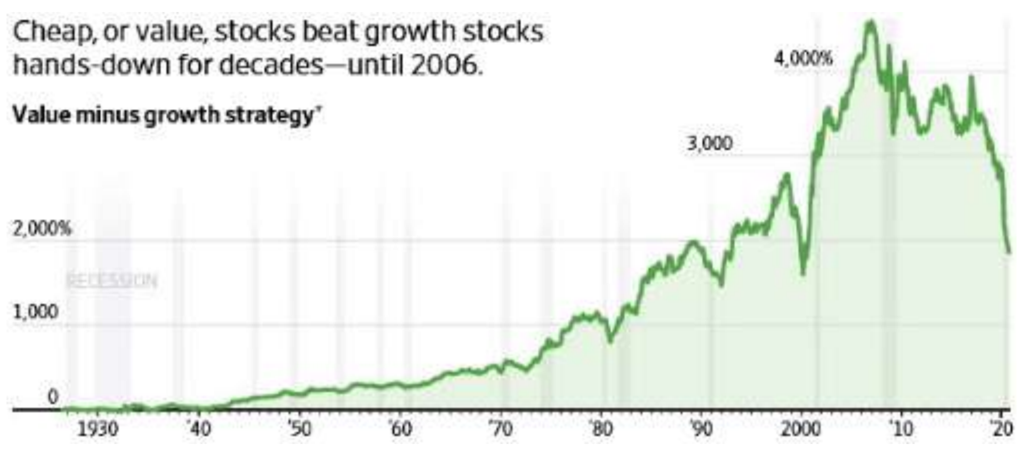
In the short run, value could do well just because the economy improves (assuming the vaccine or others in late stage trials are approved and rolled out soon). Value stocks are defined as having a low valuation, originally just on price-to-book ratio, and now often on a mix of measures such as price to earnings, price to cash flow and dividend yield. At the moment, that means value is dominated by lockdown losers, banks that did badly due to low interest rates, and economically sensitive cyclical stocks ... and oil producers.

Fix coronavirus so the economy recovers quicker than is expected, and all three groups should do better than the work-from-home winners, low-rate beneficiaries and reliable earners that dominate growth.

David Rosenberg of Rosenberg Research calculates that if the leading growth stocks— **Microsoft , Apple, Amazon, Facebook , Netflix , Tesla** and **Alphabet—** went back to their pre-Covid-19 market capitalization, they would be worth 22% less. If that money was reallocated to value stocks, it would boost the laggards by 10%. Rotation between value and growth doesn't happen only because of money flows, but this provides some sense of what could result purely from a bet on a return to normal.

However, a coronavirus fix would be only a temporary boost to value stocks. To get sustained out-performance, they need to have been depressed beyond what is justified by their poor fundamentals.

Put another way, if investors gave up bothering with value stocks, as their heads were turned by sexier growth stocks, such as the FANGs of Facebook, Apple, Netflix and Alphabet (nee Google), or Tesla, then value might be cheaper even than it deserves—and growth even more expensive. That would set value up for outperformance in future as the valuation gap closes again and those who deserted the strategy return.



It is plausible. The price-to-book ratio of the Russell 1000

Growth index trades at more than five times that of value, and the forward price-to-earnings ratio is close to twice as high, the biggest premium for growth since the dot-com bubble of 2000. Growth has beaten value for 14 years, the longest period since data from Prof. Kenneth French at Dartmouth's Tuck School of Business started in 1926. On average, for most of the past century, value has beaten growth.

This year through September, value fell behind growth by the most of any full year in the data, so there is a lot that could be reversed.

Meantime, the long period of underperformance by value began after the valuation gap between growth and value fell to the smallest on record. Since growth stocks should trade at fatter multiples than value stocks—because they offer more future growth—that suggested value wasn't cheap enough, relative to growth. Maybe it now is.

There are good reasons for caution. Most obviously, we are living in a time of innovation when growth stocks are successfully disrupting the business of many traditional value companies.

History also shows that value's big rebounds have often proved temporary. The six times in the 1930s when value beat growth by even more than on Monday mostly ran for a few months, then fizzled; only value's big win in the buildup to the election of Franklin D. Roosevelt in 1932 lasted more than a year, and that was volatile. Value has had several false dawns in the past decade too, most clearly for a year after the European Central Bank promised to save the euro in July 2012, and for a couple of months after Donald Trump's win in 2016. ...

This time around, growth stocks start with more of their potential already priced in, while value stocks have been crushed. That gives value more chance of returning to its historical position. After so many years of disappointment, it would be brave to commit too much to a bet on value— but widespread aversion to the strategy is exactly what gives value an opportunity to succeed.

Our clients are well positioned in Small Caps, including Value. From Verdad:

Horses for Courses

Some styles of investing do better in certain environments than others

By: Dan Rasmussen & Nick Schmitz

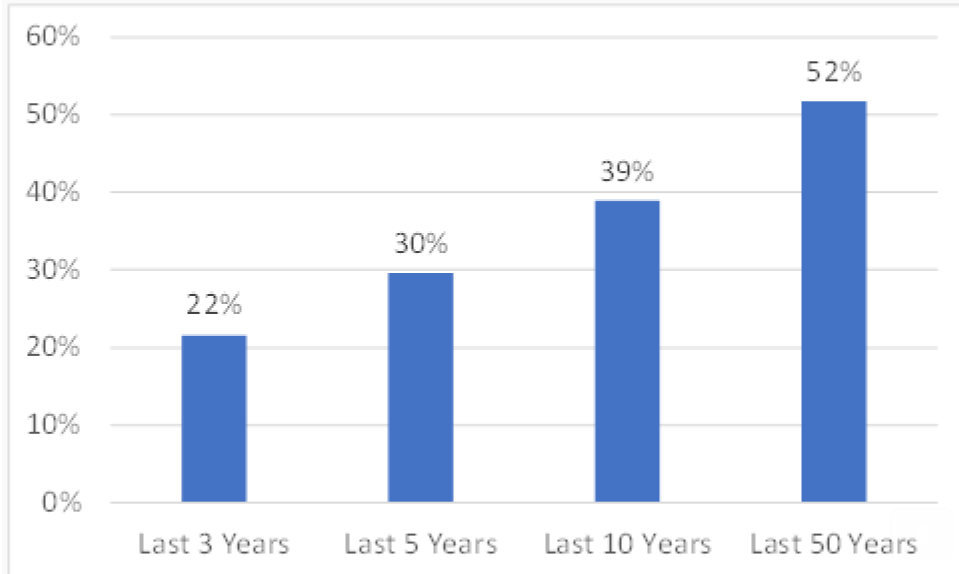
The horse racing track in Brighton and the track in Epsom are quite similar, and horses that win at Brighton are often therefore favored to win at Epsom, noted the English writer Alfred Watson in an 1890s book on the sport. "A common phrase on the turf is 'horses for courses,'" he noted, and "there is a good deal in the expression."

There's a good deal in the expression to be learned about the stock market.

Small-cap value stocks beat large-cap growth stocks in October. This was an unusual phenomenon given the recent growth rally: this was only the third month in two years when we've seen small-cap value outperform.

But while small-value outperformance has been a rarity in recent months, it’s been more common over longer periods. Below, we show the percentage of months small-cap value has beaten large-cap growth over 3-, 5-, 10- and 50-year horizons.

Figure 1: Percentage of Months Small Value Beat Large Growth



Source: Ken French Data Library

Over the past decade, but especially over the past 3–5 years, the course favored large growth.

Over the past 50 years, environments that favored large growth have been very distinctive. The below chart shows average annualized monthly returns divided into a 10x10 grid with size on the x-axis and value on the y-axis. The right horse to bet on for this course was very clearly the largest and the most expensive.

Figure 2: What Worked When Large Growth Beat Small Value 1970-2020

		Small								Large	
		1	2	3	4	5	6	7	8	9	10
Expensive	1	-21%	-14%	-11%	1%	-1%	6%	13%	15%	17%	29%
	2	-15%	-9%	-5%	-5%	-1%	3%	6%	10%	14%	22%
	3	-14%	-10%	-4%	-4%	-3%	1%	4%	6%	9%	16%
	4	-13%	-11%	-9%	-7%	1%	2%	2%	2%	8%	14%
	5	-14%	-8%	-8%	-6%	-3%	-1%	-1%	5%	6%	12%
	6	-12%	-13%	-7%	-8%	-4%	-2%	-2%	-1%	7%	10%
	7	-12%	-10%	-9%	-7%	-4%	-1%	0%	2%	5%	1%
	8	-12%	-12%	-11%	-10%	-9%	-4%	-3%	2%	2%	2%
	9	-11%	-13%	-12%	-9%	-8%	-8%	-5%	-2%	4%	4%
Cheap	10	-15%	-19%	-16%	-22%	-15%	-7%	-8%	-4%	-2%	-3%

Source: Ken French Data Library

On an annualized basis, the most extreme large growth portfolio beat the most extreme small value portfolio by 44% per year when it was winning. Any portfolio skew toward smaller companies or cheaper companies was actively punished in these environments. This is, notably, why market-cap weighted indices do so well in these periods, because they tend to have the largest weight on the largest, most expensive stocks, and most active managers prefer not to own such large concentrations in such large and expensive stocks.

But what about in months when small-cap value beat large-cap growth? Below we show the same 10x10 grid but only for months from 1970-2020 when small value won.

Figure 3: What Worked When Small Value Beat Large Growth 1970-2020

		Small									Large
		1	2	3	4	5	6	7	8	9	10
Expensive	1	33%	31%	31%	24%	22%	17%	17%	13%	7%	-2%
	2	39%	39%	36%	31%	30%	25%	23%	17%	13%	7%
	3	48%	43%	40%	36%	33%	30%	25%	22%	19%	10%
	4	47%	49%	39%	39%	38%	27%	24%	24%	18%	13%
	5	48%	43%	42%	37%	34%	30%	27%	28%	23%	12%
	6	47%	46%	46%	40%	38%	31%	31%	24%	20%	17%
	7	52%	48%	47%	42%	42%	34%	34%	27%	23%	15%
	8	48%	53%	45%	45%	43%	36%	32%	29%	21%	24%
	9	54%	53%	54%	53%	45%	44%	38%	32%	25%	22%
Cheap	10	60%	66%	57%	56%	53%	52%	40%	38%	30%	34%

Source: Ken French Data Library

Here we see the exact opposite. The most extreme small-cap value portfolio beat large-cap growth by 62% on an annualized basis when it was winning, with any move toward smaller size or cheaper companies being significantly rewarded by the market.

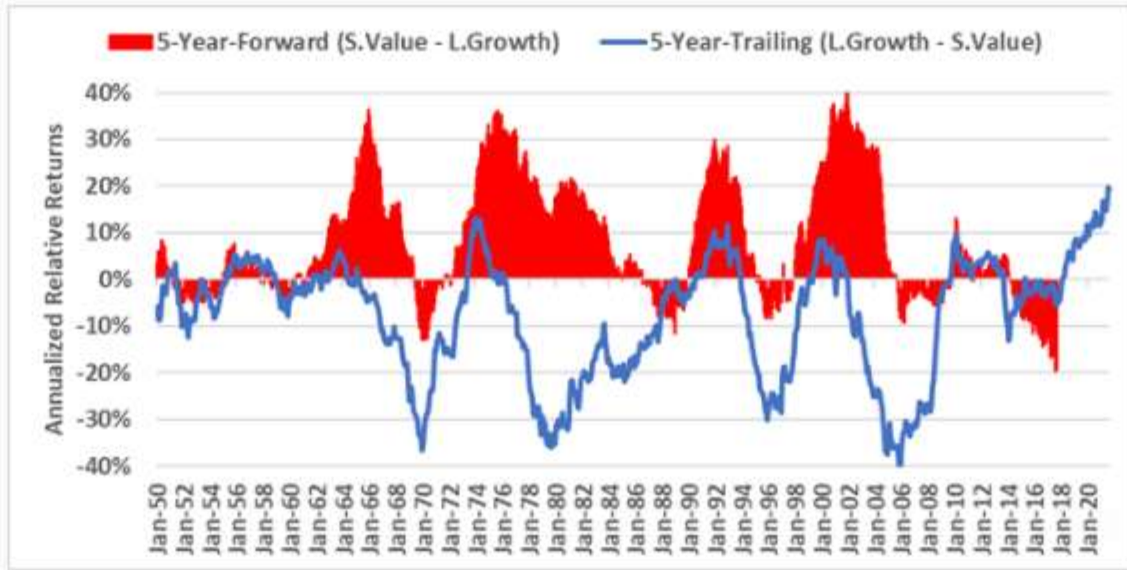
Small-cap value worked about 50% of the time, and when small-cap value worked, the margin of outperformance was significantly larger than the margin of underperformance when it didn't work. More importantly, the more extreme the bet on small value, the better the performance over the full period, according to our research. Yet that is exactly the strategy that does the worst during large growth rallies.

We call this factor inversion. In both the Nifty 50 bubble of the early '70s and the dot-com bubble of the early 2000s, small value had underperformed large growth in the majority of 3-, 5- and 10-year trailing months.

And these concentrated, consecutive strings of losses for small value resulted in relative returns to large growth that approached or exceeded the double digits on a five-year look back about five times since the 1950s. This is the blue line in the figure below.

But in each of these periods when large growth looked like it was at its best from its trailing returns, we feel these were precisely the times to bet on the other horse. This is the red shaded area in the figure below. These are the annualized relative returns over five years for the capitalization-weighted large growth index versus the equal-weighted small value index.

Figure 4: Trailing Relative Returns to Large Growth and Forward Relative Returns to Small Value



Source: Ken French Data Library. 10x10 matrix relative returns.

Had you bet on large growth in the early '60s after it had built up a lead on small value over half a decade, you would have missed one of the best opportunities to bet on the opposite horse. Had you done it again in 1974 when large growth had really pulled ahead by double digits, you would have missed out again. Same for the early '90s and, of course, March of 2000. Today, large growth is way ahead of small value.

But this was not just a curious migratory cycle of a "comeback" horse accompanied by no logic. Each time large growth had built up a sizable lead, large growth valuations increased. And the greater the valuation spikes that accompanied large growth rallies, the greater the future headwind.

Today's growth valuations look extreme relative to history. This isn't a quirk of the price-to-book metric, as shown in the chart below including cash-flow multiples.

Figure 5: Growth Stock Multiples

Source: Ken French Data Library. 10th decile multiples for extreme growth and extreme large growth.

Most invested dollars in the stock market are currently crowded into the extremely liquid, cap-weighted indexes, which are disproportionately concentrated in large growth stocks. It's an easily executable and surprisingly uncontroversial bet these days. But as in decade after decade of past market history, we believe those investors that can switch horses would have to switch (before others do) to win, place or even show.