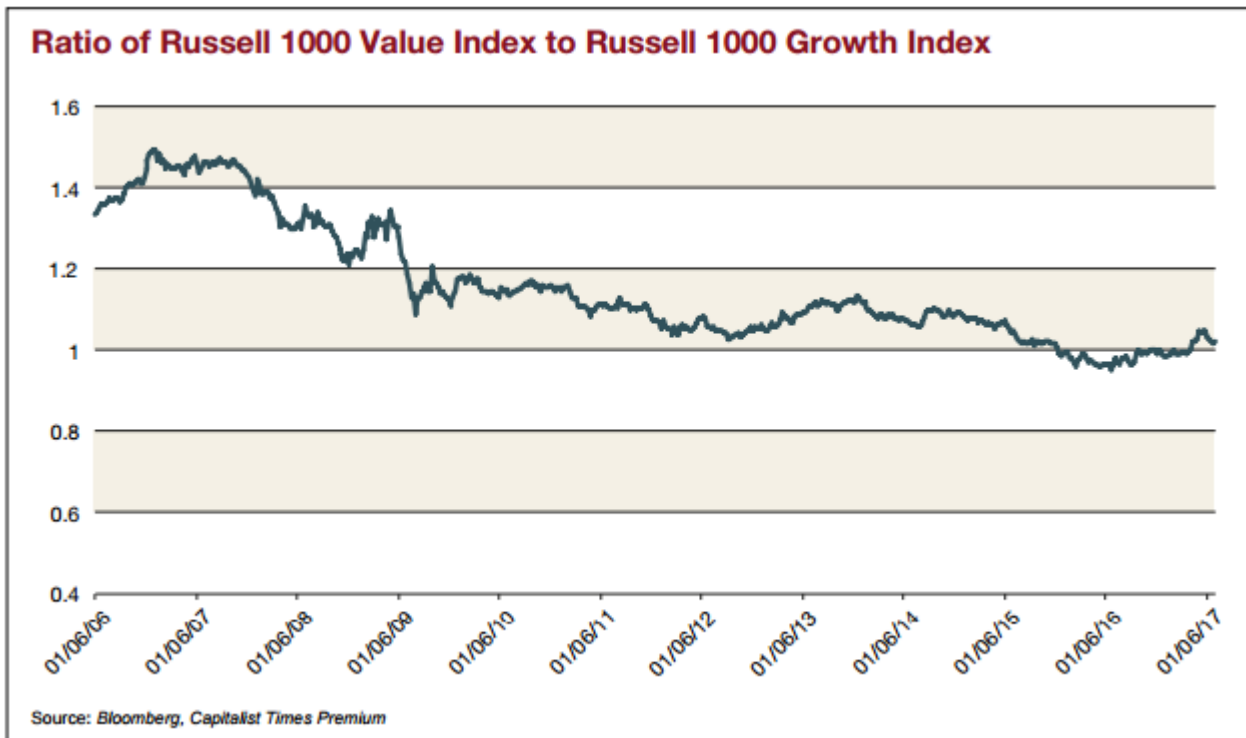


Time for Value?

From the February 15th issue of Capitalist Times:

Periods of rising growth, interest rates and inflation historically have tended to favor value-oriented stocks over growth-focused names. That might seem counterintuitive, but, in periods of low economic growth, investors are willing to pay higher valuations for companies and stocks that can generate above-average growth rates even in a weak economy.

In contrast, when the economic cycle is a tailwind and more companies are in growth mode, investor willingness to pay higher valuations for secular growth dwindles.



Dividing the market value of the Russell 1000 Value Index by the Russell 1000 Growth Index is one way to determine whether value stocks are outperforming growth-oriented names.

After several years of weak performance, value shares began to outperform growth fare roughly one year ago. Last year, the value index produced a 17.3 percent total return compared to 7.1 percent for the Russell 1000 Growth Index, a dramatic change in leadership.

And historically, when a value cycle gets started, it tends to persist for three to five years or longer before the cycle turns back to favoring growth. We believe that we're in the early innings of a multiyear value cycle

From Blackrock:

Why value is still a value

Written by [Russ Koesterich, CFA](#) Portfolio Manager for BlackRock's Global Allocation Team 2/17/17

For much of the post-crisis period investors consistently craved growth stocks. They did so for the same reason they favored stocks with a healthy dividend: Both income and growth were scarce commodities for much of the past eight years. However, with yields rising and economic growth at least stabilizing, this began to change in the second half of 2016 when classic dividend plays stumbled while value started to come back into vogue. However, these trends stalled in January, raising the question of whether the recent preference for value has further to go. My view is that it does, primarily because value still appears cheap relative to growth.

The notion of the “value of value” seems a bit redundant, but it is important when assessing style preferences. While value stocks, by definition, will trade at a lower valuation than growth stocks, the valuation spread moves over time. Based on the price-to-book (P/B) metric, since 1995, value stocks, as defined by the Russell 1000 Value Index, have typically traded at around a 55% discount to growth stocks.

During the tech bubble growth stocks became more expensive, pushing the value discount to more than 70% at the market peak in 2000. Conversely, prior to the bursting of the housing bubble, it was value that looked expensive. The rally in financial shares, which typically command a higher weight in value indexes, drove the value discount down to around 45% in 2006. The chart below illustrates this, showing the ratio of the value P/B to growth P/B. A relative ratio of 0.55, for example, translates into a value discount of 45%.



As financials started to come under pressure and the extent of the housing bubble became clear, investors started to demonstrate a strong preference for companies that could grow their earnings regardless of the economic environment. This preference for growth manifested in the outperformance of both stable growers, like defensive consumer staple companies, as well as technology firms benefiting from secular trends. As a result, value has gone from a 45% discount to growth in late 2006 to a 65% discount today.

While value was even cheaper in early 2016, today's discount still places the growth/value spread more than one standard deviation below the long-term average. In other words, value stocks still look attractive relative to growth.

To be sure relative cheapness is not a guarantee of relative outperformance, but to the extent that value stocks are cheap and the economic outlook is improving, value has a reasonable chance of continuing its run.

For investors, the challenge is that the latter condition, i.e. better growth, is somewhat dependent on whether Washington can conjure up a reasonable and timely stimulus package, including tax reform. A stumble in such efforts is likely to revive old concerns over secular stagnation and push investors back toward old habits, namely a preference for yield and stable growth. However, even a modest package that raises growth expectations stands to benefit the cheapest segments of the market.

Our thoughts

The Value Factor (preferably using PEG when available, otherwise EV/EBITDA or EV/EBIT, as the valuation metric as detailed in our White Paper posted on our website), along with Size and Momentum, forms the foundation for Factor Investing. While we agree that the current macroeconomic environment favors Value over Growth, we don't recommend attempting to time exposure. The unedited version of the following Alpha Architect post is on their website under BLOG: <http://www.alphaarchitect.com/>

November 22, 2016 [Wesley R. Gray, Ph.D.](#)

Active investing sounds so easy. [But we all know it is extremely difficult](#). Ask any deep value investor how they have felt over the past few years (although, they are feeling a lot better recently).

Certainly, any credible active investor should be able to answer 2 questions: 1) What is the source of their excess returns, or "active premium?" and 2) why is the premium sustainable in the future?

These questions are non-trivial and academics have waged intellectual wars over these questions. The disagreements run deep among the greatest minds in finance.

In order to illustrate such a disagreement, we will examine how Eugene Fama, the father of market efficiency, thinks about the "[value versus growth](#)" debate, which will be familiar to our readers.

To keep things simple and in line with academic research practices ... we consider *value investing* to be approximated roughly by the practice of purchasing portfolios of firms with low prices to some fundamental price metric (e.g., a high book-to-market or B/M ratio). *Growth investing* is the opposite approach—purchase firms with high prices relative to fundamentals, with the expectation that fundamentals will grow rapidly. Using Ken French's data, we examine the returns from January 1, 1927, to December 31, 2014, for a value portfolio (high B/M decile, value-weighted returns), a growth portfolio (low B/M decile, value-weighted returns), and the S&P 500 total return index. By *value-weight*, we mean that each stock is given its weight in the portfolio, depending on the size of the firm. ... All returns are total returns and include the reinvestment of distributions (e.g., dividends). Results are gross of fees.

	Value	Growth	SP500
CAGR	12.41%	8.70%	9.95%
Standard Deviation	31.92%	19.95%	19.09%
Downside Deviation	21.34%	14.41%	14.22%
Sharpe Ratio	0.41	0.35	0.41
Sortino Ratio (MAR = 5%)	0.54	0.37	0.45
Worst Drawdown	-91.67%	-85.01%	-84.59%
Worst Month Return	-43.98%	-30.65%	-28.73%
Best Month Return	98.65%	42.16%	41.65%
Profitable Months	60.51%	59.09%	61.74%

The historical evidence is clear: value stocks from 1927 to 2014 have outperformed growth stocks—by a wide margin. The portfolio of value stocks earns a compound annual growth rate of 12.41 percent per year, whereas, the growth stock portfolio earns 8.70 percent per year, representing an approximately 4 percent annual spread in performance. This historical spread in returns, which has been repeatedly and consistently observed over time, has been labeled the *value anomaly* by academic researchers.

As discussed earlier, academics tend to argue about such anomalies, and the reasons why a spread like this might be so large.

In the case of the value anomaly, the disagreement is simple: Does value investing earn higher returns because value stocks are simply more risky or because they are mispriced?

We have our own recent entry in this debate with our new research paper on [enterprise multiples](#) ...

The risk vs. mispricing debate is best captured by a 2008 interview with Eugene Fama ...

Here is a [link](#) to the interview ([24 min. worth watching](#)), and we have provided a [partial](#) transcript that highlights the risk/mispricing debate discussed above:

EUGENE FAMA: ...Ken and I [wrote this paper](#) about the cross-section of expected stock returns which basically said if you look at all the variables people have looked at, two seem to do pretty well, market-cap ([Size Factor](#)) and book to market ratio ([Value Factor](#)). Book to market ratio is just a price ratio, and lots of price ratios work pretty well...Up until that point there had been a lot of studies that said the CAPM ([Capital Asset Pricing Model](#)) doesn't work for this reason, or the CAPM doesn't work for this different reason. We just put it all together and said, "It doesn't seem to work at all." ...Then we said, ok, you can tell rational stories for that. Or you can tell irrational stories...

RICHARD ROLL: What is the rational story, and what is the irrational story.

EUGENE FAMA: ...The rational story is that the size premium and the value premium are compensation for risks associated with those stocks, whereas the behavioral story says the premiums are just the result of mispricing.

... I think everybody agrees that the difference between value and growth returns has a big variance associated with it. They disagree about the explanation. ...

Bottom line: Great minds can disagree on the explanation, but nobody can dispute the empirical fact that value stocks have outperformed growth stocks by a wide margin over time. One would also be remiss in suggesting that exploiting the edge in value investing is easy — it's highly volatile and needs to be pooled in a broader portfolio, ideally alongside [momentum](#).