Does Value Still Matter?

From Capitalist Times' June 20th issue:

The “Dumb Money” Bubble

By Elliott H. Gue

The mainstream financial media is full of stories about the death of active investing, the end of the hedge fund industry as we know it and the explosion in popularity of exchange-traded funds (ETFs) like the SPDR S&P 500 ETF Trust (NYSE: SPY).

The basic rationale for passive investing goes like this: Mutual funds that track a market index, such as the S&P 500 and exchange-traded funds (ETFs) that follow similar indexing strategies, offer lower fees than actively managed funds, which employ legions of professional analysts and stock pickers.

Yet, few professional investors beat the market over the long haul, so why pay up for their management?

And while hedge funds were all the rage a decade ago, their 2 and 20 fee structure–2 percent of assets and 20 percent of profits charged for their services–is far higher than even the most expensive actively managed mutual funds. Plus, many hedge funds have struggled to produce superior returns over the past few years.

Many investors have bought into these arguments. According to the Investment Company Institute’s latest industry Factbook, US domestic index mutual funds and ETFs have seen total inflows of $1.4 trillion in net new cash and reinvested dividends between 2007 and 2016. That’s while actively managed funds have experienced outflows of $1.1 trillion.

Index equity funds now account for one quarter of all assets in domestic equity funds, up from less than 10 percent in 2001 and less than 15 percent as recently as 2010.

There’s little doubt this shift could, and probably will, continue in the short term. However, it has significant longer-term implications for the market and returns for individual stocks and sectors.

Consider that out of every $100 invested in the SPDR S&P 500 ETF, $14.63 is invested in the seven largest stocks. Around $31.33 of that $100 is invested in the ETF’s top 20 holdings. In contrast, just $9.39 goes to the 250 smallest components of the index. And the 400 smallest stocks receive only $33.82, about one third of the total investment.

Think about what this means for the market: As investors allocate more money to passive index strategies, most of that cash flows into the largest stocks in the S&P 500. These stocks, in turn, perform well and their importance to the overall index grows alongside market cap. The final step is that as even more cash flows into the index, these top-performing large caps benefit from even larger passive inflows.

Over time, the larger stocks in the index get bigger and bigger regardless of valuations and fundamental performance.

Consider that during the past three months, the S&P 500 is up around 3.57 percent including dividends reinvested. And just seven stocks in the index account for about 40 percent of those gains.

On average, these seven stocks trade at ratio of just over 31 times 2017 earnings estimates. As a whole, the S&P 500 trades at a relatively small 18.73 times earnings.

The Leaders of the Pack		
Company (Exchange: Ticker)	**Contribution to S&P 500 Gain***	**Price to Fwd Earnings**
Alphabet (NSDQ: GOOG)	$8.02	21.48
Amazon.Com (NSDQ: AMZN)	$6.45	74.65
Microsoft Corp (NSDQ: MSFT)	$5.27	22.01
Apple (NSDQ: AAPL)	$3.87	14.57
Facebook (NSDQ: FB)	$3.45	25.33
Wal-Mart Stores (NYSE: WMT)	$3.26	17.10
NVIDIA Corp (NSDQ: NVDA)	$3.22	43.30
	AVERAGE	**31.21**

*Three months ended 06/16/17, close.
Source: *Bloomberg, Capitalist Times Premium*

Particularly notable, online retail giant Amazon.com (NSDQ: AMZN) and graphics chipmaker NVIDIA (NSDQ: NVDA), trade at nosebleed valuations of 73 and 44 times forward earnings estimates, respectively. Together, they account for close to 12 percent of the S&P 500's total return since mid-March.

None of this is to say that Amazon and NVIDIA aren't good or even great American companies. However, it's historically tough for a company–any company–to grow earnings fast enough to justify a multiple of 40 or 50 times earnings over the long haul.

Case in point: Few would argue that Intel (NSDQ: INTC) is a great company that dominated its industry back in March 2000 when it traded at just over 45 times forward earnings estimates. However, that doesn't change the fact that 17 years later, at the end of March this year, an investment in Intel was still down 20.7 percent including dividends.

A great stock at an inflated valuation can be a terrible investment. We see particular cause for concern given the popularity of these ETFs and recent market developments.

On Aug. 13, 1979, the cover of BusinessWeek magazine announced: "The Death of Equities: How Inflation is Destroying the Stock Market." At the time the article was written, the S&P 500 traded at 107.42, trading as low as 100.68 in March 1980. However, over the subsequent five years, stocks soared 96.8 percent. And over the decade following publication of that article, the market soared 398.1 percent.

At the same time, consumer price inflation (CPI) touched 14.8 percent in early 1980, before sinking to just 1.1 percent by the end of 1986. In other words, that BusinessWeek article could not have been more poorly timed.

Much the same can be said of The Economist's March 6, 1999, cover story titled Drowning in Oil. On that day, West Texas Intermediate crude oil prices closed at $13.30 a barrel, in the early stages of a multi-year rally that would push oil over $147 per barrel–up more than 1,000 percent–by the summer of 2008.

My point isn't to disparage either of these publications; we all make bad investment calls from time to time.

Rather, whenever a trend becomes prevalent in the mainstream media and the conventional wisdom of the investing masses, your antennae should go up to the possibility that the trend is about to change. ...

What's behind the tech selloff

Russ Koesterich, CFA Portfolio Manager for BlackRock's Global Allocation Team

June 16, 2017

On the surface things appear calm. The S&P 500 remains within 1% of its all-time high and volatility is still barely half the long-term average. However, under the surface things may be starting to churn.

Since last Friday tech stocks have been sold hard, with few obvious catalysts. For example, at the lows on Monday Netflix (NFLX) was down over 10% and Apple (AAPL) off 8%. What is going on?

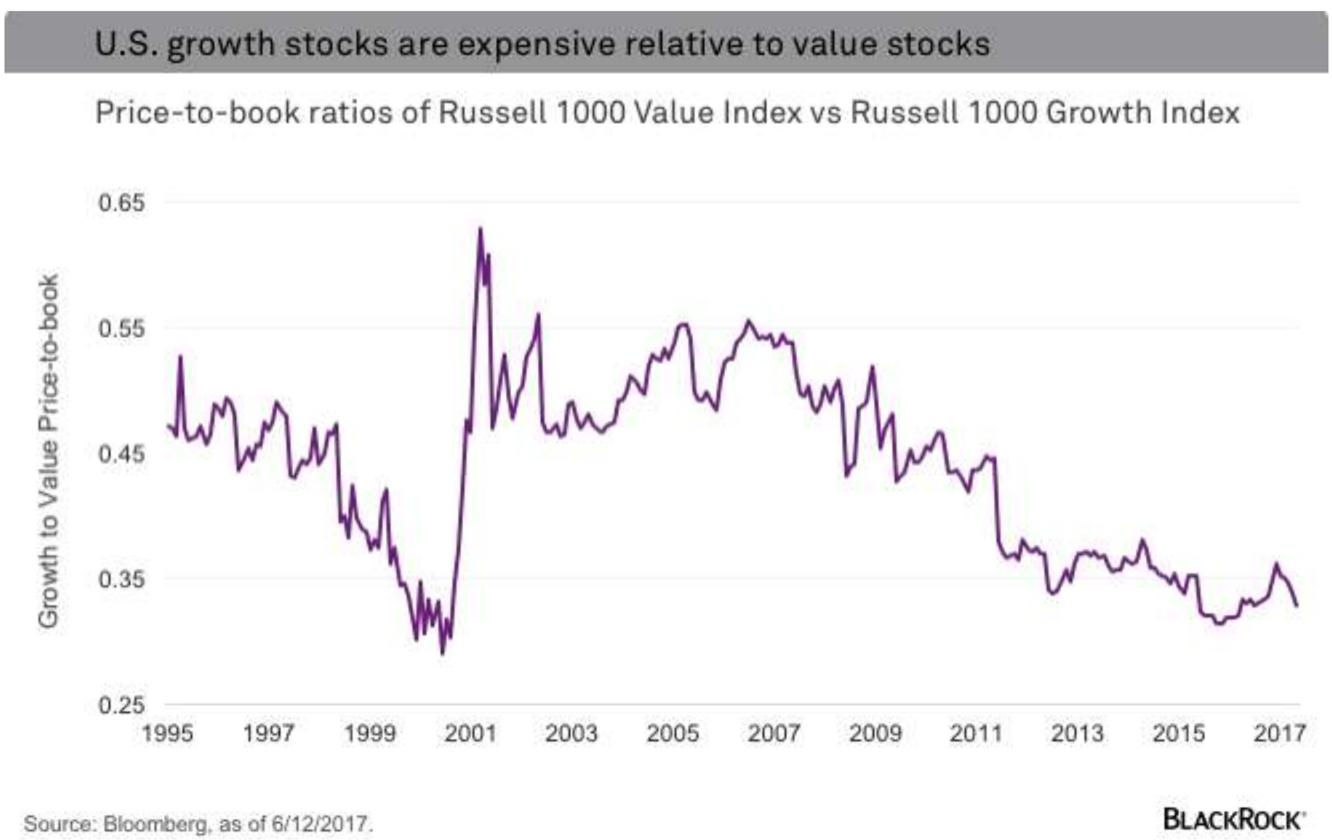
1. An abrupt reversal of this year's momentum trade.

In a throwback to the late 1990s, tech has once again become a momentum play. The reversal in tech is part of a broader reversal in momentum stocks, a style in which tech features prominently. Using the MSCI USA Momentum Index as a reference point, it is instructive that Microsoft (MSFT) is the biggest name, with a 5% weight. At the industry level, semiconductors, software and computers represent three of the top four industries.

2. Multiples are much higher.

Bulls can rightly point out that tech valuations pale in comparison to the surreal levels of the late '90s. Still, multiples have been rising fast. The trailing price-to-earnings (P/E) for the S&P 500 tech sector is up over 35% from last year's low. At nearly 25x trailing earnings, the sector is the most expensive it has been since the aftermath of the financial crisis, when earnings were depressed. On a price-to-book (P/B) basis, valuations are even more extended. Large cap U.S. technology companies are trading at the highest level since late 2007.

3. The surge in growth has made the entire style expensive.



The surge and recent drop in technology needs to be viewed through a prism, which is: As investors have reconsidered the “Trump trade,” they have reverted to two investment themes–yield and growth. This has left U.S. growth stocks very expensive compared to value stocks. While tech valuations may not be in bubble territory, the ratio of value to growth multiples is starting to bear an eerie resemblance to the late 1990s. As of the end of May, the ratio—based on P/B—was just below 0.33. This is roughly 1.5 standard deviations below average and close to the all-time low of 0.31 reached in February of 2000, right before the tech bubble burst.

In some ways, the recent selloff resembles the “quant crash” of 2007. Similar to today, levered funds were seeking to juice returns in a low volatility world while crowding into momentum names. Whether the current disruption is eventually viewed as the first crack in the edifice, as was the case in ’07, or just a temporarily blip in a long-running bull market, remains to be seen. What is clear is that the narrow pursuit of a few story stocks has left the market more fragile than top-line indicators would suggest.

The unedited versions of the following Morningstar columns:
http://news.morningstar.com/articlenet/article.aspx?id=809078
http://news.morningstar.com/articlenet/article.aspx?id=809407

Is This Time Different for Value Investors?

By John Rekenthaler | 05-16-17

Optimists and Pessimists

For growth-stock investors, every day is a new beginning. There are always fresh industries to be invented, monopolies to be created, record profits to be earned. The growth-stock buyer is the child on Christmas morning, bounding down the stairs, wondering just what delights lie under the tree. Or the puppy, tail wagging, ready to step outside that door and explore what the world offers.

No such delights for value investors. They know what awaits their eager rivals: bitter disappointment. Santa's gift turns out to be a hand-knit scarf that looks suspiciously like Aunt Edna's hat. The puppy is yanked by his leash and is never permitted to catch the squirrel that taunts him. And that sure-to-succeed cupcake chain goes bankrupt, outdone by donuts.

The value investor, in short, is burdened by experience--the knowledge that as surely as night follows day, growth companies' bright prospects will dim. However, there is compensation for living in gloom. Historically, the stock market has rewarded those who study the lessons of history, and who therefore avoid the giddy mistakes.

Grantham's Early Years

One notable example has been Jeremy Grantham, co-founder of the asset-management firm GMO. When Grantham entered the investment business in 1965, he skipped straight to adopting the old man's approach of value investing. From Grantham's perspective, Ben Graham had already done the hard work, documenting how "the important ratios always went back to their old trends." So why not do as Graham advised? Buy downtrodden companies and wait for the mean to revert.

Writes Grantham, "And [it] worked! For the next 10 years, the out-of-favor cheap dogs beat the market as their low margins recovered. And the next 10 years, and the next. Not exactly shooting fish in a barrel but close. Similarly, a group of stocks or even the whole market would shoot up from time to time, but eventually--inconveniently, sometimes a couple of painful years longer than expected--they would come down. Crushed [profit] margins would in general recover, and for value managers the world was, for the most part, convenient, and even easy for decades."

Grantham was smart--and lucky. Give Grantham full credit for recognizing that he could profit by standing on others' shoulders, and for finding among the very best shoulders to mount. However, he enjoyed the good fortune of being born in 1938, not 1968. Had he waited a generation, he would have entered the business in the mid-1990s. Since that time, value investing has largely failed.

The Party Ends

The approach hung on for a while with smaller-company stocks. Since Jan. 1, 1995, the Russell 2000 Value Index has comfortably outlegged the Russell 2000 Growth Index, gaining 10.74% annualized as opposed to the growth index's profit of 7.77%. However, that advantage comes solely from the beginning of the period. Over the trailing 15 years, the two indexes have posted almost identical returns.

(Thus, our hypothetical younger Grantham, if put in charge of a small-company stock fund, would have posted an outstanding gain during his fund's first seven years. The fund likely would have attracted considerable attention and new assets, after which its performance would have sunk back to earth. This story would then be fashioned into a morality play--about the wickedness of funds that thrive when they are small, but which then take in too many new assets and become bloated.

In reality, though, the fund's problems would have owed to general trends in the stock market, rather than to specific actions that it took. The facts would have fit the thesis that small-company stock funds struggle to maintain their early successes when they become popular. However, in this instance, correlation would not have been causation. The relationship was accidental.)

With blue chips, value investing has delivered no benefit whatsoever since the mid-90s. From January 1995 onward, the S&P 500 Growth Index has actually beaten its sibling value index. The S&P 500 Value Index does lead slightly for the trailing 20- and 15-year periods, then lags just as slightly for the 10- and five-year windows. Overall, the competition has been a wash.

Those Who Wait

When asked about this prolonged slump, value investors typically counsel patience. Yes, value stocks have not followed their historic pattern, but these things do happen. If risky investments had guaranteed periods of success, then they wouldn't be risky investments. Don't think of value stocks' struggles as a problem, but instead as an opportunity. The worse that the value style performs, the stronger its recovery when value investing returns to favor.

That argument makes much sense. It is a basic truth of investing that the rewards tend to be greatest when the prospects appear darkest. *BusinessWeek* headlined "The Death of Equities" in 1979--in hindsight, a terrific time to be purchasing stocks, not selling them. Two decades later, many wondered about the viability of value investing during the "New Era" of technology stocks. Value promptly had its best three-year stretch in years.

The claim also is consistent with human nature. It's difficult for almost anybody to revise their views when confronted with new evidence. It's especially difficult for mutual fund portfolio managers, who typically have reached a certain age, and who have enjoyed very successful careers. It's much more natural--and, usually, convincing to onlookers--to show "conviction" by reiterating long-held beliefs.

Brave Words

Not so Grantham. In GMO's most recent quarterly letter, he entitles his article, "This Time Seems Very, Very Different." The headline is something of a tease, as the verb "seems" gives Grantham much wiggle room. Nonetheless, he does suggest the significant possibility that the conditions that supported the style of value investing that he learned from Ben Graham, and that he practiced himself for so many years, may be impaired. That is a bold thought from an established portfolio manager. ...

Why Value Stocks Have Disappointed

By John Rekenthaler | 05-19-17

Tough Times

Tuesday's column covered value stocks' long dry spell. After reliably and consistently beating growth companies for decades, lower-priced stocks have lost their edge. Since the mid-1990s, value stocks have roughly matched growth stocks' returns, and during the trailing 10-year period they have lagged. So much for the notion of a "value premium."

In his most recent quarterly letter, Jeremy Grantham, co-founder of the money-management firm GMO, discusses why value investing has struggled. The letter is unusual in that Grantham is himself a value investor, and his organization's funds are suffering net redemptions (which may have more to do with being a Permabear). Fund executives who find themselves on the wrong side of the financial markets tend to defend their investment approach, not question it.

Fat and Happy

Instead, Grantham grants that this time might indeed be different. In particular, corporate profits have transformed. ...

Interest rates, of course, have also confounded expectations by breaking through their historic bands. In the case of interest rates, the barriers were floors rather than ceilings. But the pattern was the same as with corporate profitability. Rates would set new records, observers would whisper worries about their inevitable retreat, and then … interest rates would drop further. The bad news never came.

Given that corporate profits exceeded all predictions, and interest rates dropped below what anybody anticipated, it's no surprise that stock price/earnings ratios moved higher. How could they not? Corporate values are determined by the cash that companies generate (which is directly related to profitability, assuming no hanky-panky with the accounting) and by the interest rates that are used to discount their future receipts. Both measures improved greatly. Stocks had no choice but to rise.

Exhibit 2 U.S. Stock Prices Leap

As of 3/31/17
Source: Compustat, GMO

Trend Fighters

Value investors are creatures of habit. Whereas growth investors cherish the improbable, envisioning companies that achieve what their predecessors could not accomplish, value investors expect what previously occurred to happen again. Grantham's lines are symbolic, but they represent the bedrock faith of a value investor: That which excels (or stumbles) will inevitably head back from whence it came. ...

Historically, value investing succeeded for two reasons:

As a rule (there were always exceptions), the weaker companies weren't quite as bad as they seemed. If they were priced the same as the stronger companies, of course you would prefer the latter, but that was not the case. The laggards were steeply discounted--too steeply, as it turned out.

Conversely, the stronger companies weren't as good as they seemed. Their prospects were overstated. To be sure, they ended up growing their sales and profits faster than the norm, but not as rapidly as their stock prices had forecast.

In short, stock investors typically overreacted in both directions. They accurately gauged that some companies were better than others, and for the most part sorted the sheep from the goats, but they misjudged the magnitude. The good weren't that good and the bad weren't that bad.

The New Era

This time, the mean did not revert (so far). True, the bad companies have remained not so bad. (Setting aside the companies that did not survive the 2008 crisis, that is.) That part value investors continue to get right. However, they have missed the fact that the good companies have indeed become that good. For 20 years, Apple (AAPL) has confounded even the optimists. Apple is the most extreme of cases, but across the technology and healthcare industries, leading firms enjoy margins as they never have before.

Writes Grantham, "I used to call profit margins the most dependably mean-reverting series in finance. And they were through 1997. Previously, margins … were competed down to a remarkably stable return--economists used to be amazed by this stability--driven by waves of capital spending just as industry peak profits appeared. But now … there is plenty of excess capacity and a reduced emphasis on growth relative to profitability."

Overall, he states, "the general pattern … is entirely compatible with increased monopoly power for U.S. corporations. Put this way, if they had materially more monopoly power [than in the past], we would expect to see exactly what we do see."

Grantham concludes that value investors are unlikely to thrive until corporate profits recede, which he does not expect to happen any time soon. Of course, predicting the economy is a perilous task, but I believe Grantham is on the right track. The primary reason value investing has lost its mojo is not because stock buyers are behaving any differently, but because *companies* are. The economy has changed the investment math that Eugene Fama and Ken French so famously publicized. If that math is to hold again, it will require the economy's cooperation.

John Rekenthaler 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 Rekenthaler Report, his views are his own.

John Rekenthaler is Vice President of Research for Morningstar.

Our thoughts

According to legendary investor John Templeton, **"The four most dangerous words in investing are: 'this time it's different.'"** To the extent that the Value Factor's historical outperformance is attributable to investor's behavioral biases, we are not in a "New Era". However, as we have previously shared and will continue to do so, how you measure Value and construct the resulting portfolio matters a great deal. Fama and French used book value to define Value. Subsequent academic research has shown the valuation metrics we use (PEG, EV/EBITDA and the closely related EV/EBIT) to be superior. In addition, dividing the investable universe in half between Growth and Value is far removed from the long/short portfolios used by academia to determine a Factor's validity or optimized portfolio construction which requires concentration and more frequent rebalancing, as previously shared. The "V" in our IVE System stands for Value. Its superior track record is detailed in our White Paper, which is available on HCM's website.

The adage that "**History doesn't repeat itself, but it does rhyme."** applies to investing. Comparing today's markets to that of the mid to late 90s is currently fashionable among strategists. So what does that and the subsequent period teach us about Value?

FACTOR INVESTING: EVIDENCE BASED INSIGHTS

June 22, 2017 Jack Vogel, Ph.D.

... what is “evidence based investing?” What does that even mean?

If we read a index factsheet, review a long-term live track record, or read an academic finance paper, are we now an evidence-based investor? No.

To me, evidence based investing means reviewing ***all*** the relevant research on a topic, viewing this body of research as a whole, understanding the economic/human underpinnings of the finding, and then making an informed decision that is as objective as possible. Achieving the title of being an “evidence based investor” sounds easy, but the reality is that this is incredibly difficult. This difficulty is only magnified by the sheer amount of information and (so-called) research being distributed into the marketplace. To solve this information overload problem investors often get complacent and rely on a single firm's research (or research group) to inform their opinion on all matters. This approach will likely turn you into a faith based investor, not an evidence based investor (see here for a piece on the subject). And when it comes to factor investing, we often see well-meaning investors, who want to be evidence-based investors, quickly devolving into faith based investors who are no longer critically reviewing and assessing the available research. ...

Are factor premiums here to stay or have they been arbitraged away?

This is a common question we are asked. As advocates of factor-investing(1), how does one respond to the countless articles citing the evidence that factor/active funds are losing to the passive index?

Our response is not satisfying: active (factor) investing is ***simple,*** but not ***easy.***

As we have highlighted in the past (I recommend you read the entire article), active factor portfolios are notoriously challenging for investors. Consider value investing, the most well known factor approach. Value investing has had numerous periods of underperformance, especially during the Internet Bubble. Using Ken French's data, we examined just how **painful** it was to be a value investor in the late '90s.

We examine the returns from 1/1/1994-12/31/1999 for a Value portfolio (High B/M quintile, VW returns), Growth portfolio (Low B/M quintile, VW returns), Risk-Free return (90-day T-Bills), and SP500 total return. Results are shown in Figure 1 below. All returns are total returns and include the reinvestment of distributions (e.g., dividends). Results are gross of fees.(2)

Figure 1: Summary Statistics (1994-1999)

Summary Statistics*	Value Stocks	Growth Stocks	SP500	RF
CAGR	18.35%	27.71%	23.84%	4.92%
Standard Deviation	11.79%	16.53%	13.63%	0.21%
Downside Deviation (MAR=5%)	7.59%	11.25%	10.50%	0.17%
Sharpe Ratio	1.09	1.28	1.30	0.00
Sortino Ratio (MAR=5%)	1.66	1.87	1.67	-1.11
Worst Drawdown	-11.58%	-16.33%	-15.18%	N/A

Talk about a bad stretch! Looking at the annual returns (shown in Figure 2), value investing lost almost every year to the market!

Figure 2: Annual Returns

	Value Stocks	Growth Stocks	SP500	RF
1994	-2.83%	2.53%	1.35%	3.91%
1995	36.47%	35.47%	37.64%	5.60%
1996	14.22%	23.20%	23.23%	5.20%
1997	32.52%	31.15%	33.60%	5.25%
1998	29.75%	44.23%	29.32%	4.85%
1999	5.45%	33.90%	21.35%	4.69%

What would their hypothetical returns look like in the long run? As you can see below in Figure 3, value quickly recovers and outperforms the entire time period thereafter. Here are the returns to the same portfolios from 1/1/2000 – 12/31/2014, the 15 years following the 5-year underperformance:

Figure 3: Summary Statistics (2000-2014)

Summary Statistics*	Value Stocks	Growth Stocks	SP500	RF
CAGR	9.12%	2.75%	4.45%	1.86%
Standard Deviation	24.05%	16.90%	15.22%	0.58%
Downside Deviation (MAR=5%)	17.73%	12.50%	11.42%	0.46%
Sharpe Ratio	0.41	0.14	0.24	0.00
Sortino Ratio (MAR=5%)	0.37	-0.07	0.05	-6.89
Worst Drawdown	-64.47%	-58.21%	-50.21%	-0.01%

Sticking with the value strategy, although painful, was richly rewarded with a 4.67%+ edge–per year–over the market benchmark from 2000-2014.

Over the entire cycle, patient, disciplined investors were also rewarded. Here are the results (Figure 4) over the entire time period, measured from 1/1/1994 to 12/31/2014:

Figure 4: Summary Statistics (1994-2014)

Summary Statistics*	Value Stocks	Growth Stocks	SP500	RF
CAGR	11.68%	9.33%	9.65%	2.72%
Standard Deviation	21.27%	17.00%	14.92%	0.63%
Downside Deviation (MAR=5%)	16.23%	12.25%	11.19%	0.54%
Sharpe Ratio	0.50	0.45	0.51	0.00
Sortino Ratio (MAR=5%)	0.51	0.44	0.48	-4.31
Worst Drawdown	-64.47%	-58.21%	-50.21%	-0.01%