The Stan Clark Financial Team's

PERSPECTIVES

An excerpt from "Perspectives" - Volume 11 - Issue 4

Investing

The value of value

By Michael Chu, Investment Advisor

***Value investing* is buying out-of-favour stocks that are well priced compared to their underlying, intrinsic value. Historically, value investing has resulted in better-than-market returns, which makes it a bedrock principle for many astute investors. Value investing works because forecasters and investors often underestimate the ability of these companies to revert to higher profitability and growth.**

But no investment style works all the time. Despite its long successful track record, value investing has underperformed for the last 10 years, especially the last two years. History shows us that bad periods have been more than made up for in later years. Still, that doesn't make it easier when you're actually going through one of those periods.

Let's look at it from an academic viewpoint. The most basic way to measure value is by using gauges like price-to-earnings, price-to-cash flow and price-to-book value. Just by systematically investing in the cheapest 20% of companies using these simple variables, this method has strongly outperformed the S&P 500 over the last 69 years (since 1951). Over those years, value investing returned 14.3% vs. 10.8% for the S&P 500. Because the outperformance lasted so long, had we invested $1000 at the beginning, value investing would have resulted in about $9.7 million vs. $1.2 million for the S&P 500.

Value Investing vs. S&P 500

July 1951 - April 2020 (68.8 years)

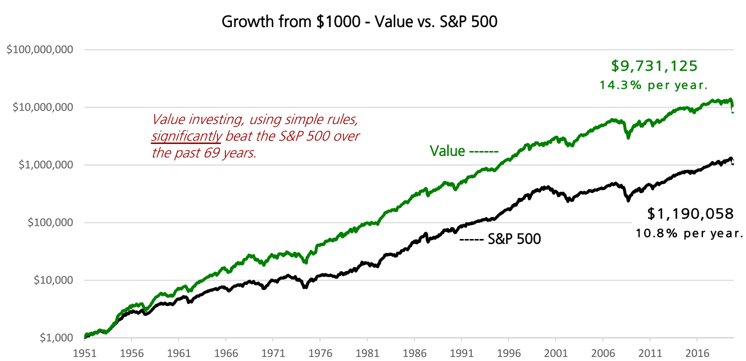

Figure 1: Growth generated by pure value stocks and the S&P 500 total return.

Based on this track record, it certainly seems like value investing is the way to go. However, long-term returns don't tell the whole story. Few people invest with 50-year time frames and the shorter-term paths are also very important.

Figure 2, combines the two lines in Figure 1 to show when value is doing better or worse than the S&P 500. When the line goes up, value is doing better. When it goes down, value is doing worse. As you can see, overall the line is upward. But there were many down periods, including some big ones that coincided with major economic events like the dot-com bubble of the late 1990s and the great financial crisis of 2007-08. Every down period eventually reversed with strong outperformance.

You can also see that, in the last 10 years, value significantly underperformed. Using the basic measures of value discussed earlier, value underperformed the S&P 500 by 44% over this time. (Note: the extra value returns in the graph include the most recent drop.)

So, what now? Ten years of underperformance is a long time. Does it mean value investing is permanently broken? Or that value investing is just temporarily out of favour, and could come roaring back? We believe it is the latter and will discuss the reasons next.

Is it crowded out there?

One worry about investment strategies is: If they're so good, what happens if everyone uses them? If overcrowding were a danger, value stocks would go up in price and there would be no more cheap stocks,

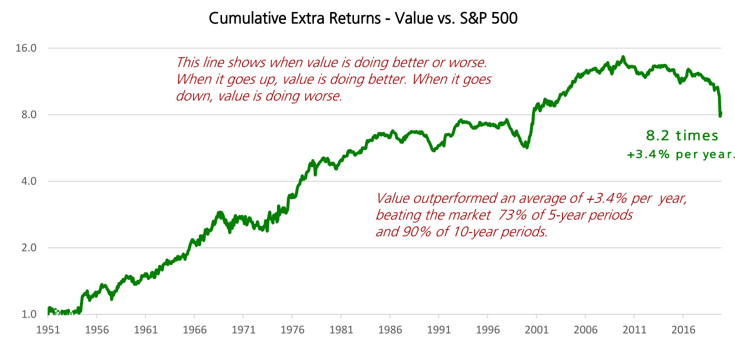

Figure 2: Cumulative growth of value stocks relative to the S&P 500.

causing the extra returns to disappear. The benefit would get arbitraged away. It's like TVs or cordless drills being offered at a really good price in a Black Friday sale; then everyone discovers the deals and they flock to buy. Soon there are no deals left. So, again, are there too many value investors, thereby reducing the benefits?

Let's look at something called the *value of value*. Basically, this is a measurement of how cheap value stocks are vs. the average stock.

Figure 3, shows that value stocks, using the simple definition from earlier, are typically priced at about a 40% discount from the average stock. This average discount resulted in the extra 3.4% per year returns from Figure 2. You can also see that this discount – the value of value – changes, but is range-bound. Today, value stocks are an unprecedented 60% cheaper than the average stock. Most of this drop occurred in the past two years. So, value stocks are now at extremely good value. If value investing wasn't working due to becoming too popular, you wouldn't see this. Rather you would see the opposite, with value stocks becoming more expensive than normal.

Based on the above, it seems very clear that value hasn't been arbitraged away. And this bodes well for value investing going forward.

Other studies

Notable hedge fund manager Cliff Asness of AQR Capital Management recently discussed a very extensive study on value investing that showed value investing is still very much alive. The study used similar value measures to those discussed earlier, but it also used different tests to see if the conclusions would change. They did not. For example, the study systematically excluded certain industries (like technology), mega-sized companies and the most expensive stocks. The story was always the same: value is exceptionally cheap and "neither the tech bubble nor the great financial crisis can claim to be the cheapest value of value anymore." Asness also concluded that "investors are paying way more for the companies they love vs. the ones they hate and doing it highly diversified, way up and down the cross-section of stocks." The value phenomenon is pervasive.

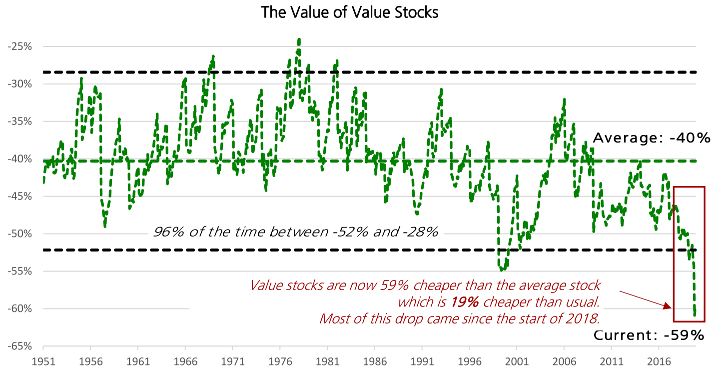

Figure 3: Average valuation of value stocks relative to valuation of the *average* stock.
The lower the line, the better the discount.

Rob Arnott from Research Affiliates and others looked closely at the various *narratives*, or stories, that investors use to justify buying popular-growth stocks. Arnott et al. examined the actual facts behind these stories. They found most of the stories simply did not stand up, and determined that value's recent underperformance was "more due to growth stocks getting more expensive relative to value stocks." They also concluded that "today's value vs. growth valuation gap is at an extreme [100th percentile of historical valuations and] the stage is set for historic outperformance of relative growth over the coming decade."

Are we there yet?

Now that we know value is looking very cheap, the question is: When will things get better? It could come quickly in the next few months or slowly over the next few years. We simply don't know. But good investing does not depend on certainty and precise timing. Good investing is about improving your odds of success and sticking with good strategies that help you do this.

No method of investing can perform perfectly consistently all the time. If such a method existed, everyone would use it, and then it would stop giving good returns. Any approach that works over the long term must have ups and downs in the shorter terms. A key to benefitting from the upswings is being resilient enough to get through the tough times.

Value investing is a big component in our investment strategies. Fortunately, our strategies use more nuanced measures of value than are used in the simple academic definitions used above. As well, they incorporate other factors such as momentum, volatility and earnings growth. These helped us strongly outperform the indexes for the first eight of the past 10 years, even though value was not doing well. However, the extraordinary headwinds of the past two years, driven by the investing herd's move away from value, have caused us to give back some of those extra returns.

We take pride in doing better than the indexes. It's always tough for us to give back some of our extra returns. We have made minor changes that are helping protect our relative performance this year. But going forward, a value approach to investing has never looked better and we remain very committed to this approach. It's important to be positioned to benefit strongly when value eventually returns to favour.

We feel fortunate to remain ahead of the indexes over the past 10 years, even though value has underperformed by nearly 50%. Sticking with a defined process is the only way to achieve long-term success. We also know that sticking with something that is good through its occasional bad times and being a contrarian is difficult. But persevering through that difficulty is how long-term investors get rewarded. ■

Source for graphs: Kenneth French, CRSP, Standard and Poors

Michael Chu is a Portfolio Manager and Investment Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Michael is a specialist in investment research and information technology.

CIBC Wood Gundy

The Stan Clark Financial Team
Where planning, investing and behavioral finance meet

Phone: (604) 641-4361 Toll free: 1 (800) 661-9442 Fax: (604) 608-5211 Email: StanClarkFinancialTeam@cibc.ca www.stanclark.ca