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PERSPECTIVES

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Investing

Value investing over the long term

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As discussed in our 2018 *Year-End Review*, value investing has underperformed lately. As a result, it's reasonable to ask if value investing is going to be less effective going forward. Despite the good long-term track record, is it possible there has been some big change – or is this underperformance just temporary?

First, let's look at what *value investing* is. Value investing is buying out-of-favour stocks that trade at a discount to their fair value. They could be out of favour for a variety of reasons: bad financial results, lower future prospects, or even just emotions. Value investing works because investors systematically underestimate the ability of "weaker" companies to revert to profitability and reasonable growth. Historically, buying value companies has resulted in better-than-market returns.

On the other side of the spectrum is *growth investing*, or buying companies that have high expectations and are usually more expensive. Here, investors tend to overestimate the high expectations, eventually to be disappointed.

But in recent years, expensive stocks have remained expensive because they have met their lofty expectations. As a result, cheap stocks have stayed out of favour. Is this something new?

To find out, we did a study of value investing, with data going back to 1927 (92 years). We looked at the performance of various individual value measures or "factors," such as *price-to-book value* (P/B). Book value is the value of the company's assets. We compared low P/B (cheap or value) stocks vs. high P/B (expensive or growth) stocks. On an annual basis, cheap stocks outperformed with returns of 12.9% vs. 9.3% for expensive stocks. At first glance, that's a very impressive track record over such a long time period. It makes value investing look great and easy to do.

But let's look closer. Like many things, returns on value investing go through cycles. Despite value investing's good long-term track record, it has had some bad periods. True, the bad years are eventually more than made up for, but that doesn't make it much easier when you are currently in one of those bad periods. Just how often do bad periods occur for value investing?

On an annual basis, value investing has bad years quite regularly. In fact, value investing only outperformed 59% of the individual years. That might seem unimpressive, but it's actually pretty good, as the better years made up for the down years. It just shows that value investing isn't going to do well year after year. It's good to know this, and shows we just have to be patient.

Let's look at *rolling three-year periods* – meaning we look at three-year periods together instead of each year individually. This gives us a longer-term perspective. Looking at three years, value outperformed 63% of the time, giving us more confidence. On a five-year basis, value outperformed 70% of the time. And on a 10-year basis, value outperformed 84% of the time. When we compare annual returns to rolling periods, we can see that patience pays off. Down periods were soon made up for by up periods.

Let's look at one more thing. Based on the above, we might feel more comfortable with a few bad years in a row. But what about underperforming for five- or 10-year periods? It has happened in the past: Value underperformed significantly over 10-year periods during the 1930s, late 1950s, the dot.com boom bust – and, unfortunately, today. While still a rare occurrence, we should be prepared.

The good news is that, historically, value has always come back. We can't tell when this will happen, and perhaps the future outperformance will be less than the past. Or, just maybe, value's current attractive relative price will enable it to outperform with a vengeance. Value is a big part of our investment philosophy and will have an impact on our results. Fortunately, with our diversified approach, we can mitigate some of the effects. ■

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