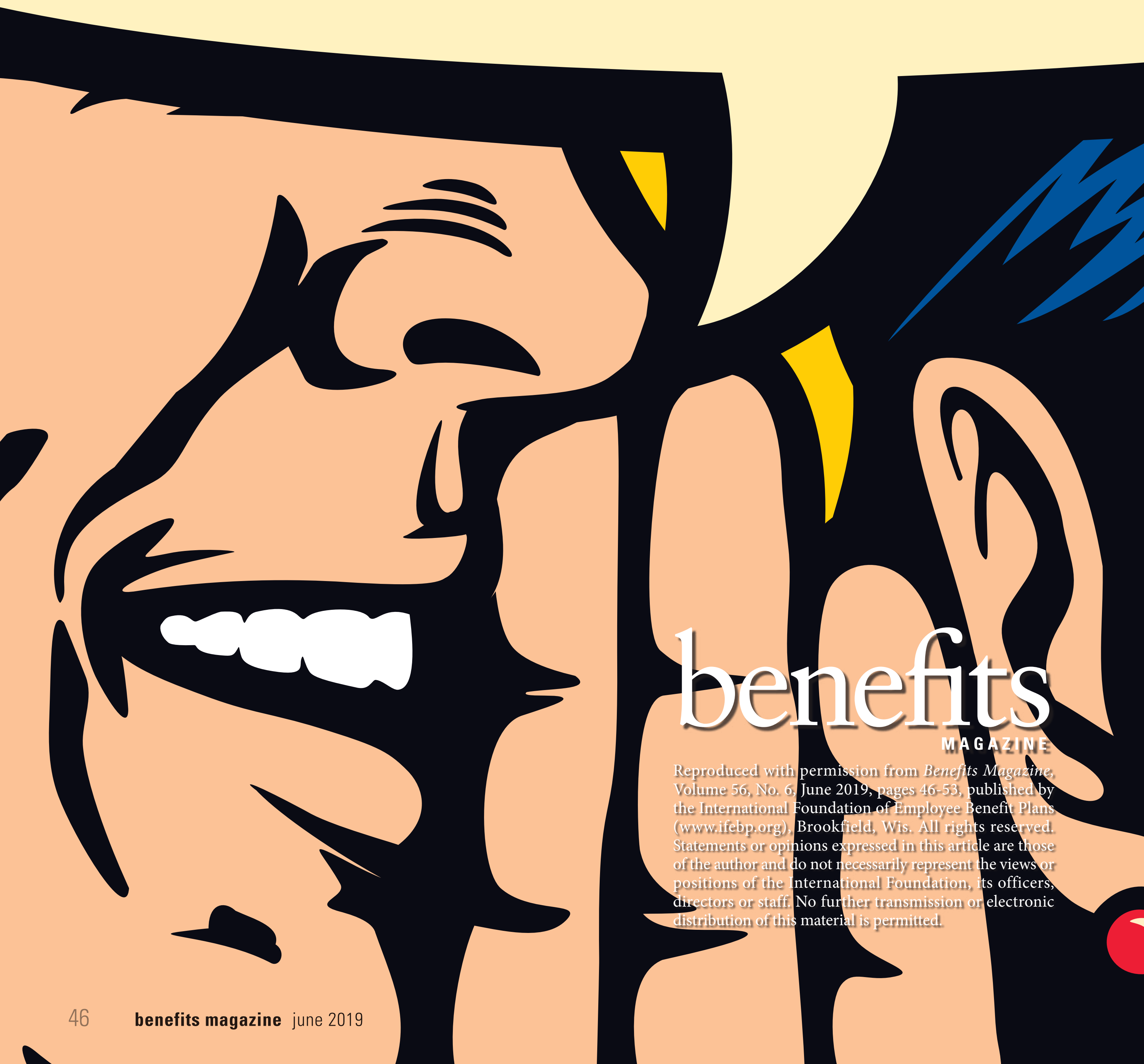
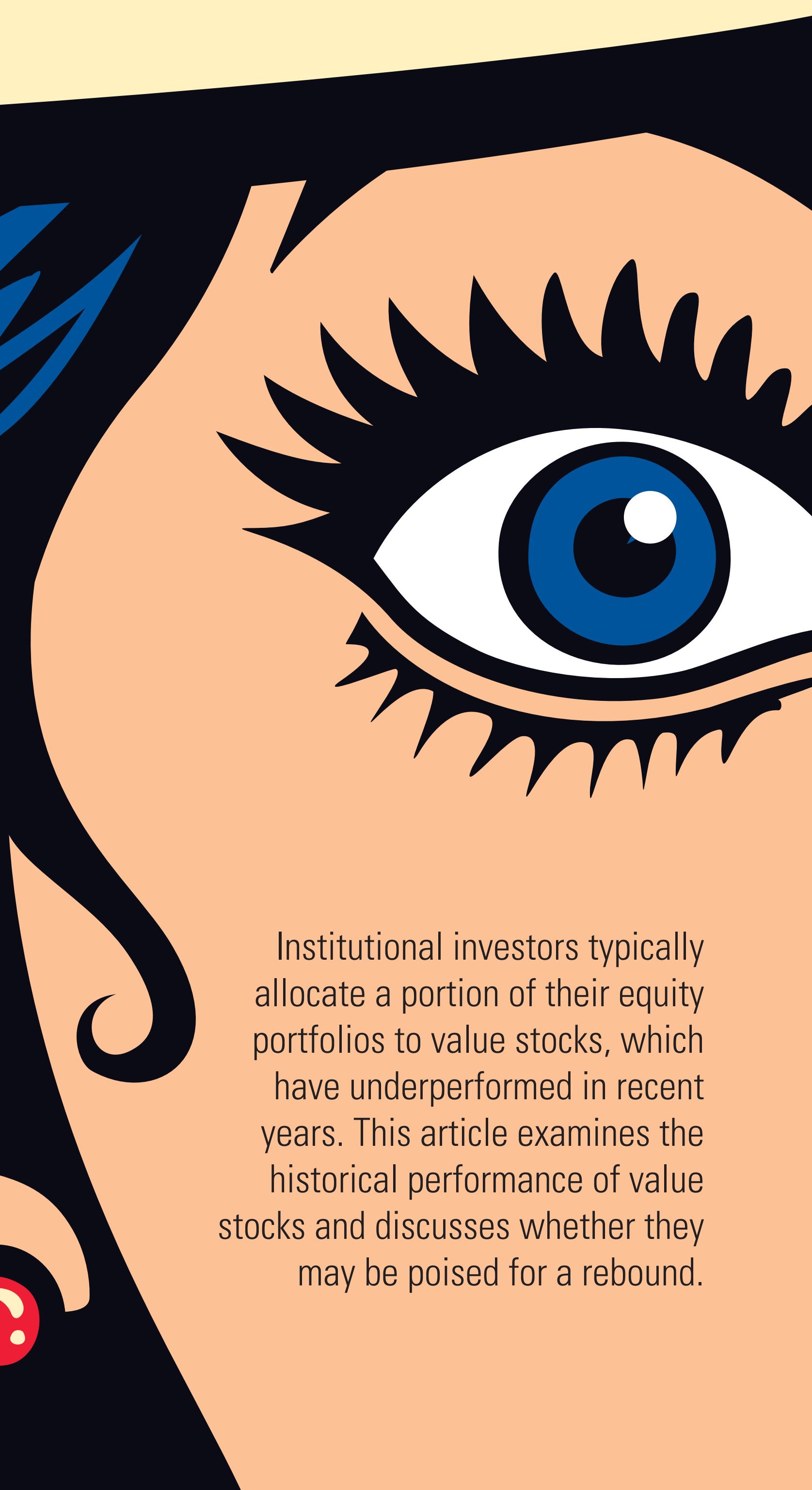
VALUE INVESTING—ARE ITS DEMISE GREATLY EX

by | **Eric C. Elbell**



RUMORS OF AGGERATED?



Institutional investors typically allocate a portion of their equity portfolios to value stocks, which have underperformed in recent years. This article examines the historical performance of value stocks and discusses whether they may be poised for a rebound.

U.S. stocks have enjoyed a robust bull market since the depths of the global financial crisis, as indicated by the 13.2% annualized total return produced by the broad market Russell 3000 Index over the last ten-year period ending December 31, 2018. Examination of performance across different strata of stocks, however, indicates that the rising tide of the last decade didn't necessarily lift all boats equally. Notably, for instance, growth stocks meaningfully outperformed value stocks over this period, with the Russell 3000 Growth Index producing a 15.2% annualized total return compared with 11.1% for the Russell 3000 Value Index.

As a result, some investors are questioning whether an approach focused on value stocks is obsolete and destined to provide substandard results. Others remain convinced that value stocks will shine once again, and there has been no shortage of proclamations in the financial press in recent years that a value stock resurgence is just around the corner. Which camp is correct? Is value investing truly "dead," or are value stocks indeed poised to take the reins of market leadership once again? If so, what could catalyze their rebound? To help address these questions, this article will review some fundamental differences between the two styles and look at their historical performance patterns.

Style Definitions and Historical Performance Patterns

The terms *value* and *growth* represent a method of categorizing different stocks based on their valuation, as described by a ratio (or *multiple)* comparing a stock's price with a fundamental financial metric of the company in question, such as book value, earnings per share or cash flow, among others. In general, stocks with lower valuations are considered *value stocks,* while those with higher valuations are labeled *growth stocks.* The implication is that growth stocks trade at higher multiples because they generate higher rates of earnings growth.

By extension, investors who seek to identify cheap or undervalued stocks (adhering to the old adage of paying 50 cents for something worth $1) generally tend to have higher exposure to stocks with lower multiples and are therefore labeled *value* *investors*. In contrast, investors who focus more on a company's growth prospects and are willing to pay higher multiples are categorized as *growth investors*.

Value investing has long held a revered status in the investment industry, partly due to its application by a cadre of well-known, successful stock investors throughout history, including Benjamin Graham, Warren Buffett and John Templeton, among others.[1] In addition, academic research has shown that value stocks have produced a return premium over long-term periods.[2] This pattern is reflected in Table I, which shows that over the past 40 years the Russell 3000 Value Index has outperformed its growth stock index counterpart while also exhibiting a lesser degree of volatility (standard deviation), resulting in superior "risk-adjusted" returns, as measured by the Sharpe ratio.[3]

For these reasons, institutional investors typically allocate a portion of a broad equity portfolio to value stocks. Often this exposure is balanced by an accompanying allocation to growth stocks so that the broad portfolio is diversified across stocks with different characteristics (e.g., valuation, earnings growth rates, sector/industry representation) that may exhibit different performance patterns. Indeed, a review of relative performance trends between the two styles over shorter periods indicates that there have been multiple occasions in which one of the two styles dominated the other for a time before the pendulum swung back in the other direction. This can be seen in Figure 1, which compares the relative performance of the Russell 3000 Value Index with the Russell 3000 Growth Index over rolling three-year periods during the past 30 years:

Figure 1 shows that value stocks lagged growth stocks by a wide margin from 1989 to 1991, with the performance differential falling as low as -10%, before roaring back in 1992 and 1993. Value stocks also trailed by a significant margin during the internet stock bubble from 1998 to mid-2000 but then dramatically outperformed from mid-2000 to 2002 when the bubble popped. Value stocks proceeded to hold their lead for a few more years from 2004 to 2006 before giving ground to growth stocks during the global financial crisis from 2007 to 2010. Value stocks then staged a muted and short-lived rebound during parts of 2012-2013 before growth stocks once again assumed control.

Viewed through a slightly longer term lens, value stocks enjoyed a sustained favorable cycle from mid-2000 to 2006, but growth stocks have led in the ensuing years. Given the duration of the latest cycle of underperformance by value stocks, and with three-year trailing returns for the value index again falling as much as 10% below those for the growth index as of mid-

TABLE I

Comparing Value and Growth Index Returns

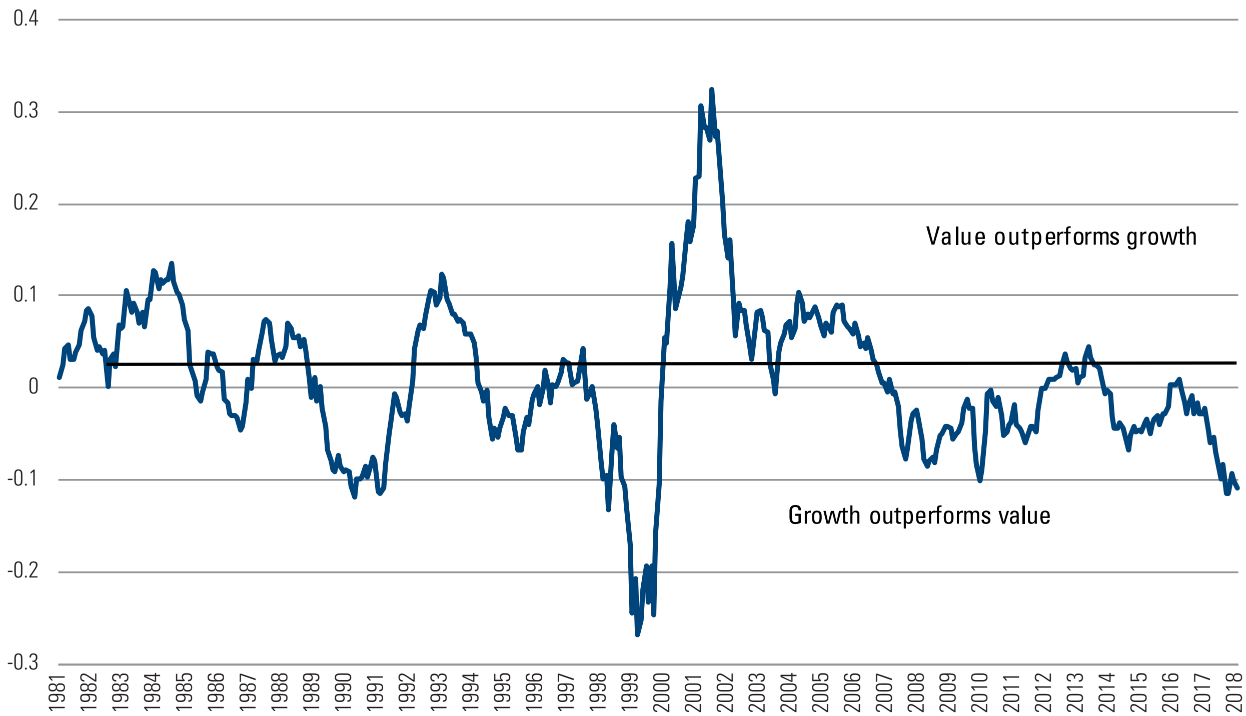
Forty-year period ending December 31, 2018

	Russell 3000 Value Index	Russell 3000 Growth Index
Annualized Total Return	11.72%	10.90%
Standard Deviation	14.44%	17.05%
Sharpe Ratio	0.49	0.37

Source: FTSE Russell, FactSet, eVestment.

FIGURE 1

Relative Performance Over Rolling Three-Year Periods
Russell 3000 Value Index Less Russell 3000 Growth Index



Source: FTSE Russell, eVestment.

2018, it's not unreasonable for investors to question whether value stocks are again poised for a rebound. A key associated question, however, is what might trigger such a reversal?

To answer the question, it's instructive to investigate some of the underlying drivers behind past value and growth performance cycles to determine whether there are common factors that typically contribute to the relative performance of value stocks during different periods of time.

Examination of Past Value and Growth Cycles

Two factors are commonly offered to explain periods of value/growth stock performance patterns:

TABLE II

Performance of Value and Growth Investing Strategies in Various Economic and Interest Rate Climates

	Style Performance Leader	U.S. Economic Growth Trend	Interest Rate Trend
1989–1991	Growth	Weakening	Falling
1992–1993	Value	Strengthening	Falling
1998–mid-2000	Growth	Strengthening	Mixed
Mid-2000–2002	Value	Weakening	Falling
2004–2006	Value	Strengthening	Rising
2007–2010	Growth	Weakening	Falling
2017–present	Growth	Strengthening	Mixed

Note: U.S. economic growth trend assessment is based on the strength and direction of U.S. gross domestic product (GDP) annualized growth; interest rate trend assessment is based on the direction of the ten-year U.S. Treasury note yield.

Source: Internal analysis.

TABLE III

Value and Growth Index Sector Weightings

	Russell 3000 Value Index	Russell 3000 Growth Index
Technology	7.2%	23.8%
Health Care	2.6%	20.9%
Consumer Discretionary	11.1%	17.4%
Consumer Staples	3.1%	12.5%
Energy	10.6%	0.8%
Materials and Processing	6.5%	2.1%
Producer Durables	6.6%	10.2%
Financial Services	30.2%	8.6%
Utilities	22.0%	3.7%

Source: FTSE Russell.

TABLE IV

Sector Impact on Value Index Performance

	Dominant Style	Largest Sector Impacts on the Relative Performance of the Russell 3000 Value Index
1998	Growth	Technology, Financial Services
1999	Growth	Technology, Utilities
2000	Value	Technology, Financial Services
2001	Value	Technology, Financial Services
2002	Value	Technology, Financial Services
2004	Value	Health Care, Financial Services
2006	Value	Financial Services, Utilities
2007	Growth	Consumer Staples, Financial Services
2009	Growth	Technology, Financial Services
2017	Growth	Technology, Financial Services
2018	Growth	Consumer Discretionary, Financial Services

Note: Red highlighting means the sector had a negative impact on the relative performance of the Russell 3000 Value Index in that given year, while green highlighting means the sector had a positive impact.

Source: FTSE Russell, FactSet, internal analysis.

1. **Rate of economic growth:** Many companies whose stocks exhibit lower valuations also tend to demonstrate cyclical and economically sensitive earnings growth rates. Examples include materials and industrial companies. These companies tend to produce higher rates of earnings growth and attract more enthusiasm from investors during periods when economic growth is picking up; conversely, in periods of low or weakening economic growth, investors are willing to pay a premium for companies with steadier and/or faster growth rates.
2. **Interest rates:** Rooted in the theory that stocks are worth the present value of their future cash flows (calculated as expected future cash flows discounted at an appropriate interest rate), this view holds that the stocks of companies with higher expected rates of future earnings and cash flow growth—that is, growth stocks—will be more highly valued, and thus perform better, in periods of falling or persistently low interest rates.

These theories have a mixed record, however, when applied to historical value and growth stock performance cycles. As summarized in Table II, over the last 30 years value stocks have outperformed growth stocks in periods of both strengthening and weakening U.S. economic growth, as well as in periods of both rising and falling interest rates.

Another explanation commonly offered to explain historical relative performance patterns between value and growth stock indexes is their different sector compositions. Table III depicts the average sector weightings of the Russell 3000 Value and Growth indexes over the last 30 years and indicates that companies in the energy, financial services and utilities sectors have historically comprised higher weightings in the value index, whereas technology and health care companies, in particular, have comprised higher weightings in the growth index.

To assess the impact of these weightings on the historical relative performance of the value index, we conducted a *performance attribution analysis,* a mathematical exercise that highlights the impact of sector exposures and individual stock performances within different sectors on a portfolio's relative performance compared with a benchmark index. For example, if a portfolio has a higher weighting to health care stocks than the benchmark index, and health care stocks outperform the broad index during a given period, the attribution analysis will indicate that the portfolio's overweighting to health care stocks positively contributed to the portfolio's overall performance relative to the index during that period. Conversely, for a portfolio underweighted to health care stocks during the same period, the attribution analysis will indicate that that portfolio's underweighting to health care detracted from its overall relative performance.[4]

For this analysis, the "portfolio" in question was the Russell 3000 Value Index, and the benchmark index was the broad market Russell 3000 Index. The measurement period covered each year from 1998 to the present. Table IV highlights the results of the analysis, indicating the two sectors that had the most significant performance impact on the relative performance of the Russell 3000 Value Index in years when the performance disparity between the Russell 3000 Value Index and the Russell 3000 Growth Index exceeded 5%.

For example, in 1998 the relative performance of the Russell 3000 Value Index was negatively impacted by its underweighting to technology stocks, which performed well that year, and also by its overweighting to financial services stocks, which lagged during the year.

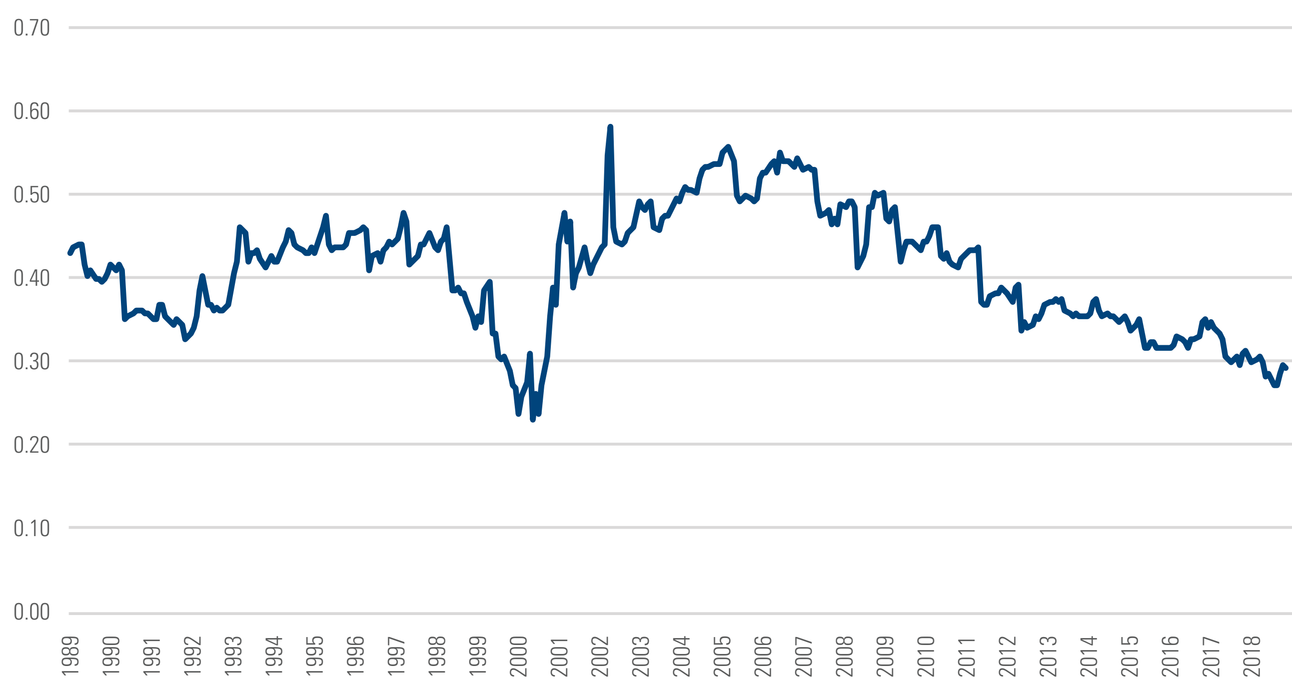
In general, the attribution analysis indicated that the performance of stocks in the technology and financial services sectors often had a significant influence on relative performance of the value index during years in which value and growth stocks diverged meaningfully. Put simply, based on historical performance the value index will be challenged when technology stocks outperform but benefit when they underperform. Conversely, the value index will benefit when financial services outperform but face a headwind when they trail.

Future Expectations

Considering these historical trends, is value investing dead, or is it poised to rebound? The history of performance cycles shown in Figure 1 would seem to indicate that value stocks may be due for a rebound, particularly after reaching a 10% performance shortfall on a rolling three-year basis in mid-2018, which has occurred only three other times in the past 30 years and from which value always eventually recovered.

FIGURE 2

Relative Price-to-Book Ratio of the Russell 3000 Value Index to the Russell 3000 Growth Index



Source: FTSE Russell, FactSet.

takeaways

- The terms *value* and *growth* represent a method of categorizing different stocks based on their valuation, as described by a ratio (or *multiple)* comparing a stock's price with a fundamental financial metric of the company in question, such as book value, earnings per share or cash flow, among others.
- Stocks with lower valuations are considered *value* stocks, while those with higher valuations are labeled *growth* stocks
- A review of relative performance trends between growth and value investing styles indicates that there have been multiple occasions in which one of the two styles dominated the other for a time before the pendulum swung back in the other direction.
- Different weightings of value and growth stock indexes to particular sectors can impact their relative performance value. For example, based on historical performance the value index will be challenged when technology stocks outperform but benefit when they underperform. .

In addition, the relative valuations of value and growth stocks at present compared with historical trends would seem favorable for value. As seen in Figure 2, the relative price-to-book ratio of the Russell 3000 Value Index compared with that of the Russell 3000 Growth Index recently hit its lowest point since 2000.

Further, given the notable impact of the technology and financial services sectors on value indexes, the prospects for value investing would seem favorable if one believes that returns across different sectors will revert to their long-term averages. Table V shows the annualized returns for various sectors in the Russell 3000 Index for different periods ending December 31, 2018. As seen, the range of performance across the sectors over the last 20 years has been limited; however, technology stocks have outperformed over the last five to ten years, while financial services and energy stocks have underperformed. Reversal of these trends would favor financial services and energy stocks at the expense of technology stocks, which would bode well for the future relative performance of value indexes.

Strategy Considerations

Considering the arguments that seem to support the prospect for a value stock rebound, an investor may question whether to tilt a broad equity portfolio toward value stocks at this time (that is, increase the exposure to value stocks beyond a neutral weighting). While this may prove fruitful should value indeed rebound in short order, the risk of such a tactical move is that underperformance of value stocks may yet linger. Figure 1 shows that value stocks continued to lag growth for another 12 months even after value's three-year performance shortfall grew as large as 10%.

At the same time, there are risks to trimming or abandoning exposure to value stocks at present. For one, doing so could produce imbalanced sector exposures in a portfolio at an inopportune time should technology stocks swoon and/or financial services stocks rally. Secondly, favorable value reversals historically have been rapid and forceful, as shown in Table VI. If this pattern repeated during the next value stock reversal, an investor who had

TABLE V

Returns for Russell 3000 Index Sectors Through December 31, 2018

	Five years	Ten years	15 years	20 years
Russell 3000 Index	7.9%	13.2%	7.9%	6.0%
Technology	14.1%	17.9%	9.6%	5.6%
Health Care	11.0%	15.2%	9.9%	7.6%
Consumer Discretionary	8.4%	17.4%	9.3%	6.7%
Consumer Staples	5.7%	11.3%	9.3%	7.4%
Energy	-7.2%	2.8%	5.9%	6.0%
Materials and Processing	3.5%	11.6%	7.1%	6.6%
Producer Durables	6.2%	12.9%	7.6%	6.9%
Financial Services	8.3%	11.4%	4.1%	4.8%
Utilities	8.0%	9.8%	8.1%	3.8%

Source: FTSE Russell, FactSet.

TABLE VI

Russell 3000 Value/Russell 3000 Growth Returns Spread

Cycle Low for Value	Prior 12 months	Post 18 months
December 1991	-16.3%	12.9%
February 2000	-37.4%	44.7%

Source: FTSE Russell, eVestment.

trimmed portfolio exposure to value stocks in advance could experience a lesser benefit from such a rally.

Summary—Value Investors Need Patience

Value stocks and value investing have undoubtedly endured a challenging environment in recent years. However, rumors of their demise appear to be exaggerated. The economic rationale behind value investing—acquiring an asset, in this case an ownership position in a business entity, at a bargain price—is timeless, and its validity is borne out by value's successful long-term track record. In addition, the history of value stocks recovering from cyclical periods of underperformance seems to indicate that the pendulum will swing back in favor of value stocks sooner or later. The challenge for an investor, however, is that it's difficult to pinpoint when this may occur, which means investors with value stock allocations will need to maintain a certain degree of patience.

An index, such as but not limited to the S&P 500, is a portfolio of specific securities, the performance of which is often used as a benchmark in judging the relative performance of certain investments or asset classes. Past performance does not guarantee future results. The index returns are generally "Total Return" which includes the reinvestment of any dividends or other income paid by the index constituents. The "Total Return" of an index generally does not reflect any brokerage commissions, other transaction costs or investment management fees that an investor may incur in connection with an actual investment in securities. Historical results should not and cannot be viewed as an indicator of future results.

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bio

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Endnotes

1. Warren Buffett has famously noted that he believes value and growth "are joined at the hip," since most value investors also expect earnings growth while most growth investors don't ignore valuations. (Berskhire Hathaway Annual Report, 1992).
2. Eugene Fama, and Kenneth French, "The Cross Section of Expected Stock Returns." *Journal of Finance,* June 1992.
3. The *Sharpe ratio* is a statistical measure that represents the excess return of an investment over a cash return relative to the volatility (as measured by standard deviation) of the investment's returns. Thus, the higher the Sharpe ratio, the greater the "risk-adjusted" excess return the investment generated.
4. The same analysis takes into consideration the performance of individual stocks held by a portfolio in a given sector relative to the performance of stocks in that sector in the benchmark index; for instance, if a portfolio were equally weighted to the health care sector relative to the index and the portfolio's individual health care holdings outperformed the health care holdings in the index during a given period, the attribution analysis would show that the portfolio's "stock selection" in the health care sector positively contributed to the portfolio's relative performance versus the index during that period.