AA View

Will value stocks ever make a comeback?

Summary

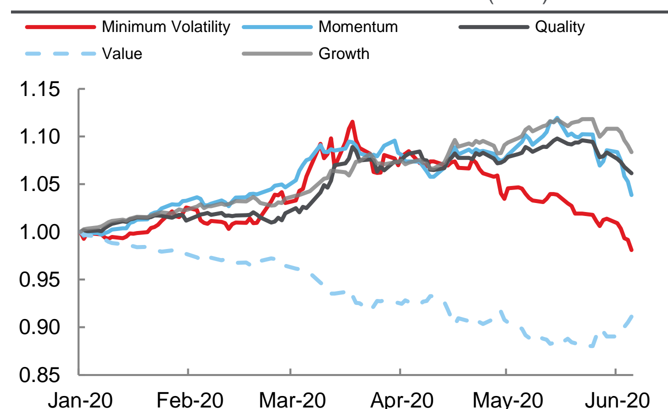
- Value stocks have lost their lustre over the past decade for several reasons, but value investing as a concept is certainly not dead.
- These reasons include persistently low profits and margins for value stocks, the continued dominance of technology and the lack of mean reversion.
- We think value investing should be recast, using different selection criteria to traditional value metrics such as the price to book ratio.
- Combining factors may make sense for those wanting to keep value working for them. Integrating this into a multi-factor investing strategy is sensible for now.
- There will be a time when value starts to perform well sustainably, but it is not imminent. Ongoing pandemic risks to economic growth and persistently low interest rates are just some of the headwinds.

Value stocks suffer badly during the pandemic…but this is nothing new

Value stocks – those that are considered cheap relative to fundamentals – have performed especially poorly this year, lagging both market cap indices and other major equity styles by a large margin. Using the MSCI World as the parent index, value stocks have underperformed the market cap index by around 10% since the start of the year and have underperformed growth stocks by almost 20% (to June 5th). However, as lockdowns have started to end, value stocks have begun to perform relatively better (see chart), whilst other equity styles have begun to underperform, although this is only for a very recent period as yet.

Value stocks underperform sharply

MSCI Factor index returns versus MSCI World (USD)



Source: Factset, data as at June 5th, 2020, USD

Market data sourced from Factset.

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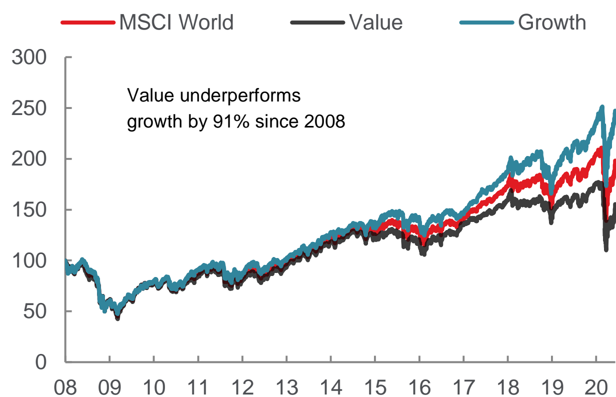
Why is this? The largest weighting in most value indices is financials, which enjoyed a strong rebound as expectations of better economic activity have improved. Value stock under-performance is nothing new of course, as the prominent indices have all returned poorly since the global financial crisis in 2008.

Value underperformance goes back a decade
MSCI World index total returns, 2008 = 100



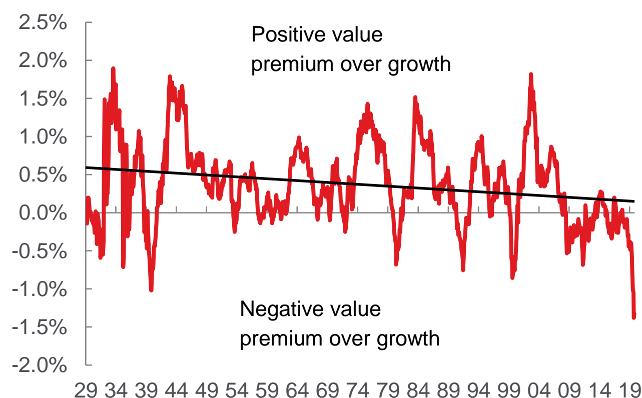
Source: Factset, data as at June 5th, 2020, USD

How value lost its lustre

Value stocks used to perform much better – they outperformed in the early 2000s, in significant periods of the 1990s and for decades between the 1930s and the 1960s. Indeed, the underperformance since the Global Financial Crisis is an especially long period of poor returns.

Using the Kenneth French database for value versus growth equities (High minus Low or HML in the jargon), the premium of value equities over growth equities has been non-existent since 2008. Indeed, it has plunged alarmingly in the current crisis!

The value premium has been absent for over a decade
HML factor, 3 year rolling average, with trend line



Source: Kenneth French, data to April 2020

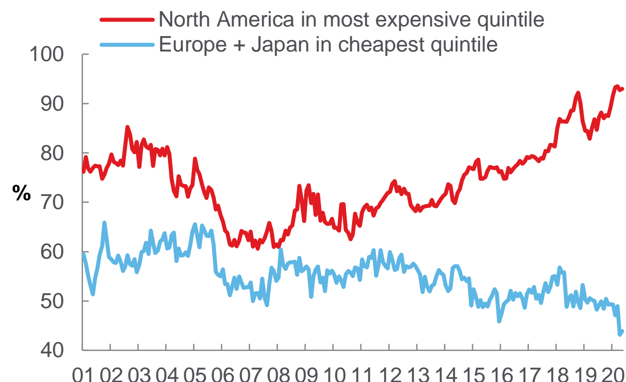
We have delved deeper into why value stocks have struggled since the financial crisis by creating our own stock screens using the valuation criterion most popular with value proponents, price to book value. Low ratios of price to book value, or the cheapness of the asset value of a company, was for a long time the defining attribute of value as an investing style. Using the MSCI World index, we have ordered all constituents by descending price to book values and split them up into quintiles[1].

High P/B value quintiles have outperformed since 2005
Annual average returns between 2005-2019

Source: Factset calculations, data as at June 12th, 2020, USD

The chart above shows that the highest price to book value stocks, have outperformed the lowest price to book value stocks on average since 2005 – this echoes the return patterns of the official MSCI World style indices. The fact that higher priced stocks have outperformed in this way is not just about value underperforming. It is also a central explanation for the way the US market has kept outperforming other regional markets. The rest of the world is overweight "value", whereas the US is underweight value. In our quintiles, the most expensive stocks (quintile 1) are almost entirely US domiciled, whilst half of the cheapest stocks (quintile 5) originate from Europe and Japan.

Growth is dominated by the US, whilst value is mainly EAFE
Weight within quintiles 1 and 5 for selected regions



Source: Factset, data as at June 12th

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[1] The calculations are based on rolling monthly rebalancing. Using quintiles addresses the problem that borderline companies can straddle both value and growth indices in some cases. It should be noted that there are issues with using the price to book value ratio to categorise stocks as "value" or "growth" – we will look at this later – but it does provide a decent approximation of the universe of value or growth stocks as they are currently considered.

Past performance is no guarantee of future results.

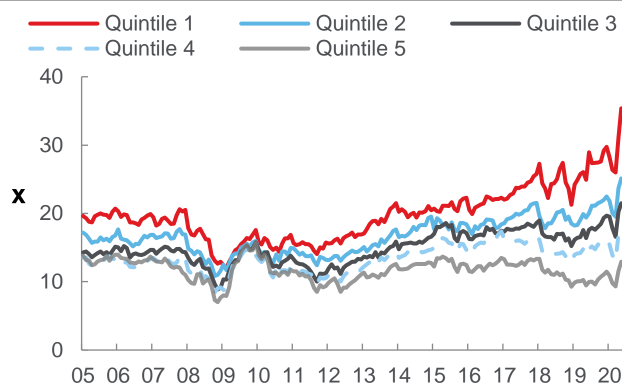
High P/B companies also became higher P/E companies

We can take this a step further. Higher price to book ratio companies have also re-rated in terms of their earnings-based valuations, i.e. contrary to earlier received wisdom, more expensive companies by asset value have also become more expensively valued in terms of how markets value their earnings. Looking at trailing and forward price to earnings ratios, the first quintile of the most expensive companies by book value, have also moved towards the most expensive by their forward price to earnings ratios.

Also, the spread of valuations has increased markedly over the past decade. It's important to note that our first quintile or growth stocks, were already expensive relative to their own histories at the start of the decade and have only become more and more expensive.

Valuation spread widens since the GFC

12m forward price to earnings ratio, quintiles based on P/B



Source: Factset calculations, data as at June 12th, 2020

By contrast, the lowest quintile of stocks by price to book value have not rerated at all. Cheap stocks have remained cheap and have hardly been noticed by investors in the rally.

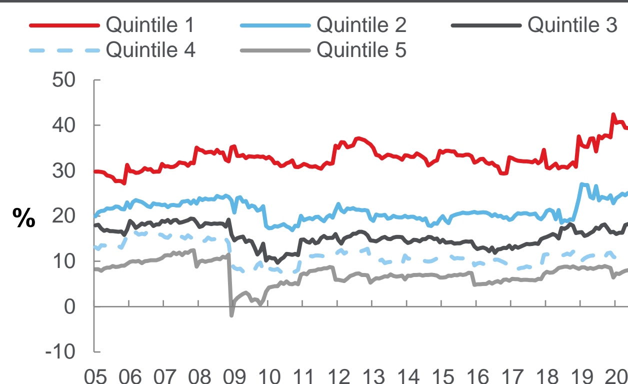
The lack of profitability explains quite a lot

A major reason why the cheapest stocks have stayed cheap is the clear lack of profits growth. Using return on equity, we can see that the cheapest stocks suffered a huge plunge in profits during the Global Financial Crisis in 2008-9 and have not recovered much since then, with average return on equity for the fifth quintile running at around 8%. For context, the long-term average return on equity of the S&P 500 is 14%.

At the same time, whilst profitability according to this measure has remained largely unchanged in more recent years for the cheapest stocks, the first quintile has enjoyed a surge in profitability since 2018.

The cheapest companies have remained unprofitable

Return on equity by quintiles based on P/B

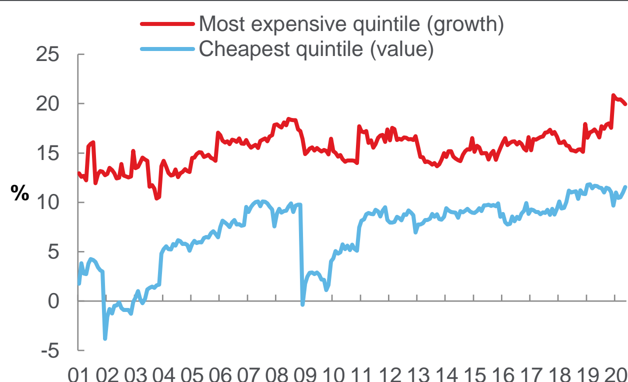


Source: Factset calculations, data as at June 12th, 2020

The contrast in profit margins between the cheapest stocks which are more representative of "value" and the most expensive which might conventionally be called "growth" below is very marked[2]. The cheapest stocks have faced some serious challenges to profitability over the past decade and we can easily see the much higher cyclicality of profit margins for this group in the chart below. By contrast, we can see that net profit margins for growth stocks (quintile 1) have been much more resistant to the economic cycle, especially during the big downturns of 2001 and 2008-9. Investors have rewarded this stronger and more resilient performance of profit margins, a key explanation for value stocks' underperformance for a prolonged period.

Value stock profit margins much more cyclical than growth

Net profit margins for growth quintile versus value quintile by P/B



Source: Factset calculations, data as at June 12th, 2020

Low interest rates and sector divergence

The duration angle

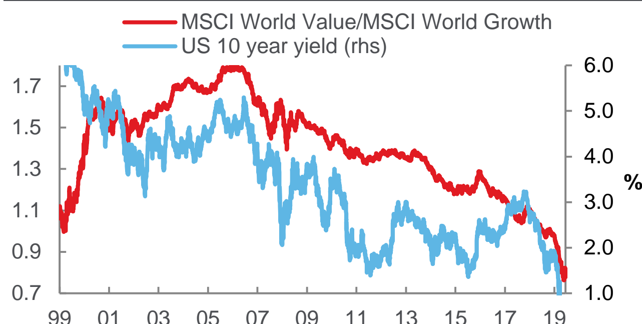
Value equities tend to be short duration investments, with their earnings beginning in the near-term. By contrast, the cashflows for growth stocks are much further out in the future. As a result, value stocks tend to outperform growth stocks in rising yield

[2] Usually, growth stocks are identified by their high expected earnings or earnings per share growth rates.

Past performance is no guarantee of future results.

environments. Of course, the other reason is the type of companies that tend to be "value". Earnings for many are linked closely to the health of economic activity, especially the dominant financial and energy sectors. Value stocks have performed poorly for a decade because interest rates have remained stuck at low levels or gone even lower.

Value stocks underperform as bond yields fall
Ratio of total returns for MSCI Value versus Growth

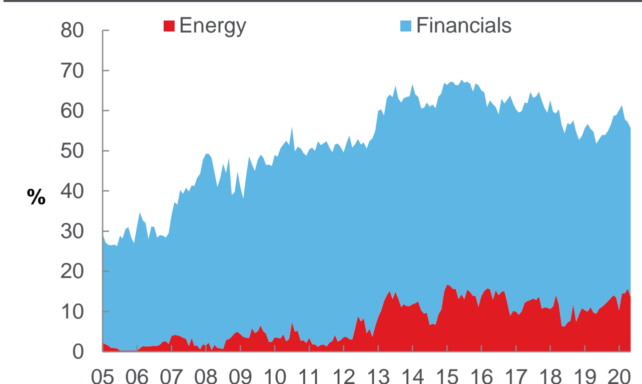


Source: Factset and Aon, data as at June 12th, 2020

Financials and energy suffer

The two largest sectors within most traditional value indices are financials and energy, comprising around 30% of the MSCI World Value Index – these dominate our lowest P/B quintile too.

Around half of the cheapest valuation quintile is financials
Fifth quintile by P/B selected sector weights over time



Source: Factset, data as at June 12th, 2020

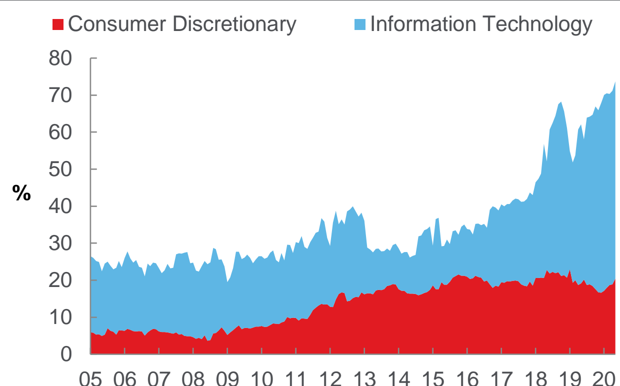
As we mentioned, both sectors have faced strong headwinds. Financial companies, particularly the banks, have struggled for profits over this period. The flatness of yield curves has meant that profit margins from lending (net interest margins) have been very low. Energy has suffered from high volatility in energy prices and falling profit margins owing to increased competition and rising substitution for renewable alternatives.

The rise of ESG considerations by investors has also meant that average portfolio allocations to energy firms have been falling. We do not see these factors changing soon.

The dominance of technology companies and limited "mean reversion"

Technology is the largest sector in global equity indices (MSCI World), with even larger weights in the S&P 500 and the growth tilted indices themselves. In our most expensive quintile by price to book value, half the stocks comprise technology companies and the weight has grown since 2016 (see chart).

Technology moves to domination in recent years
% weight of selected sectors in most expensive quintile by P/B



Source: Factset, data as at June 12th, 2020

Technology's rise and rise also exposes one of the key changes in the way value investing is supposed to have worked. A guiding principle was the idea that high profits in a sector attract new entrants and this increased competition erodes these profits, thus bringing stock prices back down. By contrast, lower priced companies' profit margins would revert to higher levels over time, or at least the ones that survived, a process of "mean reversion". We can see that this has clearly not been happening in the technology sector in the past decade – we can all count the dominant technology companies and we also struggle to see any proper competition to them. Equally, at the other end of the scale, low interest rates and easy access to credit mean that companies have remained in business for much longer than would have been expected.

The underlying reasons here are unlikely to change soon either.

Value is not dead

So, is value investing now dead as a concept? We do not think so for several reasons. Here are the main ones.

Recasting value investing differently

Our view is that the metrics of value investing need to be selected differently. Selecting value stocks only using a limited set of metrics is unlikely to be rewarding. Price to book values have, for example, become increasingly unreliable on account of intangibles. Up until the late 1980s, tangible assets, such as physical equipment, machinery or buildings, dominated balance sheets and were fully accounted for on company balance sheets. However, since then, investment in intangible assets has grown sharply. Intangible assets are things like brand value, research and development or patents, all of which have varying

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accounting treatments and can mean that book values can be understated. This, in turn, means that a company with large amounts of intangible assets on the balance sheets could look more expensive relative to its assets than is strictly accurate. Equally, a company that is internally generating intangible assets, such as patents and brand value, will have a much smaller book value than one that purchases these in the market.

The aim of value investing is to find bargains – stocks that have decent fundamentals that are currently traded at a cheap price. In our view, it is certainly not about selecting the very cheapest stocks regardless of the health of the company. This, of course, lends itself to active managers that cast their nets wide, but it is possible to reframe value investing at the index level as well. For example, we can acknowledge that the decline in tangible assets on balance sheets has made it more important to look at sales or cash flow, as well as their multi-year averages to check for stability. Some, therefore, say that price to sales or price to cashflow ratios are better criteria for selecting value stocks. There is logic to this, but more research is required to be more confident of the efficacy of these alternative approaches. After all, the MSCI value indices use the 12-month forward price to earnings ratio and dividend yields, as well as price to book, to weight stocks but it has still underperformed growth stocks markedly over the past decade.

The valuation gap is large

As mentioned in the valuation section above, the gap between the valuations for growth versus value stocks has rarely, if ever, been as wide as it is today. The forward price to earnings ratio chart previously showed this gap but it is clear in several other valuation metrics too – the chart below shows a 20-year history of the price to sales ratio of the MSCI World growth index versus the MSCI World value index.

Value versus growth valuation spread at multi-decade high
Price to sales ratio of MSCI World value divided by growth

Source: Factset and Aon calculation, data as at June 19th, 2020

There are legitimate considerations as to why the valuation gap may persist over the medium-term, but there is plenty of evidence that such wide valuation gaps do not last into the long-term (5-10 years). At the same time, there is a close link between valuations and long-term returns. The potential returns for expensive stocks are more limited than those for the cheapest stocks and this principle will always apply in our view.

Value's time in the sun? Not yet

For the next year or two, we do think the prospects for value stock outperformance look limited. Some of the conditions that we see needing to be met for better returns are a strong economic recovery, a steeper yield curve and/or a fall-back in technology stocks. Given the risk of further virus waves and the mounting economic costs, we are not optimistic for economic strength, tighter monetary policy or substantially higher interest rates in the coming months. This has implications for the regional equity view. The lack of impetus for value stock outperformance implies that US stocks are unlikely to underperform non-US stocks over the medium-term either. Obviously, for non-US investors, there are currency effects to consider too, which could alter the outlook.

Looking further ahead, if conditions for a sustainable economic recovery start to fall into place, and interest rates become less anchored to the floor, we can see conditions in which value does make a comeback. This is arguably some distance away. For now, the prospects for value to start to close the gap with their outperforming peers might instead lie in the possibility that conditions change such that those outperforming sectors which investors are chasing, start to fall foul of some unexpected changes, such as tighter regulation or higher corporate taxation for some of their high profit margin peers that investors have sought out.

History tells us that some stocks and sectors periodically become investor darlings, whilst others are largely ignored for years. This means that investor favourites tend to be more vulnerable to negative surprises such as the ones we highlight above. On the flipside, neglected value stocks could benefit from even small positive surprises. This is because Investors tend to hold onto the "winners" longer than they should and to sell the "losers" quickly as they are averse to losses of any kind. At some point, these trends reverse and sometimes spectacularly.

Can we say that these investor biases and valuation trends have now put the outperformers in a bubble? By extension, is it the case now that value is so cheap that it is discounting an unrealistically negative view of their prospects? Our view is that we cannot, not yet anyhow.

However, trends since the COVID-19 pandemic need to be watched. The further extension of value's underperformance; the fact that most retail investors and some institutional investors are selling value; and that the range of market winners being sought by investors is narrowing, might be creating at least some of the conditions for a reversion at some point. All we can say at this time is 'not quite yet'.

For now, looking at value metrics in stocks a bit differently, and integrating value within a multi-factor approach, may be the best way to keep value in the investment radar. Value investing is far from dead from a longer-term strategic viewpoint.

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Appendix: Index Definitions

S&P 500 Index – The market-cap-weighted index includes 500 leading companies and captures approximately 80% of available market capitalization.

MSCI World Index - The MSCI World Index captures large and mid-cap representation across 23 Developed Markets (DM) countries. With 1,637constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI World Value Index - The MSCI World Value Index captures large and mid-cap securities exhibiting overall value style characteristics across 23 Developed Markets (DM) countries. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield.

MSCI World Growth Index - The MSCI World Growth Index captures large and mid-cap securities exhibiting overall growth style characteristics across 23 Developed Markets (DM) countries. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend.

MSCI World Minimum Volatility Index – The MSCI World Minimum Volatility (USD) Index aims to reflect the performance characteristics of a minimum variance strategy applied to the MSCI large and mid -cap equity universe across 23 Developed Markets countries. The index is calculated by optimizing the MSCI World Index, its parent index, for the lowest absolute risk (within a given set of constraints). Historically, the index has shown lower beta and volatility characteristics relative to the MSCI World Index.

MSCI World Momentum Index - The MSCI World Momentum Index is based on MSCI World, its parent index, which includes large and mid-cap stocks across 23 Developed Markets (DM) countries. It is designed to reflect the performance of an equity momentum strategy by emphasizing stocks with high price momentum, while maintaining reasonably high trading liquidity, investment capacity and moderate index turnover.

MSCI World Quality Index – The MSCI World Quality Index is based on MSCI World, its parent index, which includes large and mid-cap stocks across 23 Developed Market (DM) countries. The index aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth and low financial leverage. The MSCI Quality Indexes complement existing MSCI Factor Indexes and can provide an effective diversification role in a portfolio of factor strategies.

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