Lazard Insights

Is the Market Setting Up for **Value's Comeback?**

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Summary

- Value has underperformed growth for nearly a decade. During this extended economic cycle, investors have favored quality, growth, and low volatility stocks, which has driven strong performance from momentum strategies.
- Value stocks are typically considered as one of the best ways to preserve capital, but in recent years this group of stocks appears to have a higher level of embedded systematic risk.
- There has been a lack of truly cheap stocks over the last decade for value investors. Significant returns tend to come when stocks are cheap not only on a valuation basis but also on a depressed profit basis. However, things are now changing, as a few sectors are currently trading at large discounts to book value.
- While the timing of the resurgence of the value premium is difficult to forecast, we believe that once it returns, this premium will again be an important tailwind for active investors.

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The existence of the value premium (i.e., the greater long-term return of value over growth stocks) is rarely questioned due to the proven success of exploiting unloved stocks and mispriced risks. A library could be filled with papers detailing the extent and breadth of the value premium across all world markets, in both large and small companies (see box titled "Selected Works on Value Investing, page 2). However, nuances of value stocks and the performance pattern offered by this style of investing are not always well understood by investors and, despite taking a long-term view, some will be disappointed by the performance of their value allocations over the last decade.

The current, and ongoing, underperformance of value versus growth (and implicitly versus the entire market too) is getting an increasing amount of attention. Given the very clear, and more extreme, polarization in the market between value and growth stocks we will evaluate how extended these extremes are, pinpoint characteristics of prevailing value stocks, and identify the catalysts for a comeback of the revered value premium.

Where Has My Value Premium Gone?

Using MSCI World Value and Growth indices data going back to 1974, we can begin by looking at the aggregate difference in performance of value minus growth (V-G) during different time horizons. We can also take the average of (V-G) over the entire history of data we have available—essentially this represents the value premium (Exhibit 1, page 2).[1] During both three- and five-year time horizons, the V-G lines comfortably average above zero (the three-year V-G average is 6.0%, the five-year V-G average is 15.9%).

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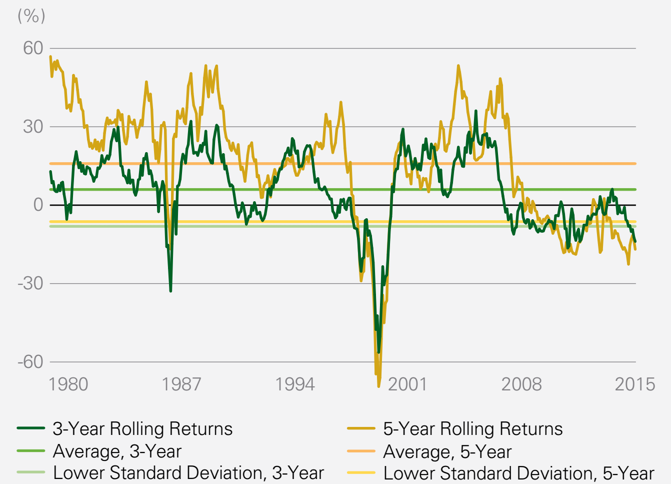
Selected Works on Value Investing

In the early 20th century Benjamin Graham pioneered the methodology of value investing. Starting in the late 1970s, academics and practitioners have documented the rewards of the value premium.

Author	Title
Benjamin Graham	Security Analysis (1934)
S. Basu	Investment Performance of Common Stocks in Relation to Their Price-Earnings Ratios: A Test of the Efficient Market Hypothesis (1977)
Fama and French	The Cross-Section of Expected Stock Returns (1992)
Lakonishok, et al.	Contrarian Investment, Extrapolation, and Risk (1994)
Fama and French	Value versus Growth: The International Evidence (1998)
J. Piotroski	Value Investing: The Use of Historical Financial Statement Information to Separate Winners from Losers (2002)
Brandes Institute	Value vs. Glamour series (multiple years)
Frazzini, et al.	Buffet's Alpha (2012)

Exhibit 1
The Value Premium



For the period December 1974 to December 2015

Data are based on MSCI World Value and Growth indices, total return (gross) in USD. The performance quoted represents past performance. Past performance is not a reliable indicator of future results. This information is for illustrative purposes only and does not represent any product or strategy managed by Lazard. The indices referenced herein are unmanaged and have no fees. It is not possible to invest directly in an index.

Source: FactSet, MSCI

Compared to the last forty years, the duration of the recent underperformance of value is stunning and it certainly speaks to the difficulty of market timing, with few investors conceiving that the underperformance of value could go on for so long. Value has underperformed growth for close to a decade (outside of a brief period in 2009), and exacerbated in recent years (given the rolling returns are largely below the lower standard deviation lines shown in Exhibit 1). This underperformance is also evident when comparing the cumulative five-year returns of value and growth indices (Exhibit 2).

During This Weak Economic Recovery, Investors Have Sought Reliable Growth

Naturally, this begs the question, if investors have shunned value stocks what have they been buying? Looking at value and growth in isolation is a somewhat narrow way to understand what investment preferences market participants have had during this economic cycle.

In fact, focusing on the last five years—which have been particularly challenging for value investing—can provide a more broad perspective of what investor preferences have been. To do this, we have framed the last five-year performance of various different factors versus their longer-term average (since 1998) to get a sense of how strong recent preferences have been (Exhibit 3, page 3).

Regardless of how valuation is defined, value has generally offered significantly less alpha during the last five years relative to the long-term alpha. No surprises there. This has been at its worst for non-earnings based valuation measures like price to book (P/B) than it has been for both earnings (P/E) and dividend yield valuation techniques.

Exhibit 2
Five Difficult Years for Value

As of December 2015

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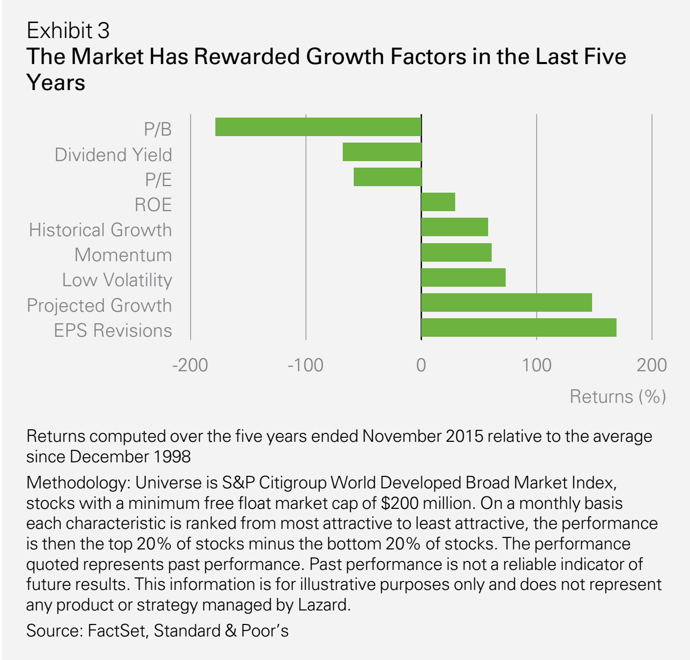
Source: Haver Analytics, MSCI

On the flip side, and contrary to long-term trends, investors have favored growth stocks during this period, generating the most extreme outperformance versus their long-term average. It is also noteworthy that, during this economic cycle, both quality and low risk styles have been meaningfully more in favor than they have been in the past. The consistency of these trends favoring quality/growth/low volatility stocks has driven extremely strong performance from momentum- and sentiment-orientated investment styles in recent years.

Exhibit 3
The Market Has Rewarded Growth Factors in the Last Five Years



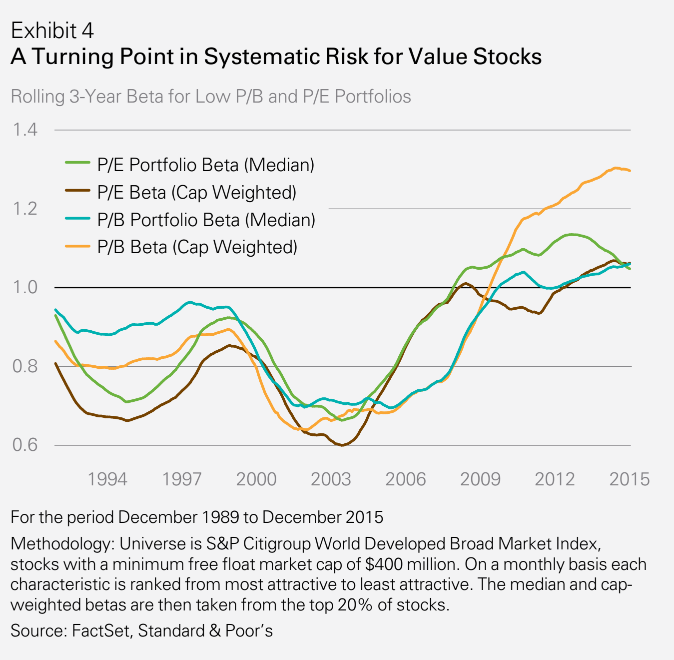
Returns computed over the five years ended November 2015 relative to the average since December 1998

Methodology: Universe is S&P Citigroup World Developed Broad Market Index, stocks with a minimum free float market cap of $200 million. On a monthly basis each characteristic is ranked from most attractive to least attractive, the performance is then the top 20% of stocks minus the bottom 20% of stocks. The performance quoted represents past performance. Past performance is not a reliable indicator of future results. This information is for illustrative purposes only and does not represent any product or strategy managed by Lazard.

Source: FactSet, Standard & Poor's

Exhibit 4
A Turning Point in Systematic Risk for Value Stocks

Rolling 3-Year Beta for Low P/B and P/E Portfolios



For the period December 1989 to December 2015

Methodology: Universe is S&P Citigroup World Developed Broad Market Index, stocks with a minimum free float market cap of $400 million. On a monthly basis each characteristic is ranked from most attractive to least attractive. The median and cap-weighted betas are then taken from the top 20% of stocks.

Source: FactSet, Standard & Poor's

What's been driving this trend? Is it that this era of high sovereign, corporate, and personal debt—which has perhaps led to structurally low interest rates—has permanently impaired the value premium? Are value stocks just those companies that are more exposed to today's fragile, debt-bloated economy? What is it about value stocks that are driving this relentless and extreme underperformance? These are all important questions that investors are now asking.

Value Portfolios Have Become More Risky

One key development that stands out regarding the changing characteristics of value stocks has been the loss of defensiveness. Value stocks are typically considered as one of the best ways to preserve capital, but they have disappointed in recent years.

There are a number of different ways we can identify this shift. First, we will begin by looking at the evolution of the median market beta of the top 20% of cheap stocks in the market over time (Exhibit 4). For the last twenty-five years, one constant of value portfolios has been that they have generally traded with a beta of below 1. This often reflected a lower level of embedded macro risk and the perception that they just were "boring" low growth investments with a discounted valuation that reflected that perceived outlook. This "unloved" and "boring" status often led many of these stocks to be overlooked and, in turn, allowed the value premium to be consistent alpha for patient investors. But, in 2008, something changed, with the beta of value portfolios drifting higher and staying above 1, reflecting their new elevated level of risk.

This increased beta and risk has been borne out in the three most recent market sell-offs starting with the global financial crisis (2008, 2011, and 2015/16). Significantly, in each of these instances typical (or perhaps naïve) value portfolios did not defend against the drawdown.

Exhibit 5
The Loss of Defensive Characteristics Is also Evident in Value Benchmarks

Beta and Drawdowns for Value Indices

Benchmark	Beta versus MSCI World Index[a]
FTSE RAFI Developed 1000	1.081
MSCI World Value Index	1.046

	Drawdown from Previous 12-Month High (%)		
Benchmark	**2008**	**2011**	**2015**
FTSE RAFI Developed 1000	-61.0	-25.0	-17.7
MSCI World Value Index	-60.7	-22.7	-16.0
MSCI World Index	-57.5	-21.8	-14.0

As of 22 January 2016

a For the period 1 August 2007 to 22 January 2016 using daily data.

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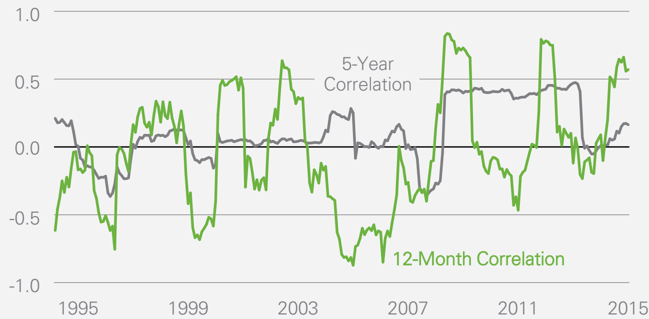
Source: FactSet, FTSE, MSCI

It is also notable that, when we look at this economic cycle the beta for these two examples of broad value index portfolios (rather than P/B-focused) is well above 1 (Exhibit 5).

What is driving this increased beta and drawdown risk? The discounted valuation being applied to certain stocks appears to reflect not just a poor growth (or earnings) outlook, but also an implied higher level of embedded systematic risk. This is something that we can capture by looking at the concurrent returns to both value and default risk.[2] If value and default returns move in lock step, this suggests a high level

Exhibit 6
Greater Systematic Risk May Be a Proxy for Distress

Correlation of Low P/B and Default Risk[a]



For the period March 1990 to December 2015

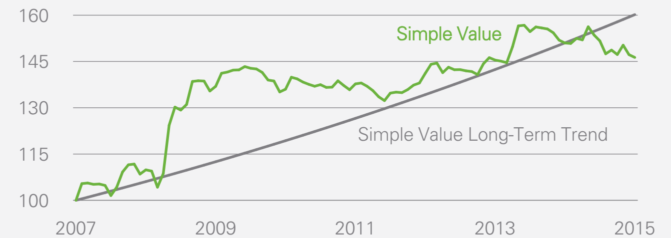
a Default risk is calculated using the Merton distance to default model. Stocks are ranked from high to low risk.

Methodology: Universe is S&P Citigroup World Developed Broad Market Index. On a monthly basis P/B and default risk are ranked from high to low. Subtracting the top 20% of stocks minus the bottom 20% of stocks we calculate monthly quintile spread returns. Over 12-month and 5-year horizons the correlation of two time series is then calculated on a rolling basis.

Source: FactSet, Standard & Poor's

Exhibit 7
Despite a Burst of Performance in 2009, Value Alpha Has Fallen Notably below Trend

Index, November 2007=100



Data shown for the period November 2007 to November 2015 (long-term trend computed since 1995)

Methodology: Simple Value is an equal-weighted combination of P/B, P/S, dividend yield, and P/E. Universe is S&P Citigroup World Developed Broad Market Index, stocks with a minimum free float market cap of $200 million. On a monthly basis each characteristic is ranked from most attractive to least attractive then the average ranking across the four metrics determines the value combination. The performance is then the top 20% of stocks minus the bottom 20% of stocks. The long-term trend is the average of the monthly top minus bottom 20%. The performance quoted represents past performance. Past performance is not a reliable indicator of future results. This information is for illustrative purposes only and does not represent any product or strategy managed by Lazard.

Source: FactSet, Standard & Poor's

of overlap between value stocks and stocks that trade with an elevated level of default risk. The evolution of this relationship over time can be seen in Exhibit 6, and has trended higher after 2008.

Since 2008, there have been three instances of value returns moving very tightly in lockstep with default returns; the global financial crisis in 2008/2009, the peak of the European crisis in 2011, and more recently the commodity crisis in 2015. The sheer frequency of these systematic crises has resulted in a closer link of value returns and default risk.

Not All Value Strategies Are the Same

At this point it is worth noting that not all valuation techniques, ratios, and methodologies are the same. Many investors will default to choosing a simple combination of valuation metrics to capture the value premium, the performance of which is illustrated in Exhibit 7. We have taken an equal-weighted combination of stocks ranked by P/B, P/S, dividend yield, and P/E. Using the performance of this equal-weighted basket, back to 1995, we extrapolated the average of this series as the "expected trend" performance of value. As one can see, the recent performance (since 2007) of this value basket versus its long-term average has been disappointing (since 2007 it is about 14% below "trend").

We previously noted that the returns to non-earnings-based metrics (we used P/B in Exhibit 3) have been especially disappointing while earnings-based metrics and dividend yield have underperformed their long-term average more mildly. Indeed, we believe it is important to understand the various performance patterns of different types of valuation techniques and the economic rationale as to why performance patterns evolve in the way they do. This is critical when it comes to deciding on what is the most effective way to find value stocks.

In essence, it is important to strike the right balance between defensive and cyclical valuation techniques. By doing this well, it can be possible to limit the damage from the overall headwinds to the value premium by essentially being a bit smarter about which value stocks one favors. This helps investors to "ride out the storm" relying on other parts of your investment process to add value until the value premium returns and, once again, becomes an important tailwind for active investors looking to consistently exceed benchmark returns.

What Can We Learn from History?

This extended period of extremely poor value returns and elevated risks to value investing is highly unusual, but not without precedent. Exhibit 8 (page 5) shows the rolling five-year return of the 30% cheapest stocks minus the 30% most expensive stocks in the United States (equal weighted rather than cap weighted) dating back to 1926. The measure is P/B, and although it is far from the perfect value measure, it is a good representation of whether value stocks were in favor or not. Two things stand out, firstly, the 5-year rolling value returns are above zero 87% of the time (hence the value premium) but also, this pattern is extremely cyclical in nature. The bottom chart in Exhibit 8 shows the Shiller P/E of the S&P 500 Index.[3]

Today's value environment bears some similarities to the 1930s–early 1940s period. It is not quite the same—the sell-off was deeper in 1929–1932 than in 2007–2009 (note the Shiller P/E only briefly went below average in 2009), hence the huge surge in the early- to mid-1930s, but then there was a relapse in value returns as the market struggled up until 1942. The market then exploded again, as did value returns.

However, the really interesting (and helpful) aspect of this analysis is that it is instructive as to what market and economic conditions were present during periods of extreme outperformance or underperformance of value.

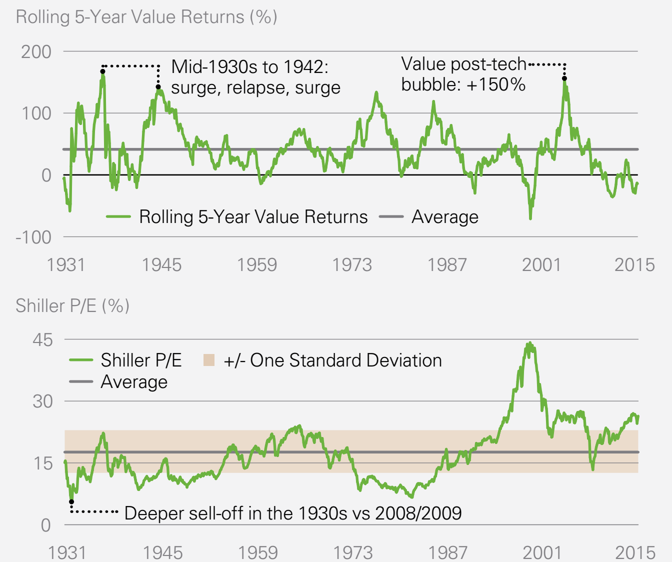
Strong value returns were generally preceded by low *cyclically-adjusted market valuations*. Both market ratings **and** profits were depressed before value offered significant alpha for investors. The one major exception (if we consider that the average five-year value return in Exhibit 8 is 41%), was the aftermath of the tech bubble in 2000. At that time, market valuations were very full, yet by 2005 value had delivered 150% over that of the most expensive 30% of stocks during the preceding five years. The explanation is straightforward. During the late 1990s as tech stocks were increasingly bid up, "old economy" stocks became increasingly shunned and unloved. Like today, in fact, the market became extremely polarized with regards to investor preferences (i.e., in today's market energy and materials stocks have been avoided in favor of tech stocks). As the bubble burst, these "old economy" stocks actually offered good value on earnings that, in retrospect, were at cyclical lows as the emerging economies went on to boom.

In our view, there has been a lack of truly cheap stocks over the last decade for value investors. Significant returns tend to come when stocks are cheap not only on a valuation basis but also on a depressed profit basis. We have been unable to observe this for a long time; however, things are now changing. Some stocks grouped in a few sectors (banks, oil & gas, and basic resources) are beginning to look cheap and are trading at unusually large discounts to book value (Exhibit 9).

Relying on book value is useful because it ignores short-term earnings power (we all know that commodity-oriented companies are having a tougher time with their earnings at the moment) and focuses on their raw asset values. The Shiller P/E data showed that the best value returns come after the economy has gone through a tough period and short-term earnings are depressed. Asset values are often indicative of long-term earnings potential, with equities trading at discounts to asset value identifying early value opportunities. Keeping an eye on trends like this can be instructive for value investors looking for opportunities.

Investors can now search for stocks that are cheap in the way that even Benjamin Graham might find interesting! Today, investors may look at the ongoing carnage in oil & gas, mining, and increasingly, banking sectors and take the view that P/B ratios are not yet reasonable because of huge write-offs to come, the likely slower future growth in China and emerging markets, or may consider the default and dividend cut risks to be too great—and that is fair. After all, it is worthwhile to remember that even Benjamin Graham with his extremely strict investment requirements, went on to lose two-thirds of his capital during the crash of 1929. But in our view, the foundations are being laid for value's comeback as more stocks emerge exhibiting attractive valuations based on book values.

Exhibit 8
The Value Premium and Long-Term Cyclically Adjusted Valuation



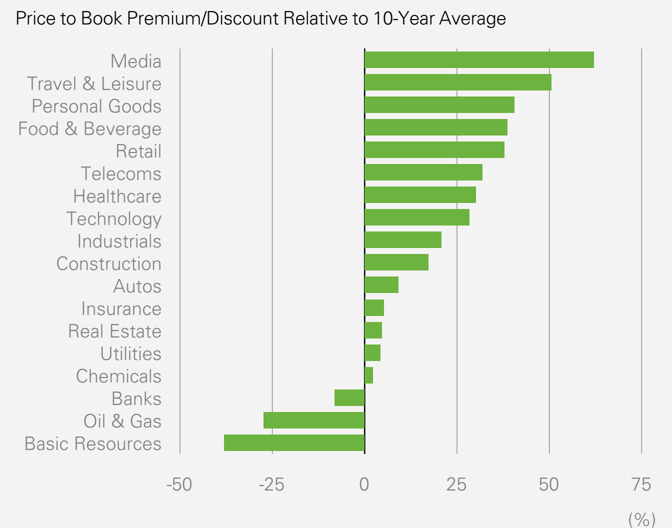
For the period July 1926 to November 2015

Value is the HML factor defined in Kenneth French's data library. Shiller P/E is the cyclically adjusted real P/E ratio for the S&P 500 Index.

Source: Kenneth French data library, Robert Shiller

Exhibit 9
Searching for Cheap Stocks

Price to Book Premium/Discount Relative to 10-Year Average



As of 31 December 2015

Data are based on the MSCI World Index.

Source: Societe Generale Cross Asset Research

Conclusion

The significantly extended underperformance of value investing strategies is one of the most interesting features of today's stock markets. The flip side of this has been the unusually strong performance of strategies oriented towards quality, growth, momentum, and low volatility stocks. In this era of high leverage, the financial crisis signaled a turning point, as value stocks appear to be higher risk investments exhibiting betas that have been consistently above 1.

In turn, this has led value stocks to display weaker capital preservation properties. This goes against historical patterns and investor behavior which saw value investing as trawling through low growth, unloved stocks, which were characterized by their defensive nature. Historically, value stocks' defensiveness was due in part to low investor expectations for these companies. As a result, downside risk was limited because of a smaller chance of disappointing investors given the low baseline expectations.

While some valuation methodologies can be more effective than others, more developments are needed in order for the value premium to be a strong tailwind to an investment process. Looking at longer-term data, the resurgence of the value premium seems to have been missing one key ingredient, cyclically depressed valuations—those periods when valuations, profits, and expectations are running at extremely low levels. However, there is more evidence that this is now changing, with increasing numbers of stocks trading at low cyclically adjusted valuations.

For now these stocks are somewhat limited to a few sectors. However, we may see the opportunity spread in the upcoming quarters. The timing of a resurgence in the valuation premium is difficult to forecast, and may begin in one sector before it spreads to the entire market. But for those investors who have found that having exposure to value stocks was a headwind to their ability to achieve strong and consistent alpha, that headwind may soon turn into a tailwind.

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Notes

1 Although MSCI ACWI shows a similarly strong underperformance from value over the last five years, index data only begins in 1996, rendering V-G averages heavily influenced by the 1996–2000 period, the technology bubble. Therefore we concluded the developed-only data (i.e., MSCI World Index) were more representative of the very long-term V-G premium that can be earned.

2 Default risk of a stock is calculated using the Merton distance to default model. This model describes the probability of the company going bankrupt expressed as a unit of the volatility of the company's equity value. Stocks are then ranked from high to low risk of default.

3 The Shiller P/E is the cyclically adjusted real P/E ratio of the S&P 500 Index. Earnings are adjusted for inflation and the average is computed for the trailing 10 years.

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