VALUE RESURRECTION ON PAUSE, BUT FOR HOW LONG?

Value investing has had a tough decade of underperformance. This seems to have led many investors to ignore the extensive research showing how value investing outperforms the market over longer time horizons, and today many are under-allocated to value stocks. However, history suggests that periods of value underperformance always end – and often they end abruptly - as we saw last year. The question is whether the factor rotation seen in the second half of 2016 was a one off event, or the beginning of a more sustainable comeback.

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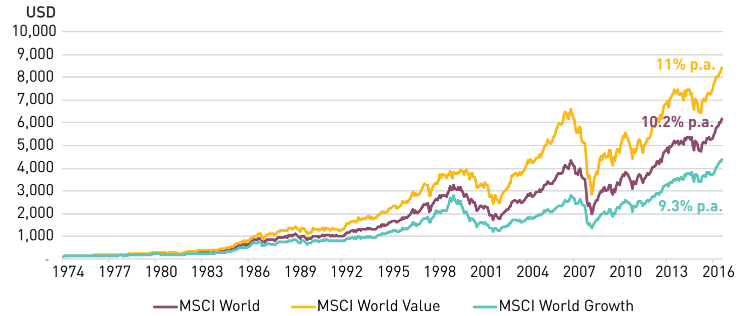
In recent years, investors have generally preferred the perceived safety of stable dividends and growth rather than hunting for potential bargains among value stocks – which we might broadly define as stocks that are statistically cheap according to some ratio of price-to-fundamentals, like price-to-earnings or price-to-book. Moreover, in the ultra-low interest rate environment, investors hunting for yield substituted bond investments with so-called 'bond proxy' stocks, which offered low volatility and steady yield. **While valuations for such stocks became stretched, a decade of underperformance for value means that value stocks are now at depressed valuation levels relative to the overall market.**

Recent years have seen fierce debate about factor timing based on such relative valuations. While that debate will perhaps never end, it has become obvious to many that the pricing of risk factors is not constant. Rather, the valuation of factors – including value – seems to move in cycles, which can last for years. This implies that as valuations deviate from long-term, cross-cycle levels, there should be decent potential for them to mean revert. One extreme example was the late 1990s, where growth companies traded at a substantial valuation premium – until the reversion came. Current markets do not seem that extreme, but investors seem to put a below average valuation on the value factor today. From a factor valuation perspective, it may not be a bad entry point for value.

Rising rates likely to drive value

A cheap entry point is a healthy starting point for any sound investment, but it is important to understand the catalysts that could drive outperformance for value. Individual factors react differently to market events, and the drivers and catalysts for factor performance tend to vary over time. The rotation that took place last year confirmed that factors can rotate quite quickly, but the explanations for value underperformance in recent years are subject to debate.

Value investing outperforms over the long term

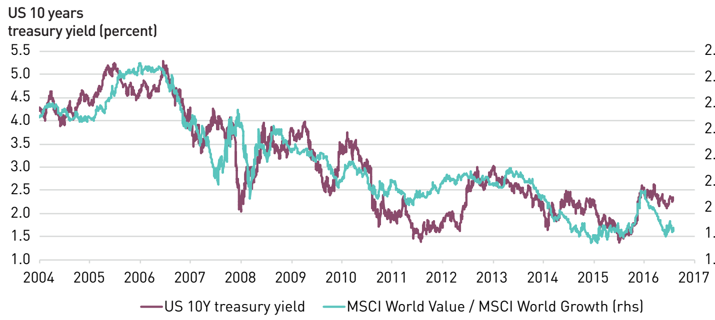


Source: Bloomberg, MSCI as of 31.07.2017 (base 31.12.1974 = USD 100)

Last year, as economic growth expectations soared and bond yields rose, value stocks outperformed. After the US election, President-elect Trump's spending plans, and the associated rise in inflation expectations, developed into a major catalyst for value. This points to a relationship between value performance, the economic cycle, and interest rates. A correlation between value outperformance and an expanding business cycle is not new. For decades, investors have seen links between the performance of different industry sectors and the economy, with cyclical companies typically expected to perform well when growth is strong, and defensives providing protection in a downturn. A similar pattern has been found with factors, where value stocks have often been associated with better relative performance during phases of economic recovery. That might suggest the current conditions of relatively benign global economic expansion offer a good entry point for value, but this correlation with the business cycle does not really explain why value continued to underperform so long after the global financial crisis, even when economic conditions had started to improve.

Most investors have noticed a strong correlation between value underperformance and falling bond yields since the global financial crisis. The causal link is the concept of 'duration', defined loosely as the sensitivity of the price of an investment to a change in the level of interest rates. When this traditional bond market concept is applied to equities, the value underperformance up to last year makes more sense. If we assume a value stock has a price-to-cash-flow (P/CF) ratio of 10, it implies that investors see year 1 cash flows equivalent to 10 percent of their investment. Meanwhile, say a growth stock has a higher P/CF-ratio of 30. This implies it delivers only 3.3% of your investment in year 1 – with a greater proportion of cash flows expected further in the future. **In other words, growth stocks are longer duration assets than value stocks.** The longer duration means higher interest sensitivity: as bond yields kept falling, so did the discount rates used to value future cash flows, justifying higher and higher current values for growth stocks. This explains why the value factor underperformed when bond yields kept falling. Similarly, it explains why the value factor responded so strongly in late 2016 to rising inflation expectations and bond yields. Although 2017 has been a bit rocky so far, many investors are aware that the current development in employment and inflation data could lead to higher interest rate levels. That suggests that the stars are aligned for value investing.

For years, value performance correlated with bond yields



Source: Bloomberg, MSCI as of 31.07.2017

Active management adds value

Before investors blindly leap into value stocks, there is an obvious risk they need to consider: so-called value traps. A value trap might be described as a security that appears to have low valuations, but turns out not to be truly undervalued, because something is fundamentally wrong. The notion of value traps is well-known, but recently popular quant or smart beta strategies often use simple ratios of price-to-fundamentals to give easy and affordable access to the value factor. These ratios do not necessarily reflect the underlying economics of the securities.

Such strategies should not be confused with managers who look beyond nominal price ratios, and use a comprehensive approach to determine the intrinsic value of the underlying securities. Identifying true value stocks requires in-depth analysis of a company's financials and operations, including balance sheet risk, management quality, the competitive situation, and so on. Gaining value exposure through a fund that has the appropriate research capabilities and an experienced team who engage with management teams to support value creation is a simple way of minimising the risk of value traps.

Interestingly, the Danish investors Winther and Steenstrup (The Journal of Investing: 2016, vol. 25) have recently argued that, while concepts like smart beta may generate better returns than purely passive market cap based investing; active management can add even more value. Their research suggests that smart beta strategies might serve as a useful benchmark, but additional performance can be obtained through active management: through the individual selection and deselection of stocks. They call this concept 'smart alpha'. **Consequently, investors who seek value exposure should find a manager with a consistent bias to securities that are statistically cheap, and a track record of avoiding value traps by selecting truly undervalued stocks within this value universe.**

To learn more about Sparinvest's value investment strategy, please visit

www.value.sparinvest.lu

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About Sparinvest

Founded in 1968, Sparinvest is a boutique asset manager specialising in factor strategies – both for equities and fixed income. Since 1997, we have pursued a time-tested value-oriented approach to equity investing. Our consistent long-term investment style of using in-depth research to select underpriced companies with strong business fundamentals has led to two decades of successful results.