Is value investing dead?

BY : NEO TENG HWEE

VALUE investing has a long and illustrious history since the influential work of Benjamin Graham Security Analysis, which he co-authored with David L Dodd in 1934. The concept is simple and straightforward: investment success lies in finding unspectacular companies selling at a deep discount to their liquidation value, largely based on the balance sheet asset value.

Warren Buffet, arguably the most famous value investor of all time, used the analogy of someone searching the street for used cigar butts that had a last puff in them. In contrast, a growth investor is someone who seeks out companies with high growth potential and is not deterred by expensive valuations.

Book-to-market as a measurement of value

Over the years, academia weighed in on the value investing phenomenon. In 1977, Sanjoy Basu documented evidence of a value excess return or premium using the price-to-earnings ratio.

Further traction followed in the early 1990s with Eugene Fama and Kenneth French, both Nobel Laureates, confirming that value selection using book-to-market (the inverse of price-to-book ratio) generated excess return.

Book-to-market was the eventual measure of value chosen by academics to sort stocks mechanically. It is important to highlight that the resulting portfolios involve no qualitative assessment of the underlying business, its brand value or management quality.

However, academic validation ignited the financial industry, which then set out to exploit the value factor in order to enhance returns.

Indices incorporating the value style were packaged as exchange-traded funds (ETFs), which can be easily purchased. Some asset management firms have also positioned value investing as the cornerstone of their investment process.

The value setback

Despite its long history and reliability, value investing has disappointed its fans since 2007. Its poor performance streak extended into 2020 as the unfolding global pandemic added a booster shot to growth sectors such as technology.

The value style (defined commonly by "high minus low" of book-to-market, or HML) underperformed by 5.4 per cent per annum on average from January 2007 to June 2020. Despite its travails in the past 13 years, the value style still managed to deliver a strong performance from July 1963 to June 2020 with an annual excess return of 3.0 per cent.

In other words, the value factor had worked up to 2007 but has lost out to the growth style ever since.

This raises the question of whether the benefit of value investing has been permanently impaired, or is the underperformance an aberration that will likely correct in the future.

There are various explanations posited for value investing's poor performance. The first is that the style has been uncovered and is now fully exploited among investors. Arguments for the so-called crowding effect, which has driven up the average valuation of stocks, point to the trillions of assets invested in value instruments ranging from value funds to factor-based ETFs.

Yet, the opposite is true - value stocks have become cheaper over time. Research by the National Bureau of Economic Research in 2018 suggested that almost all purported mutual funds with a value investing style have almost no exposure to the value attribute defined as a high book-to-market ratio, which further invalidates the over-crowding hypothesis.

A more appealing explanation proposed by well-known investment figures of late is the structural change in the economy that may render the value style less relevant. Globalisation and the monopolistic nature of digital platforms may enable firms to scale globally and have more durable growth than in the past.

Today, the six FANMAG stocks (Facebook, Apple, Netflix, Microsoft, Amazon and Google) are collectively valued at US$8 trillion (as at Feb 17, 2021), larger than every stock market outside of the US and China.

It is also worth noting that there are currently four companies in the US with more than US$1 trillion in market capitalisation which was unheard of in the past.

More than just speculative excesses, Apple Inc, for example, is projected to generate close to US$100 billion in earnings before interest, taxes, depreciation and amortisation (Ebitda) in 2021 based on consensus estimates.

Challenge of accounting book value

Using the book value of companies as a measurement of value also poses challenges - for instance, accounting measures fail to capture intangibles such as brand value, proprietary technical know-how and market position. New business models in the digital world are often asset-light but involve significant research and development (R&D), which is immediately expensed.

On the other hand, an asset-heavy business will have its physical assets capitalised and gradually depreciated over time. Hence, a high price-to-book or price-to-earnings ratio may not necessarily point to over-valuation when some of the new businesses are assessed. This can be adjusted for by capitalising R&D as well as selling, general and administrative expense. This way, the underperformance of the value style since 2007 would be reduced from 5.4 per cent to 3.2 per cent.

Growth-value debate

In his recent research paper, Reports of value's death may be greatly exaggerated, Robert Arnott concluded that revaluation effects account for most of the underperformance of value stocks. In fact, the starting valuation of these stocks is in the 100th percentile within their data window and they should deliver a positive return even if the huge valuation gap between growth and value stocks persists.

Any mean reversion will be a bonus. To date, any evidence pointing to a structural impairment of the value premium remains inconclusive or is at best, premature.

Amid the Covid-19 pandemic, the K-shaped dichotomy between the new and old economy has further exacerbated the growth-value divide in recent market narratives. While we expect disruption from digital business models to be an undeniable and durable trend, the extreme starting valuation and the eventual normalisation of economic activity led by successful mass vaccinations have rendered the value style attractive.

Hence, investors can consider allocating some part of their investment budget to the less glamorous but undervalued parts of the market. For growth investing fans, it is important to be cognisant of the risk of overpaying even for great companies. As an example, Amazon declined more than 90 per cent between 2000 and 2001 despite turning its Ebitda positive. Similarly, while technology stocks are generally labelled as growth investments, it is worth highlighting that when Warren Buffet started investing in Apple back in early 2016, the company was trading at 10 times earnings, a value play by most standards.

While the growth-value debate is often delineated through historical accounting constructs such as book values, appraising the future of a business is often more of an art. As we stand in the throes of industry transformation, new opportunities and risks will emerge. These will not be uncovered through analysing decades of earnings trends. Instead, it is essential that investors keep an open mind, be nimble to seize market opportunities and ensure that their investment portfolios are adequately diversified. In that broader sense, value investing is certainly not dead.

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