Successful value investing: the long term approach

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Do you have the patience to be a value investor?

The long-term outperformance of a value investment strategy versus the market doesn’t sit very well with a belief in efficient stock markets. The efficient market theories suggest that the price of a share reflects all of the available information relating to that stock. This suggests that a strategy of buying shares in cheap companies should not outperform over the long term because there is no special information in noticing that a company is cheap as measured by observable factors such as the ratio of price to book value or a higher than average dividend yield.

It may be that overall investors do not have the patience or discipline to stick with a value approach through troubled times. There have been defined periods in each of the last four decades during which the value investment strategy has underperformed the market. Our aim is to tease out some of the factors responsible for each case of underperformance and to examine how long it took for a value strategy to recover. This may indicate how much patience is required!

A brief refresher: value investing

For those of you who would like a reminder, value investing is a long-term strategy which focuses upon thorough analysis to identify and then purchase stocks where the market price is below an assessment of the stock’s intrinsic value. While there is a myriad of techniques used by investors to identify undervalued stocks, the Price to Earnings and Book Value to Market Value financial ratio are commonly used1. The main idea is to buy a stock for less than it is truly worth, according to the firm’s financial statements, in the expectation that over time this intrinsic value will be recognised by the market and you will be proved right. The disparity between intrinsic value and market value exists due to human behaviour; as Benjamin Graham (one of the fathers of value investing) notes: “Most of the time common stocks are subject to irrational and excessive price fluctuations in both directions as the consequence of the ingrained tendency of most people to speculate or gamble.”

This disparity between a fundamental value based assessment of the true value of a firm and what the market believes it is worth is a well known flaw of markets and can endure over long periods of time (sometimes years!), hence why value is touted as a long-term strategy. Indeed, in the words of Warren Buffet (another successful value investor): “I never attempt to make money on the stock market. I buy on the assumption that they could close the market the next day and not reopen it for five years.”

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1 The Price to Earnings ratio is the price of a stock divided by its earnings per share. It provides a measure of how much money you have to pay to ‘buy’ an earnings stream. Book Value is the value of the firm’s assets according to its financial statements. A firm’s Market Value is the price of each share multiplied by the number of shares, and is thought of as the market’s view of a stocks value.
The attraction of value investing lies not only in the capital gains that can be obtained from buying low and selling high, and in the benefit of securing a stream of corporate earnings at a low price, but in the margin of safety provided by the disparity between what was paid for the share and what you believe it is actually worth.

The vast wealth accumulated by celebrated proponents of value investing, such as Benjamin Graham and Warren Buffet, is often taken as evidence of the efficacy of this approach. While there is clearly a bias inherent in the use of such individuals as examples – after all, investors find fame only if they are successful – other, more extensive studies have also found that in the long run a value investment strategy has outperformed both growth stocks and the market as a whole. Explaining this long-term outperformance is the tricky bit and perhaps unsurprisingly, there is very little consensus amongst academics. Some suggest it is because value stocks are riskier and therefore attract a higher risk premium, whereas others suggest it could be due to behavioural biases from investors, such as a short-term focus, and agency conflicts from professional money managers.

Value underperforming and recovering – evidence from recent history

While it can be argued that a value strategy has outperformed a market strategy over the long term, there have been clearly defined periods where value investors have suffered. In our analysis we have used the publically available calendar year performance of the MSCI World Value and MSCI World indices and matched the periods when value underperformed with macroeconomic events to see if there are some common factors that emerge.

Historical analysis suggests that value investing tends to underperform during recessions or during periods where investor sentiment drives market prices. The graph below shows the relative performance of the MSCI World Value and MSCI World since 1975.

Relative return of the MSCI World Value and the MSCI World Index
Total Returns from 1975 – 2009

Source: Bloomberg, MSCI World Value (Total Return) and MSCI World (Total Return), in local currency

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To provide a macroeconomic context to our analysis we have used the economies of the UK, US and Japan as they represent a significant proportion of the MSCI World Index.

**The recessions of the early 1980s, 1990s and 2008:**

Before we launch into an analysis of why Value investments tend to underperform in recessions, it may be helpful to provide some historical context.

The recession of the late 70s and early 80s in the US, UK and Japan was linked to the Second Oil Crisis, which was triggered by political instability in Iran and Iraq. Increasing unemployment and inflation, particularly in the US, was the order of the day. The recession of the early 1990s was also a global one. In the US the economy was left reeling from the Savings and Loans Crisis, during which a number of savings and loan institutions went bust due in part to risky lending practices (sound familiar anyone?). The UK had extremely high interest rates to combat inflation and support the value of sterling, and this contributed to a decline in corporate investment and economic growth. Finally, Japan was experiencing the asset price bubble.

The most recent recession, now commonly known as the ‘Credit Crisis’, was yet another global recession, initiated by subprime lending in the US as a catalyst for the markets to realise the extent of the borrowing within the financial systems of the developed world.

One rationale for the underperformance of a value investment during recessions is related to the very reason investors buy cheaper companies in the first place. A key element of the value investment approach is buying a stock whose financial statements and fundamentals suggest it may be worth more than its market price. One risk is that the market is placing weight on negative factors that may affect the business in future. Value stocks are therefore seen as riskier in some respects, as there is a chance the stocks are cheap for a reason, and as investors anticipate a forthcoming recession they sell off their risky stocks and buy shares in companies they believe could better weather the approaching economic storm.

**The ‘Roaring Nineties’**

The late 1990s – in the US and UK at least – was a period of exceptional growth which eventually led to the Dot Com bubble. This growth was fed by expansion in the information technology sector (particularly in the US), by strong credit growth, and by low unemployment. Japan however, was in recession driven in part by banking problems and a withdrawal of government consumption and investment.

Value investments underperformed in this context as within this narrow ‘new economy’ focused environment stock prices became completely disconnected from fundamentals. Investors became willing to spend excessive amounts for the chance to invest in information technology. This disconnect lasted until the Dot Com bubble burst in 2000. Value investing therefore has the potential to underperform a sharply rising stock market driven by investor sentiment. There is always a story with substance behind the rising market, for example in the run up to 2000, technology was going to change our lives forever (and of course it has). The issue is that the price placed on the future stream of corporate earnings from the tech sector didn’t leave any room for disappointment. Then intense competition and innovation in the sector brought some gravity to profitability. The combination of a real story and a stock market with strong momentum can last a number of years and thus the disappointment from a value based strategy can also sometimes last a few years.
Recovering value

While the analysis highlights periods during which value investments have underperformed, it has also shown that a value investment strategy can be successful in the long term for investors who stick with it. This poses the question, how long does it take for a value investment to recover when compared to the market?

The chart below shows the cumulative relative performance of a value investment as compared to the market, again using the MSCI World and MSCI World Value indices with rough timescales for recovery. Leaving aside the split in value underperformance in the early 80s, the time taken for a value investment to recover, if past history is any guide, seems to be between two and three years. This is clearly a long enough period to test investor patience. For a pension scheme three years is the time between actuarial valuations. However, we should notice that the second part of this ‘recovery period’ tends to include quite a sharp recovery and perhaps signals that a material underperformance from value is not the time to lose patience due to the potential to be ‘whipsawed’ as the strategy recovers (1982, 1994 and 2001 for example).

Historical analysis of the time taken for a value investment to recover

MSCI World Value Index vs MSCI World
Base 100 = 1974

Source: Bloomberg, MSCI World Value (Total Return) and MSCI World (Total Return), in local currency

Conclusion

At the start we asked ‘Do you have the patience to be a value investor?’

Value investments do appear to provide excess returns in the long run, but this requires a long-run mindset as there have been prolonged periods of disappointment. While there have been periods of underperformance over the last 35 years, these have resulted from specific economic events, and the excess returns to value investments have tended to reappear with the normalisation of economic conditions. The key to value investing seems to be patience – by holding out during periods of poor relative performance investors are able to benefit from the long-term excess returns associated with the ownership of undervalued or cheap companies from a ‘value’ investment approach.

These conclusions raise an interesting question of equity portfolio construction. If it is unlikely that the volatility of the performance of a value strategy is acceptable, or if you feel that you may not have the necessary patience, (but as a long term investor, the value premium is worth capturing), then perhaps there is room for balancing complementary strategies alongside the value strategy. We have outlined that value can disappoint at times when economic stress is on the horizon. This is partly due a flight to quality from investors and thus a balance of exposure to high quality, strong companies may sit well alongside the value strategy.