Value: The post-mortem

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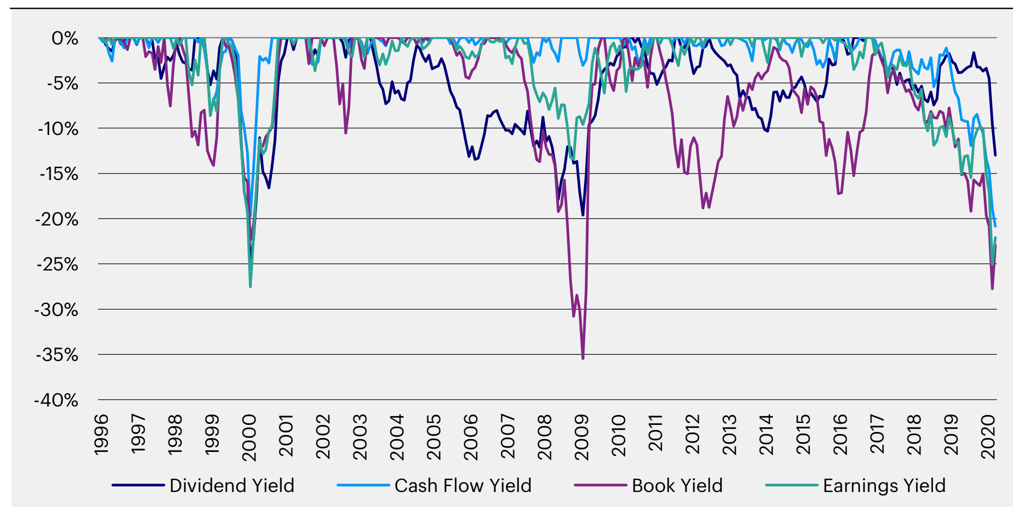
1. Time of death

Value factor returns have been extremely poor around the world in recent years, hampered by weakening economic conditions which culminated in a severe collapse as the COVID-19 lockdowns decimated global economic activity. While value style underperformance is to be expected in these conditions, the degree of underperformance over an extended period has wiped-out longer-term gains from the value style, and has led investors to question the ongoing viability of value investing as a whole.

The performance and drawdown periods of some common value signals for global equities over the past two and a half decades is shown in Figure 1. Here we see that previous extreme value drawdowns have eventually recovered, but the current drawdown is noteworthy for the extended period of its persistence and the breadth of measures it has affected.

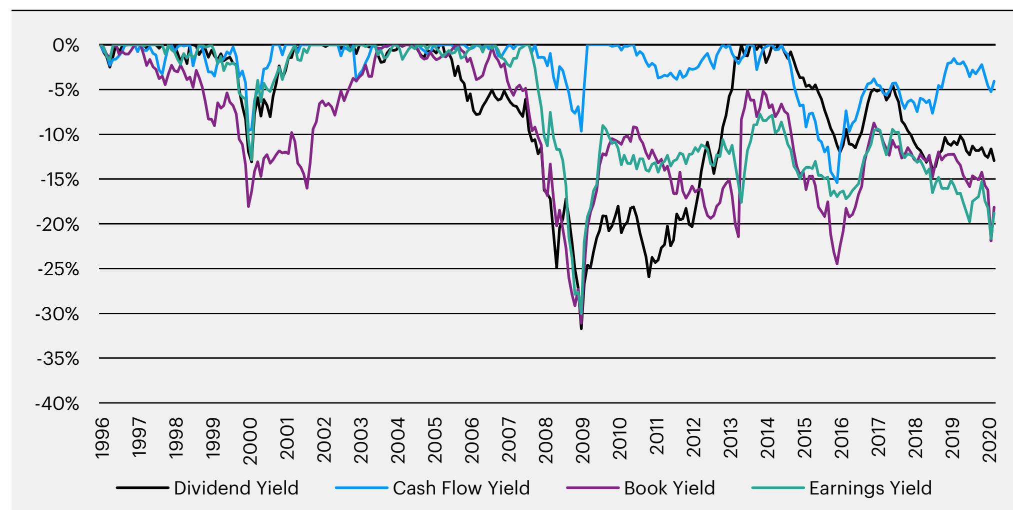
Figure 1: Value signal drawdowns for global equities (Global ex EM 1/1996 to 4/2020)



Source: Invesco

The same value signals for the Australian equity market can be seen in Figure 2. Here the classic value signals have struggled to regain losses from significant drawdowns - particularly that of the GFC - and underperformance has been notably extended.

Figure 2: Value signal drawdowns for global equities (Australia 1/1996 to 4/2020)



Source: Invesco

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It's apparent that a tilt toward basic valuation metrics has not provided a reliable return enhancement for a considerable period. If there is little premium in tilting toward value style stocks, what does this mean for value investing? Does this mean that investors should give up on value? Or is the market environment of the previous decade a poor guide to style returns going forward? To properly understand the returns to value investing, and the implications of poor style performance, it is worth looking more closely at its application in both fundamental and quantitative investment processes.

2. The anatomy of value

Value investing is a popular style in Australia, as in many other equity markets, and is widely used by both fundamental and quantitative managers globally. But the actual return benefit from value investing is not merely driven by a simple tilt toward value stocks.

The Meaning of Value

Stocks commonly referred to as "value stocks" are essentially companies whose prices are low relative to their near-term earnings (and other financial metrics such as cashflow, book value etc.). The most common cause of this phenomenon is the cyclicality, or economic sensitivity, of these companies. This cyclicality manifests as company earnings fluctuating over the course of an economic cycle and is predominant in economically sensitive industries such as primary commodity producers, capital equipment manufacturers, or discretionary goods providers. The volatility of these companies' earnings leads investors to apply an implicit discount to the earnings level when pricing the securities, resulting in an apparent valuation discount.

As a result, value stocks tend to be more cyclical than the general market and will outperform during an economic upswing but underperform during a downturn. Over the course of an economic cycle the upturns and downturns tend to cancel out, such that a gross tilt toward value stocks does not provide a meaningful return enhancement over the long term.

Most style analysis and risk models which assess the value exposure of portfolios measure the exposure to these types of stocks and infer a return to the value style which is highly correlated with the economic cycle. The measures used in this type of analysis are often price-to-book or price-to-earnings style ratios, with no explicit industry neutralisation. There are important differences between this type of exposure and the relative value premia sought by quantitative investors which is generally industry neutralised and more heavily cash flow based.

The Fundamental Value Investor

Fundamental value investors aim to generate enhanced returns by picking individual stocks which are mispriced and are anticipated to outperform their peers as the market addresses the mispricing. Such stocks are assessed by their pricing relative to the long-term earnings they are forecast to generate and are "cheap" relative to some form of intrinsic valuation. This does not necessarily lead the value investor to always buy classic "value" stocks in the sense described above, however they do tend to find a preponderance of their intrinsic value opportunities amongst these types of stocks. This results in value investors generally having a demonstrable value stock tilt in their portfolios that causes stronger returns during periods of strong economic growth, despite this not being the primary driver of their long-term excess returns. Over the entire economic cycle it is the manager's ability to pick mispriced individual stocks that provides the lasting return benefit.

A skilled value stock picker can still provide a return premium even when the economic cycle is against value as a style, and a value style tilt is underperforming. For these managers it is important that they are given latitude to pursue intrinsic value where they see it, rather than being pushed to demonstrate a classic value tilt in their stock picks according to quantitative style measures. **If such latitude is granted, the skilled stock picker can continue to outperform regardless of the life or death of value factor investing.**

The Quantitative Value Investor

Quantitative value investors generate returns by tilting toward factor exposures at the *portfolio* level, and averaging these exposures over many securities, rather than picking individual stocks. Despite an overall tilt toward classic value stocks adding little in terms of return enhancement over the long term, it is still possible to successfully use Value factors in quantitative investing. The key for a quantitative investor is to apply value metrics in a strongly relative sense. A tilt toward cheaper stocks amongst a reasonably homogeneous set of industry peers can add to long term performance in a way that broad industry tilts do not. The key here is to try to compare stocks with a very similar growth outlook and industry dynamics, so the pricing relative to near term financials is more meaningful.

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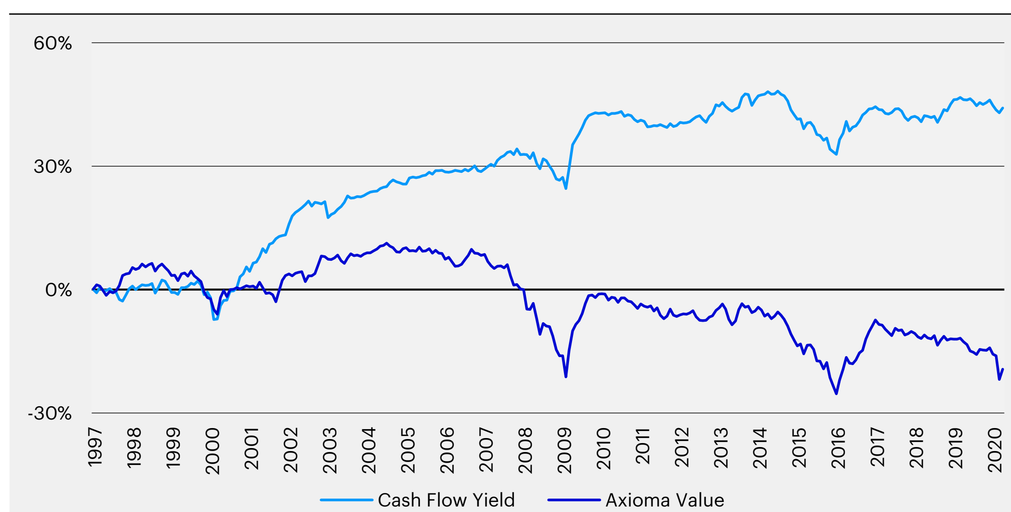
There will be a spread of valuation ratios within any group of stocks, even if they are very similar companies, and some of this will be due to legitimate differences between the companies' intrinsic values. However, there is also actual mispricing for reasons such as investor biases and market forces (like liquidity demand). Selecting stocks with the cheapest ratios within the group will pick up some stocks that have legitimately cheaper ratios but will also tend to select more of the under-priced securities than the overpriced securities. This gives rise to a relative value premium for investing in a group of stocks despite the uncertainty around any particular stock actually being "cheap".

This effect is illustrated for Australian stocks in Figure 3. Here an industry neutralised Value factor (Adjusted Cash Flow Yield) is compared to a non-neutralised Value factor (Axioma Value). The factors exhibit similar risk characteristics; their sensitivity to the economy and risk sentiment are evident in their synchronised drawdowns. However, the industry neutralised version shows a clear return drift that persists over the long term. This is the effect of relative value investing within a peer group, which identifies cheap stocks rather than just cyclical industries.

Figure 3. Cumulative Return of Value Tilts - Impact of Industry Neutralisation 1/1997 – 4/2020



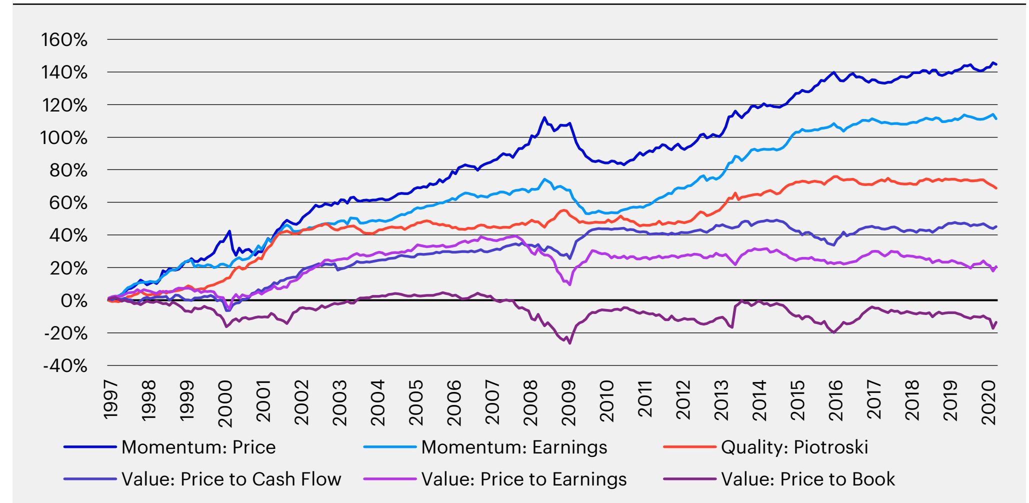
Source: Invesco

The quantitative investor's value tilt is therefore more intra-industry based, and often less pronounced than that of a fundamental manager. Less thematic cyclicality results from this, despite explicitly targeting the value premium.

The role of value in Multi-Factor Investing

While the relative value premium is evident in Australia, it is significantly weaker than other types of factor premia, particularly Momentum, as illustrated in Figure 4.

Figure 4. Cumulative Return to Factors in Australia 1/1997 – 4/2020



Source: Invesco.

Factor performance in Australia over the long term has been stronger than in almost all other developed markets, and to a large extent this has been driven by the very strong performance of Momentum in Australia. Despite the relatively weaker performance of Value on a univariate basis, Value can still be significantly additive to a multi-factor process as it provides a valuation guard-rail to the other factor signals. Momentum signals, in particular, have the tendency to drift into extremely expensive stocks giving an anti-Value exposure that is at a high risk of large losses when sentiment changes. Counterbalancing these anti-Value exposures provides improved return and risk outcomes that are distinct from the value premium of buying actual cheap stocks.

Figure 5 shows an example of a Momentum strategy with and without Value exposure controls. The performance statistics are shown for a hypothetical Australian equity portfolio strategy which tilts towards price momentum exposure (the medium-term Momentum factor of the Axioma risk model). This tilt introduces a negative exposure to Value due to the tendency of Momentum signals to chase companies with rising prices regardless of valuation support. The second column shows the impact of constraining the portfolio to be neutral to the Axioma Value factor. This produces a marked improvement in return information ratio.

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Figure 5: Impact of modifying a Momentum factor by conditioning it on the scores of a Value factor

Market neutral factor portfolios	Momentum	Momentum with no Value exposure	Momentum with no Value beta
Annualised returns %	11.15	11.34	12.09
Standard deviation %	10.02	9.98	7
Information Ratio	1.11	1.14	1.73
T-stat	4.98	5.09	7.74
Maximum drawdown %	34	34	14
Turnover	700%	674%	665%
	Performance statistics for the Momentum factor exposure (based on Invesco IQS factor definitions for global equities over the period 12/1996 – 12/2016). This factor is known to exhibit negative exposure to Value, which is itself a return generating factor.	The impact of neutralising the value bias in the Momentum factor, with respect to the Value factor scores. This demonstrates a very modest improvement.	The Momentum exposure has been adjusted to remove any beta to the Value factor – a slightly different method of neutralising the Value bias. This provides a much more significant benefit, illustrating the importance of understanding how factors interact and tuning the specific implementation of the factors used.

Source: Invesco

The Momentum factor, on its own, can tend to favour stocks which are richly priced relative to fundamentals. The benefit of the Value factor, in a multifactor process, is that it will act to temper potential excesses of the Momentum factor, rather than the benefit resting in the Value factor premium per se. The ‘tempering of excesses’ effect is somewhat independent of the economic environment and value performance cycles and has not been eroded by the recent Value factor performance challenges.

For a reasonably style neutral, multi-factor Australian equity process the value premium is a minor contributor to long-term outperformance, and the issue of whether value investing has lost its effectiveness is not particularly critical.

The extreme economic contraction induced by the COVID-19 pandemic has created conditions for a strong rebound in value as lock down restrictions are eased. We have seen this playing out through late 2020 and early 2021 with some spectacularly sharp rotations from momentum stocks into value stocks.

3. Cause of death

A little knowledge is dangerous

Why did value appear to die? Because it was never really alive; at least not in the sense that is often debated. Value as a gross style tilt is not the underpinning of value investing, for either a fundamental or a quantitative manager. Increasing awareness and focus on gross style biases has led to an over emphasis on the style return, giving a sense that its fortunes dictate the validity of value investing.

Admittedly value processes do tend to bring with them a style bias that impacts the performance profile, and value managers need to overcome this with excellent stock picking when market conditions cause style returns to run against them. Value style returns have run against value managers in a big way, and for a long time. Furthermore, a number of value managers have let this exposure run unchecked to the point that their overall performance has been severely impacted by poor value style returns. But this does not negate the underlying performance generation thesis of valuation-based stock picking, or relative valuation quantitative investing. It does, however, underline the importance of risk and exposure management, and implementing sufficiently nuanced valuation processes to generate returns in a range of economic environments.

The increasing realisation that a gross value style bias is not a great long term performance enhancement has been unfairly labelled the 'death of value', but value managers bear some blame for this themselves in not sufficiently managing their style bias.

4. The afterlife

Getting value from Value

The extreme economic contraction induced by the COVID-19 pandemic has created conditions for a strong rebound in value as lock down restrictions are eased. We have seen this playing out through late 2020 and early 2021 with some spectacularly sharp rotations from momentum stocks into value stocks. This kind of style rotation is typical of a strong economic recovery and provides the opportunity for a highly profitable tactical tilt toward value stocks if timed correctly. This is likely to be a relatively short-lived phenomenon, with value rebounds from global crises typically lasting 12 months or less, but provides a welcome relief from the headwinds of the value drawdowns of recent years.

Beyond the COVID-19 crisis recovery the longer-term outlook for the Australian and global economy is less clear, however there is cause for hope that the secular underperformance trend of value may abate. Record low interest rates and liquidity provisions from central banks have supported speculative growth companies above high quality, good value stocks for many years. A return of inflation and rising rates would see a resurgence of the importance of cash generation and debt servicing, elevating the relative attractiveness of value companies.

Investors should nonetheless take heed from the lessons of the long years of poor value style returns and seek to harness valuation-based investing in a more nuanced, risk-controlled manner. There will continue to be a role for value investing for those who use it wisely.

For fundamental investors...

A skilled fundamental value stock picker can provide a return premium even when the economic cycle is against value as a style, and quantitative value signals are not performing. If they have the ability and permission to pursue intrinsic value where they see it, rather than being pushed to demonstrate a classic value tilt in their stock picks, a fundamental value investor can outperform regardless of the life or death of value style returns.

For quantitative investors...

For a well-diversified, multi-factor Australian equity process the value premium is a minor contributor to long term outperformance, and the issue of whether value style returns are positive is not particularly significant. The important role of value metrics as a guard rail against the excesses of extrapolative signals will continue to function in the absence of a value premium per se.

For asset allocators...

The current pandemic crisis presents an opportunity for asset allocators to time markets and factor returns, and an extremely large reward to value style exposure is possible in the near term. As always, such macro calls are very difficult to time and in this case value exposure is likely to be subject to bouts of very high volatility as the pandemic runs its course.

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Important information

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