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The presumed end of the Value premium

Das Ganze sehen. Die Chancen nutzen.

THE PRESUMED END OF THE VALUE PREMIUM

Value benefits from Behavioral Finance effects

In 1934, Benjamin Graham and David Dodd stated in their book „Security Analysis" that investors could profit from mispricing by investing in low-valued and unpopular stocks. This Value effect, that was later confirmed worldwide by academic research, can be partly explained by investors extrapolating past growth too far into the future and thus systematically overestimating the future growth of Growth companies and systematically underestimating the growth of companies that had recently performed disappointingly. A portfolio of undervalued Value stocks therefore benefits from positive surprises while Growth stocks are significantly more vulnerable to negative surprises.

The development of share prices has long vindicated this theory: from 1926 to 2007, Value stocks recorded around 5% higher annual returns than Growth stocks. Since then, however, the situation appears to have reversed (figure 1).

Value premium approaching all-time lows since 1929

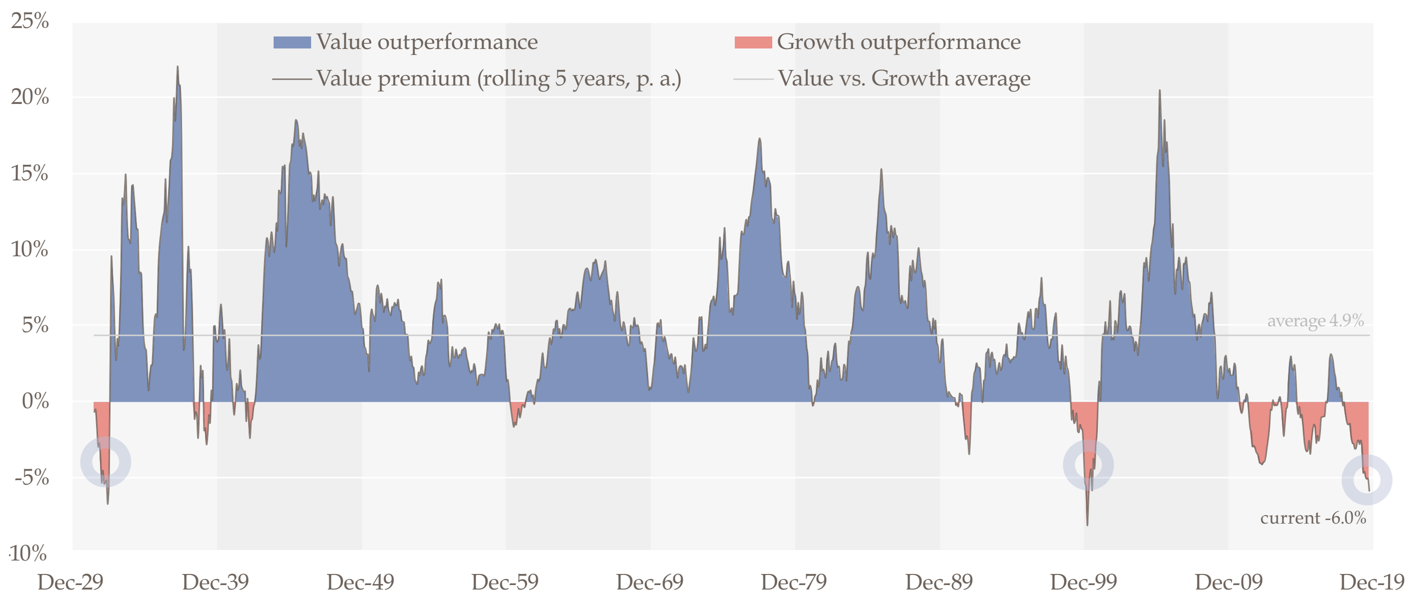


Figure 1: The chart shows the average outperformance over 5 years of Value stocks compared to Growth stocks since 1929 based on the Fama-French HML factor (p.a.). Source: Fama, French, StarCapital as of August 2019.

Over the last five years, Value stocks have underperformed Growth stocks by an average of nearly 6% per year. The extent of the underperformance can be seen from all 1,059 monthly rolling five-year periods since 1932: the current drought belongs to the 1% of the worst underperforming market periods in history (figure 2).

Underperformance of Value near historical extremes

This year alone, Value companies have been underperforming Growth stocks by around 15% (in EUR). Value has disappointed in almost all regions, in terms of almost all common definitions and even after size and sector adjustments.

It is not surprising that factor strategies may disappoint for years. Any consistently successful strategy would attract so much capital over time that it would rob itself of its own basis for success. Cycles are the price of outperformance. Nevertheless, after more than ten years of disappointment, the question arises whether we are experiencing a normal weakness or whether structural changes mark an end to the Value effect.

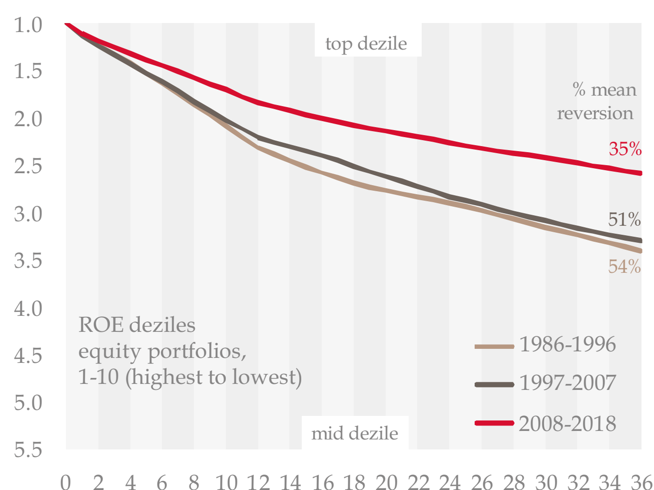
Recent 5 year Value underperformance one of the worst in history

Figure 2: The charts show the distribution of the same Fama and French HML Value premium and the Value premium of the subsequent five years (p.a.). Source: Fama, French, StarCapital as of August 2019.

Reasons for Value weakness

The fact that a reversal was overdue after the extremely strong value period 2000-2007 explains only a part of the recent underperformance. The increased use of smart beta products which might reduce the Value premium especially in the large-cap segment of established stock markets, is also likely to have had only limited impact due to the current low demand for Value ETFs. More importantly, many Growth stocks have been able to maintain their above-average growth rates and profitability in the current cycle much longer than in the past. While the most profitable companies (mostly Growth stocks) generally lose their profitability and thus underperform, this mean reversion has been significantly weaker in the current cycle (figure 3). This has a direct negative impact on value strategies, as they usually benefit from this unpriced return to average corporate fundamentals.

High ROE stocks: Mean reversion in the current cycle weaker than in the past



Low ROE stocks: nearly similar mean reversion compared to history

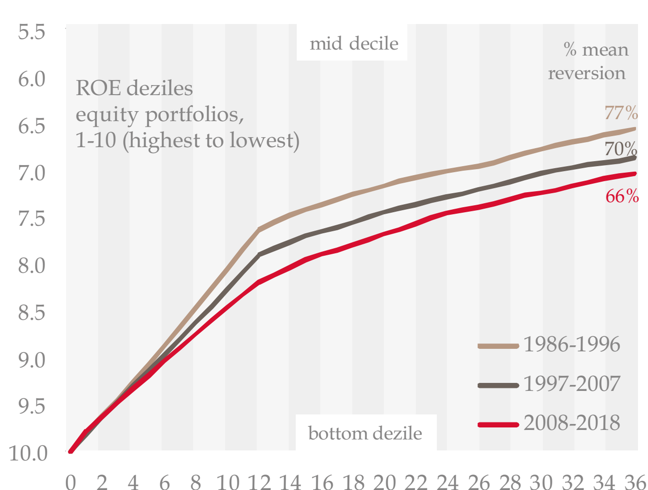


Figure 3: J.P. Morgan US Equity Strategy and Quantitative Research. The charts illustrate the average mean reversion of return on equity (ROE) over the next three years.

Mean reversion of Growth stocks currently significantly reduced

The usual disappointment with growth stocks recently failed to materialize because the convergence of the technology, media and communications sectors coupled with the simultaneous integration of new technologies and the lack of regulation of new business models left many traditional companies lagging behind. Numerous Value investors are overweight in this segment and although many of these traditional companies do not even report exceptionally weak fundamentals, their market share is partly eroded by disruptive Growth companies.

The persistent preference for cyclically resistant business models in the low interest rate environment – particularly institutional investors continue to demand for “bond proxies” and avoid the cyclically sensitive sectors that are traditionally overweight in Value portfolios – increased the demand for Quality and Growth stocks further. At the same time, easy global access to venture capital boosted the development of innovative products and services.

This resulted in unusually strong price increases, particularly for the large technology groups, while many classic industrial companies disappointed despite attractive valuations. Hence, the aggregated market capitalization of the six FANMAG companies (Facebook, Apple, Netflix, Microsoft, Amazon, Google) alone currently exceeds the market capitalization of all French, German, Dutch, Spanish and Italian companies by EUR 3.9 trillion (figure 4).

Passive investors also contributed to the acceleration of this trend: due to the ETF preference of numerous investors and the associated index-linked positioning, large and expensive companies benefited disproportionately. Moreover, the low interest rate environment and growing regulation burdened the financial sector, which is overweight in many Value portfolios.

Market capitalization of FANMAG stocks exceeds market capitalization of nearly all countries

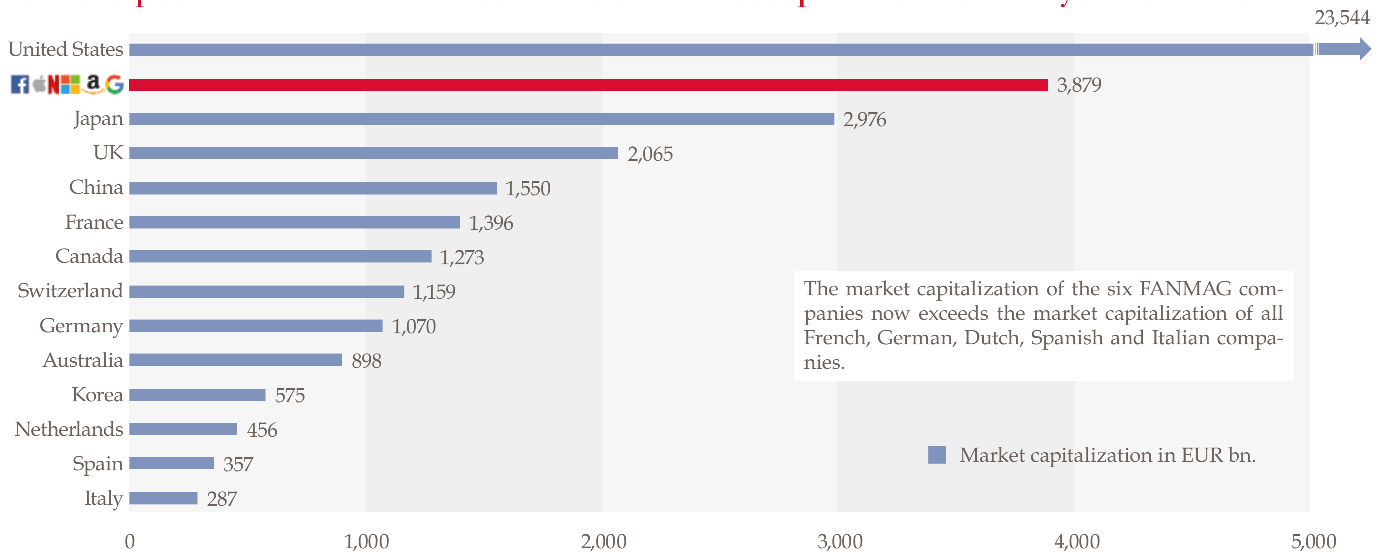


Figure 4: All data in EUR bn. as of 07/31/2019 based on MSCI country indices. Source: Thomson Reuters, MSCI , Research Affiliates and own calculations.

As a result of these factors, valuations in the Growth segment rose significantly, which is reflected in the valuation premium of Growth stocks compared to Value stocks based on classic Value indicators (figure 5). While European Growth stocks, for instance, have been valued on average 78% higher than Value stocks in former decades, this valuation premium has recently climbed to 156%. Only in spring 2000, immediately before the bursting of the dotcom bubble and before the beginning of one of the strongest value periods ever, the level of overvaluation of Growth companies was comparably high. Even then, in the wake of technological innovations, the idea of value investing seemed outdated.

Undervaluation of Value exceeds extreme levels from 2000

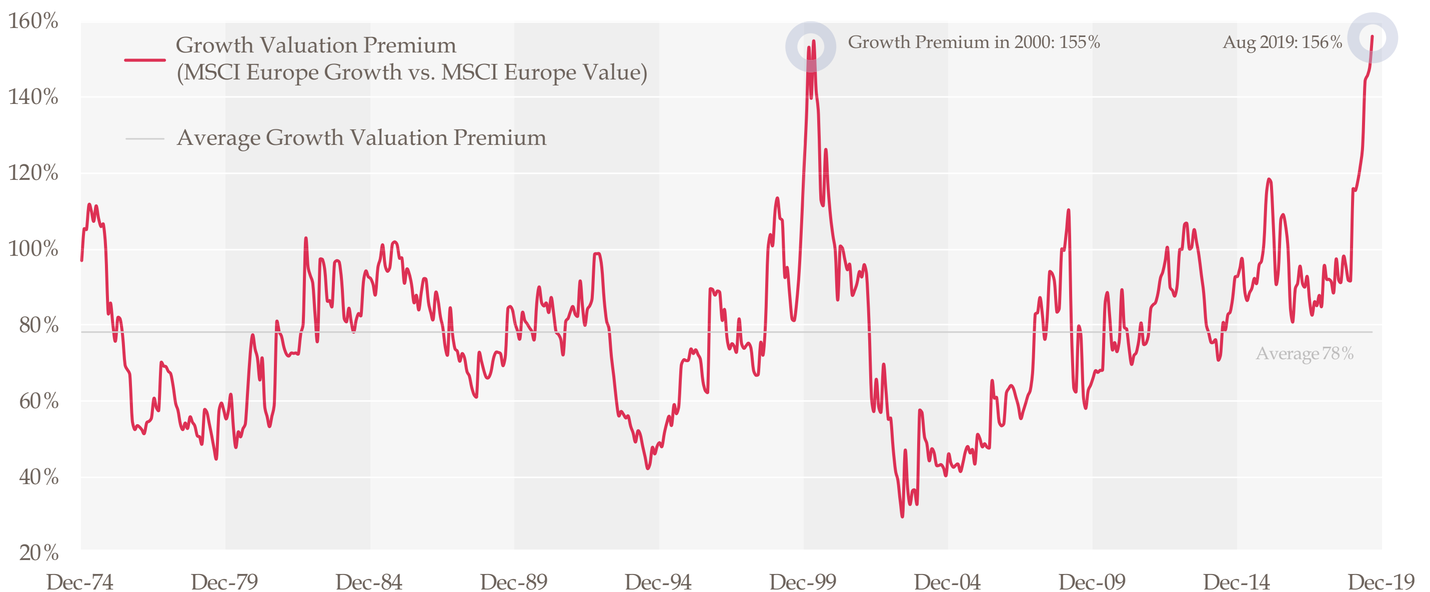


Figure 5: Average valuation premium based on PE, PC, PB and Div. Yield of MSCI Europe Value vs. MSCI Europe Growth as of 08/31/2019. Source: Thomson Reuters, StarCapital.

Is Value about to make a comeback?

Whether the Value segment is experiencing a comeback depends to a large extent on the sustainability of the above-average profitability in the Growth segment. History dampens high expectations: above-average growth rates and profitability could never be sustained in past technological innovation phases such as the introduction of mass production, whether due to competition, regulation or a broad adaptation of new technologies in traditional companies.

The effects of the trade war, which disproportionately affect the supply chains of the technology sector, the long neglected dangers of excessive technological dependency on only a few technology groups as in the case of Huawei, or the growing demand for stronger regulation of the technology sector, which is characterized by "the winner takes it all" mindset, offer considerable disappointment potential for numerous Growth stocks that is hardly priced in. The consequences of credit-financed share buybacks at excessive prices, or the short life span of many business models in the current highly innovative market phase are also frequently ignored.

Factors that have so far supported this trend, such as increased demand for large companies with strong momentum through passive ETFs or the demand for stable bond proxies in the institutional sector, could quickly reverse in the event of disappointment.

Empirically, it seems unlikely that today's big players in technology will retain their leading position in the next decade. Considering the ten largest companies of the last decades, only two companies on average will remain among the largest in the subsequent decade. The remainder is dropped out due to below-average performance, as in the case of Deutsche Telekom in 2000 (figure 6).

The world's largest companies switch permanently

IBM	NTT	Microsoft	PetroChina	Microsoft
AT&T	Bank of Tokyo	General Electric	Exxon Mobil	Apple Inc.
Exxon	Industrial Bank of JP	NTT DoCoMo	Microsoft	Amazon.com
Standord Oil	Sumitomo Mitsui	Cisco Systems	ICBC	Alphabet Inc.
Schlumberger	Toyota Motors	Wal-Mart	Wal-Mart	Berkshire Hathaway
Shell	Fuji Bank	Intel	China Constr. Bank	Facebook
Mobil	Dai-Ichi Kangyo Bank	NTT	BHP Billiton	Tencent
Atlantic Richfield	IBM	Exxon Mobil	HSBC	Alibaba Group
General Electric	UFJ Bank	Lucent Technologies	Petrobras	Johnson & Johnson
Eastman Kodak	Exxon	Deutsche Telekom	Apple Inc.	JPMorgan Chase

Figure 6: Research Affiliates, LLC; Arnott, Rob, and Lillian Wu. During 1982-2011, an investment in the world's largest stocks would have resulted in an (sector-adjusted) average underperformance of -5.3%. The investment in the world's largest stock would have caused an annual underperformance of -12.5% compared to the global stock market (underperformance in 95% of all holding periods).

At the same time, the valuation spreads reflect the extreme level of negative expectations already priced into the Value segment. Bearing this in mind and given the fact that an increased valuation gap between Growth and Value cannot theoretically be sustained in the long term, it would not surprise if once again the greatest risks were to be found in presumably safe investments that have been characterised by high valuations, high popularity and a high outperformance over the past few years. Since the timing of an investment has a major impact on long-term performance, a current investment in the most expensive market segments could destroy more capital than it receives. Thus, it is too early to proclaim an end to Value investments.

More contrarian trade than Value is currently hard to find

On the contrary: after almost all investors have left the Value segment and even fundmanagers have softened their strategies with Growth criteria, there are interesting opportunities in the Value segment. Even though it is impossible to predict when the cycle will rotate and Value will make a comeback, it can be concluded that a more contrarian trade than Value is currently hard to find; and in recent decades Value has rarely been as attractively valued as today. These are good preconditions for long-term investors!

Norbert Keimling

Further information and current data from our capital market research can be found regularly at www.starcapital.de/research/stockmarketvaluation.

About the author

Norbert Keimling is Head of Capital Market Research at StarCapital AG. After completing his studies in business information technology, he started his career in quantitative research at AMB Generali in Cologne. He has been working for StarCapital since 2004 and is responsible, among other things, for the global equity fund StarCapital Priamos.

StarCapital AG was founded in 1992 and belonges to the Bellevue Group AG since 2016. As independent asset manager, the company uses professionalism and passion to develop investment strategies for its institutional business partners and private clients, true to the motto „See the big picture, grasp the opportunities“. The StarCapital team consistently relies on benchmark-independent and contrarian investment methods as well as on rule-based asset allocation strategies. The company is also one of the few asset managers to have its own in-house capital market research.

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