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The Internal Conflict Rages

Patience is bitter, but its fruit is sweet
– Rousseau

There are periodic instances when a prudent investment manager is tested. A logically-grounded, historically-proven, data-tested strategy that prevails over the long-run is subject to bouts of short-term underperformance.

One's mettle is tested; does the manager patiently adhere to his beliefs, confident that his approach will be successful, just as it has in the past? Or does he surrender to emotion, become anxious, and abandon his philosophy? Welcome to the internal conflict that has raged within value managers these past few years.

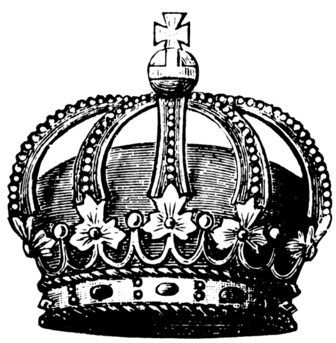
Value strategies that own a disproportionate amount of stocks trading at low price-to-earnings, price-to-book, price-to-cash-flow or price-to-dividend have generated a meaningful headwind for recent returns, but simultaneously laid the foundation for meaningful outperformance going forward. In 2015, small value stocks were the worst performing US equity category, down near 8%. The Russell 3000 Value index of domestic stocks fell by over 4% last year while the Russell 3000 Growth index was up over 5%. The MSCI EAFE Growth index of international developed stocks was up over 4% in US-dollar terms while its value counterpart was down almost 6%. Foreign large cap growth funds outperformed their value counterparts by over 4%. Even in the Jean-Jacques Rousseau-esque bloodbath of emerging markets, more value stocks were guillotined than growth stocks, as the MSCI Emerging Markets Value index fell by over 18.5% in US-dollar terms while the MSCI Emerging Markets Growth index declined by "only" 11%.

However, let all who would dispute the long-term value of value prepare themselves for a Napoleonic-style smack down of historical data.

Based on returns data from 1940 to 2012, large value stocks have outperformed large growth stocks by almost 4% annualized while small value stocks have outperformed small growth stocks by over 6.5% annualized. Over this cumulative time frame, it is true that the market-driven price fluctuation of large value is noticeably higher than large growth, but small value stocks and small growth stocks are practically identical.

Ultimately, the risk-adjusted performance of both value segments exceeds growth by a meaningful amount. Some critics of the "value premium" contend that value-driven outperformance has greatly diminished since the widespread publication of investment research on the topic began in the last quarter of the 20th century. However, from 1967 through 2014, large value stocks have still generated excess returns against large growth stocks of about 4% annualized, and this time it's with lower volatility, while small value stocks have generated excess returns against small growth stocks of about 6% annualized with lower volatility. This outperformance isn't even predicated on a particular measure of value; it comes whether measured by price-to-book, earnings-to-price, cash-flow-to-price or dividends-to-price. In addition, the success of value spans the globe; from 1975 to 2014 in non-US developed equity markets, value stocks outperformed their growth counterparts by 5.70% annualized and in emerging markets from 1989 to 2014, value stocks outperformed by 4.48% annualized.

To conclude with a final French Revolution-inspired analogy, the Tuileries Palace can quickly turn into a prison if it's surrounded by revolutionaries, and the head that bears a crown doesn't have to be attached to a body.



The superior risk-adjusted performance of value is most likely to occur as the time-frame over which returns are measured lengthens. For example, over any particular one year holding period large value and small value outperformed only 65% of the time. However, over any particular five year time frame, large value outperformed 75% of the time while small value outperformed almost 90% of the time. For a ten year time frame, large value outperformed almost 80% of the time while small value outperformed almost 100% of the time. Since 1979, US value has outperformed growth in 20 of 37 calendar years, or 54% of the time, while small cap value has outperformed small cap growth in 57% of calendar years. During this time frame, value had only two instances of three consecutive years of underperformance; 1989 to 1991 and 2009 to 2011. And when value "turns the corner" after a period of underperformance, investors will regret that they abandoned their principles. For example, value underperformed the S&P 500 by 2% annualized over the past ten years when measured as of February 2000, but then outperformed the S&P 500 by 2% annualized if measured as of November 2001, less than two years later.

A key lesson to draw from this evidence is that over any shorter time frame, it's quite possible that growth will outperform value, but in almost all cases, the patient investor will achieve superior results by overweighting value stocks.

What do you think is the most important word in the preceding paragraph? Superior? No…it's patient. Why? Because superiority may only be achieved via patience. Patience does not guarantee success, but it is a necessary condition for outperformance.

Beware overhyped and overpriced growth areas of the market. For example, the price-to-sales ratio for biopharma firms in the Russell 2000 was 14x at the end of August 2015 versus a sector average of 1x for the rest of the Russell 2000 index. Fantastic growth stocks, right?! More alluring than Marie Antoinette! Then, to start 2015, the SPDR biotech ETF was down almost 15% for the initial two trading weeks and the Powershares Dynamic Biotech and Genome ETF was down almost 12%, while the "medical breakthroughs," "biotechnology clinical breakthroughs," and "cancer immunotherapy" ETFs were down between 15% and 20%.

To conclude with a final French Revolution-inspired analogy, the Tuileries Palace can quickly turn into a prison if it's surrounded by revolutionaries, and the head that bears a crown doesn't have to be attached to a body. Instead of compulsively grasping at what seems immediately pleasing, be patient and hold fast to what is proven. You might just get out alive; and maybe you can take some of the dead queen's gold with you. ❧