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# Investment viewpoint

# Let's make Value great again

1798 Alternatives • Alternative Risk Premia

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Several consecutive years of underperformance have prompted an intensive debate on the future of value investing in equities. With Value being the most distinguished equity factor, this debate casts a doubt on factor investing as a discipline.

Recently, we have witnessed the emergence of multiple theories explaining why Value is not "great" anymore. One of these theories states that due to low interest rate environment investors are less sensitive to valuations and more focused on growth. Others claim that traditional valuation ratios like price-to-book are no more relevant as the balance sheet measures do not reflect intangibles such as R&D investments. Certain analysts also blame the rise in passive investment for the inability of the market to correct mispricing.

It is not uncommon to question the future of a strategy after its disappointing returns especially if it disagrees with past performance. In factor investing, the 2018 equity momentum crash was an example of such an event that was truly a historical outlier. Investors learnt hard their lesson in risk management but did not abandon equity momentum, which proved to be beneficial since then. Our risk-based approach to factor investing was also born out of reflections on such events in the past.

The story of Value seems to be different as there is no firm evidence that the apparent disconnection between fundamentals and stock valuations has not happened before.[1] However, this does not mean that we should sit and wait for the comeback of Value as it may not happen very soon. Any disappointing experience is an opportunity to revisit the strategy and that is what we did. In this note we present what we know about Value, and propose a way to improve it.

### What we know about Value

In our discussion, we will consider the most basic approach to value investing, which relies on price-to-earnings (PE) ratios to assess stock valuations. However, the main conclusions are valid for a more sophisticated approaches to Value such as the one that is implemented in our systematic equity strategies.

[1] See "Is (Systematic) Value Investing Dead?" from AQR (https://www.aqr.com/Insights/Research/Working-Paper/Is-Systematic-Value-Investing-Dead).

## EX. 1 PERFORMANCE OF PE-BASED VALUE STRATEGY IN US

Source: LOIM calculations, 30/04/2020. For illustrative purposes only. Past performance is not a guarantee of future results. This illustration is not directly comparable to the investment objectives, strategy or universe of any fund.

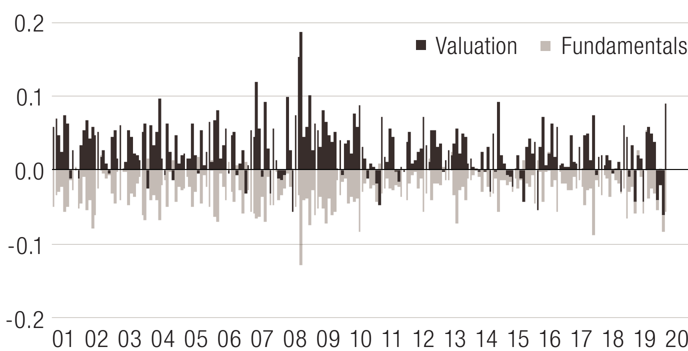
Exhibit 1 shows the performance of a long-short portfolio formed by ranking S&P 500 stocks according to their PE ratios.[2] The picture looks familiar for those of us who have been following the performance of Value in US stocks over time, where it is especially challenging. The value strategy has been in drawdown for more than three years now. In the fourth quarter of 2019, Value has shortly recovered bringing hopes for a long-awaited rotation. However, those hopes died in 2020 after Value capitulated following the outbreak of Covid-19.[3]

Let us now slice and dice the performance of the value strategy. Using a simple identity, the portfolio return can be attributed to two sources: changes in PE ratios of stocks (valuation) and their earnings growth[4] (fundamentals). As we can see from the first graph in Exhibit 2, the effect of fundamentals is mostly negative meaning that earnings of value stocks tend to decline relative to growth stocks. At the same time, stock valuations seem to normalize over time working in favor of the value strategy.

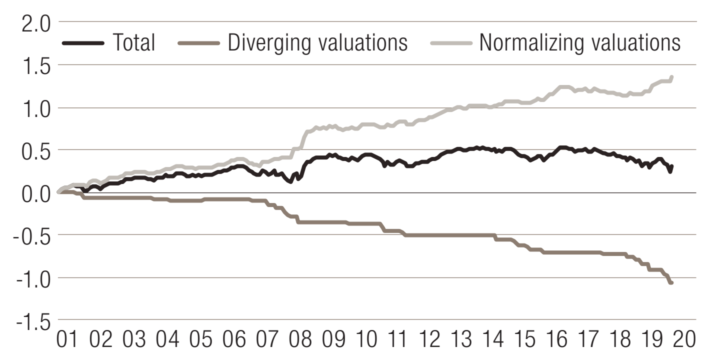
The fact that the two sources of performance tend to have opposite directions suggests that they are probably closely related. Indeed, the majority of value stocks are likely to be “cheap” for good reasons as the market is pricing in a deterioration in their fundamentals. This explains negative contribution of fundamentals to the value strategy performance. As earnings deteriorate, stock PE ratios get automatically normalized, which is consistent with positive contribution of the valuation effect. Such a process need not involve price action, therefore, it is not where we expect to earn a premium. By engaging in a value strategy, we hope that the market might be overly pessimistic about certain stocks, and expect their valuations to be normalized through a price action.

## EX. 2 INSIDE THE VALUE PERFORMANCE

COMPONENTS OF VALUE RETURNS




VALUE RETURNS IN DIFFERENT REGIMES




Source: LOIM calculations, 30/04/2020. For illustrative purposes only. Past performance is not a guarantee of future results.

2 In defining PE, we used median analysts’ forecasts from IBES database. For each stock, we selected the forecast for the further year available. The long-short portfolio is sector neutral with stocks’ weights being defined by their ranks in PE within sectors. The performance corresponds to monthly rebalancing frequency. Last performance is April 2020. Past performance is not a guarantee of future results. Simulated performance results do not reflect actual trading and have inherent limitations.

3 To be fair, the performance of Value in 2020 is not surprising at all if we recall what happened in 2008 during GFC

4 Since price is a product of earnings and the PE ratio, the percentage change in stock price is approximately equal to the sum of the growth in earnings and the growth in the PE ratio.

Looking closer at the performance split, we notice that the valuation part occasionally turns negative contrary to our story. To see the effect of such events over time, the second graph in Exhibit 2 shows the cumulative return of the value strategy during months characterized by diverging valuations. It is clear that those events explain most of strategy drawdowns and particularly well the last one. Furthermore, these events seem to be clustered in time meaning that the strategy seems to get periodically caught in a "value trap" by holding stocks with deteriorating fundamentals and cheapening valuations.

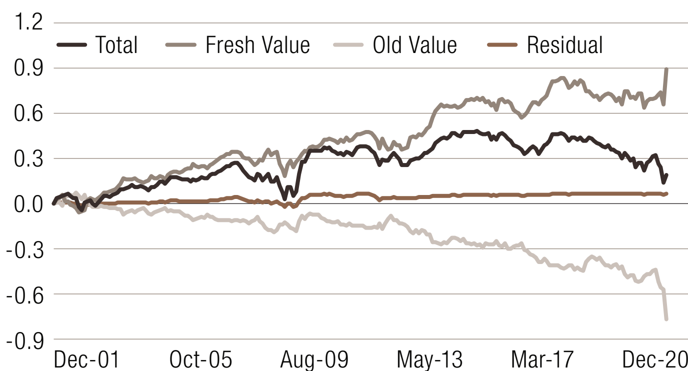
Clearly, the performance of Value could be greatly improved if we were able to somehow avoid or at least minimize value traps. One possibility is to develop a more sophisticated approach to measuring value incorporating additional stock information. We are not fans of such an option as it goes against the simple and robust nature of factor investing. Instead, we prefer to stick to traditional valuation metrics and rethink how value is achieved in portfolios.

### Time for refreshments

Being essentially a contrarian strategy, Value does not have a natural stop-loss mechanism that prevents it from holding constantly underperforming stocks, whose falling valuations actually make them even more attractive. We can attempt to break this vicious circle by forcing a faster rotation of value stocks.

Clearly, we need to differentiate value stocks that have become cheap only recently, from those that have been such for a while. We can disentangle the impact of "fresh" and "old" value stocks on the performance of our PE-based strategy using standard tools of risk-based performance attribution.[5] The result of this decomposition is shown in Exhibit 3, where "Old Value" corresponds to the Value one quarter before.

**EX. 3 ATTRIBUTION OF VALUE PERFORMANCE**




Source: LOIM calculations, 30 April 2020. For illustrative purposes only. Past performance is not a guarantee of future results. This illustration is not directly comparable to the investment objectives, strategy or universe of any fund.

We observe that the two factors explain the performance pretty well, with the residual being relatively small. Old Value is consistently detracting performance. While this is not happening only recently, the negative alpha of Old Value is noticeably larger during recent years even if we ignore the sharp drawdown of this year.

The main take-away here is that if we are to choose between two "cheap" stocks, we would prefer to invest in the "fresher" one that has not been cheap before. In the context of our PE-based strategy, this can be achieved by de-correlating stocks' PE scores from their past values before the portfolio is built. If this transformation is done properly, the performance of the resulting portfolio will be identical to Fresh Value shown in Exhibit 3.

One possible criticism of the proposed solution is that the new strategy is no more a value strategy but something else. To dispel any doubts, returns of PE-based strategy have a 0.7 correlation with Fresh Value and only 0.2 with Old Value, meaning that Fresh Value is the main short-term driver of performance. Furthermore, by simply looking at Exhibit 3, it becomes evident that Fresh Value and the original strategy show very similar patterns in terms of ups and downs. This observation strengthens our conviction that Fresh Value will benefit from the future comeback of Value. While waiting for this to happen, we expect Fresh Value to be generating alpha.

### Conclusion

In this note, we proposed a simple way to improve the performance of Value. This is achieved by enhancing the rotation in value stocks without changing the definition of Value.

For some readers, the discussion may seem to be a bit theoretical as we are dealing with long-short strategies. However, the implementation of the Fresh Value in long-only portfolios is very straightforward within our approach to factor investing.[6] Since we optimize our portfolios explicitly controlling risk-based exposures to each factor, it is sufficient to simply add a new factor (Old Value) and set its target exposure equal to zero.

We tested this modification in our current strategies and found that it improves the performance of Value and reduces its drawdowns in all regions. The only downside we found is an increase in turnover due to a higher rotation of stocks. Our analysis shows that an incremental increase in transaction costs is more than justified by higher returns.[7]

[5] This is done in two steps. The first step is to infer returns of "Fresh Value" and "Old Value" using cross-sectional regressions of stock returns on their current and past Value exposures. The second step is to compute the contribution of each factor to the portfolio return as a product of the factor return and the portfolio exposure to it.

[6] Details can be found in our paper "Our Approach To Factor Investing" available at tiny.cc/cfffpz

[7] Past performances is no guarantee of current or future returns, and the investor may receive back less than he/she invested.

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2. It assumes purchase and sale prices believed to be attainable. In actual trading, the prices attained may or may not be the same as the assumed order prices.
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