The Viability of the Value Premium

If you've been an evidence-based investor for a while, you know the drill:

> ***You've already built your low-cost, globally diversified portfolio to help you achieve your personal goals. You've done so by tilting your portfolio toward or away from long-term sources of expected returns – and their risks. When those risks arise, if your goals haven't changed, neither should your portfolio.***

Let's assume you've already embraced this advice, and are *relatively* comfortable maintaining your investment resolve. You also may be aware that investments concentrated in **value stocks** have delivered higher long-term returns than their growth stock counterparts. As Multifactor World's Jared Kizer describes in a January 2019 post, "value stocks have outperformed growth stocks by 4.8 percent per year over the period of 1927–2017."

However, it's also no secret that the value premium has been hiding for quite a while. At least in U.S. markets, value stocks have been underperforming relative to growth stocks for around a decade.

This has led some investors to wonder whether the value premium has lost its mojo. Even among financial academics and practitioners, healthy debate exists over what to make of the past decade. Are the underwhelming returns a temporary, if painfully long bump in the road, or does it represent a permanent new reality for value stocks?

We won't keep you in suspense:

> ***Nobody knows, for sure, what the future holds. We cannot guarantee success, but based on historical and ongoing evidence, we have found no compelling reason to alter our approach to value investing.***

Let's explore why we feel it remains in your best interest to keep the faith on value investing (relative to your personal financial goals and risk tolerances).

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Historical Context
In 1992, professors Eugene Fama and Ken French published a landmark study in *The Journal of Finance*,"The Cross-Section of Expected Stock Returns." Their work gave birth to the **Fama/French three-factor model**, which suggested three sources of expected returns could explain almost all of the differences in returns among different portfolio builds:

1. **The equity premium** – Stocks (equities) have returned more than bonds (fixed income).
2. **The small-cap premium** – Small-company stocks have returned more than large-company stocks (although continued inquiry has added an important footnote to this finding).
3. **The value premium** – Value company stocks have returned more than growth company stocks. Value companies are those that appear to be under- or more fairly valued by the market, relative to growth companies; they exhibit lower ratios between their stock price vs. their various business metrics such as book value, earnings, and cash flow.

What does this mean to you as an investor? It suggests financial analysts can take any two investment portfolios and compare their long-term performance using just these three factors. With more than 90% accuracy, the analysis should explain why one portfolio returned, say, 10% annualized over 20 years, while the other one only returned 5%.

To put it another way, the Fama/French three-factor model showed us that, costs aside, it barely matters whether each security in your portfolio has been hand-picked by a high-priced expert, or chosen at random by a group of dart-throwing monkeys. Almost all that matters is how you've allocated your holdings among (1) stocks vs. bonds, (2) small-cap vs. large-cap stocks, and (3) value vs. growth stocks. Almost any other stock-picking or market-timing efforts are far more likely to add unnecessary costs and/or unwarranted risks than to improve your returns.

This is powerful stuff to build on. In 2014, Fama and French published a five-factor asset pricing model, which now explains nearly 100% of the cross-section of expected returns. Whether returns among different portfolio builds can be explained by three or a few more factors…

> ***If your investment portfolio were a house, your particular allocation to value stocks is an essential, load-bearing wall. It should not be abandoned lightly.***

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The Investor's Long Haul

Still, we understand. A decade is a long time to tolerate disappointing numbers, while awaiting an expected reward. For many of us, our children are about the only other misbehaving "investment" we're willing to put up with for that long.

However, as is the case for any other source of expected investment returns (including the equity premium itself), we prefer to consider value stock performance over a decade or more, since the expected outperformance can go into hiding for years on end – and often has.

In a 2-15 CFA Institute post, Enterprising Investor contributor Dougal Williams commented (emphasis ours): "A 'disappearing' value premium, even over a 10-year stretch, is nothing new. In fact, since the late 1970s, **27%** of all rolling 10-year periods have seen a negative value premium." Of course, on the flip side, this means **73%** of them delivered a positive premium.

These seem like pretty good odds. However, when a source of expected return does resurface after a hiatus, it's often in the form of an exuberant leap nobody saw coming, except in hindsight. For example, in the same CFA Institute post, Williams pointed out that growth stocks had outperformed value by 2.1% annually for the decade ending October 2000. Then, abruptly, the tables turned; ***value bested growth by 35% over the next five months***. Based largely on this single surge, value ended up outperforming growth by 2.4% for the 10 years ending May 2001.

In short, only those who can tolerate the doldrums tend to still be around to reap the unpredictably timed windfalls that often dramatically impact your end returns. As Vitaliy Katsenelson of Contrarian Edge has suggested more recently, "value investing is not dead; it is just waiting until all value managers lose their hair and capitulate."

Going Global

It's also worth noting: While the United States is ***not*** the entire world, much of the press covering the value premium has focused on U.S. performance. Over the past decade or so, international value stocks have often performed more robustly than their U.S. counterparts.

In a 2018 ETF.com post, financial author Larry Swedroe commented: "If value is 'dead,' we should find confirming evidence in other [non-U.S.] markets." He then used data from Ken French's website to show that the premium was alive and well in international developed markets in the then-current 10-year stretch.

Depending on which business metric he used, the value premium ranged from 1.9% (book/price) to 4.1% (earnings/price) from 2008–2017.

In financial academia, where assumptions are best validated by presenting across multiple markets and various timeframes, this suggests U.S. value stocks are more likely experiencing a random setback than defining a new global norm.

Popularity Contests and Future Expected Returns

In a more recent piece, Swedroe also rebutted the suggestion that value investing has become a victim of its own success. That is, as more investors have incorporated the value factor into their portfolios, has old-fashioned supply-and-demand eliminated its expected premium?

We don't know for sure, but we don't think so. It's more likely that investors who cannot tolerate the recent underperformance are unwittingly setting the stage for the value factor's comeback.

Think about it: Whenever one investor wants to sell their shares, somebody else has to buy them, or the transaction cannot occur. As some investors waiver and sell their value stocks at lowered prices, other bargain-hunting buyers swoop in and position themselves for future expected growth. Eventually the pendulum is likely to swing. In a chicken-or-egg relationship, sentiments shift as prices crawl or lurch back upward. The next thing you know (although nobody knows just when), value has once again resurfaced, stronger than ever. The cycle begins anew.

That's how efficient markets have worked for decades if not centuries. It's how they're expected to continue to work moving forward. In other words, in an ironic twist, lower current prices actually suggest future higher returns.

We can point to supporting evidence from a stock pricing measurement known as **the spread**. In this case, the spread measures the difference between the price *buyers* want to pay for a stock (the bid) vs. the price *sellers* want to receive (the ask). Wider spreads mean bid/ask prices are far apart; narrower spreads mean they're closer together.

As Swedroe observed in his paper, "If overcrowding has occurred, we should see a dramatic narrowing in [spread] valuations, as cash flowing into value stocks and out of growth stocks impacts relative prices." After analyzing the spreads among various market factors, he concluded: "The bottom line is that we see no evidence that cash flows have caused the ex-ante value premium to narrow, either in small stocks or large stocks."

To put it another way, J.P. Morgan's chief U.S. equity strategist was quoted as follows in a June 2019 MarketWatch column (emphasis ours): "[V]alue is currently trading at the biggest discount ever, ***and offers the largest premium over the last 30 years***." The strategist was referring to future, not current expected premiums. In other words, for those who stick with the value factor, solid evidence remains that the best is yet to come.

What Matters in the End

So, where does this leave us? We remain confident that the value premium is far more likely slumbering than dead. Unfortunately, nobody can predict when it will awaken, or whether it will do so gradually or in a rush. We can't even offer an iron-clad guarantee we're correct.

For better or worse, this is the nature of market risks and their expected rewards. Suffice it to say, the market's inherent uncertainties challenge the most disciplined investors. Even the late, great Vanguard founder John Bogle once said about his own, roughly 50/50 stock/bond mix:

> ***"I spend about half of my time wondering why I have so much in stocks, and about half wondering why I have so little."***

So, if you have your doubts, that's perfectly understandable. However, before you actually change your investment strategies or abandon value investing, consider this 1999 sentiment from *The Journal of Portfolio Management's* founding editor Peter Bernstein. His words are as relevant today as when he wrote them 20 years ago:

> ***"Even the most brilliant of mathematical geniuses will never be able to tell us what the future holds. In the end, what matters is the quality of our decisions in the face of uncertainty."***

So, what still makes for quality decisions? **Global diversification** is a huge part of it. By spreading your risks across multiple sources of expected returns, you can better manage the very real risks involved in pursuing them. In the frightening face of uncertainty, patient resolve and objective evidence are also among your greatest guides. Last but not least, we're here to help as well. Questions? Comments? Time for a talk? Let us know!

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