The Death of Value and Recency Bias – What's Your Time Horizon?

Have you heard the news? The value factor is apparently dead!

As most of us know, buying cheap and selling expensive stocks, or "buying low and selling high," has been a well-documented strategy for many investors. This belief is supported by empirical evidence, which displays the tendency for relatively cheap stocks to outperform relatively expensive stocks. Academics and practitioners measure the relatively "cheapness" of a stock by comparing the relationship between a stock price and fundamental inputs of the underlying company. This style of investing was pursued by famous investors such as Benjamin Graham, and is still pursued by many investors today.

A more systematic approach to this investment strategy, otherwise known as the value factor, was first made popular by Eugene Fama and Kenneth French[1] when they discovered that simply buying high book-to-market stocks and shorting low book-to-market stocks created a unique premium uncorrelated to other market factors. Additionally, the long side of this portfolio actually helped them explain the risk and return characteristics of many actively managed mutual fund strategies.

Since Fama and French's seminal paper, other measures of the value factor have been tested in academic literature and practice, including measures such as a company's price-to-earnings ratio (P/E), price-to-free-cash flow ratio (P/CF), and dividend yield (D/P). As factor investment strategies became a more prominent tool in practitioner portfolios, these different value measures may be combined or even independently applied to different sectors (e.g., price-to-book may be best applied to bank stocks, while it may not be the best measure for technology stocks).

Despite longstanding support of the value factor from empirical studies, value stocks have struggled relative to growth stocks in recent years. Recency bias has caused some to claim that value investing is dead because of this recent underperformance. But is the value factor really dead, or has it just not worked recently? The answer really depends on 1) how far back one is willing to look and 2) how one actually measures value.

Exhibit 1 shows the four measures of value previously mentioned, each of which is measured as equally weighted portfolios of the most attractive 30% of stocks for the following factors: "Earnings Yield," "Book Value," "Cash Flow," and "Dividend Yield." In other words, "Earnings Yield" is an equally weighted portfolio of the cheapest 30% of stocks, as measured by their P/E ratios, "Book Value" is an equally weighted portfolio of the cheapest 30% of stocks, as measured by their P/B ratios, and so on.

From January 1, 2009 to June 30, 2019, $1 invested in each of these portfolios would have resulted in a portfolio value of $4.38, $4.50, $4.17, and $4.54, respectively. By comparison, the broader market, measured by the Center for Research in Security Prices (CRSP) Total Market, would have resulted in a portfolio value of $4.16 over that same period of time. Notice all four of these measures of value outperformed the broader market over this time period.

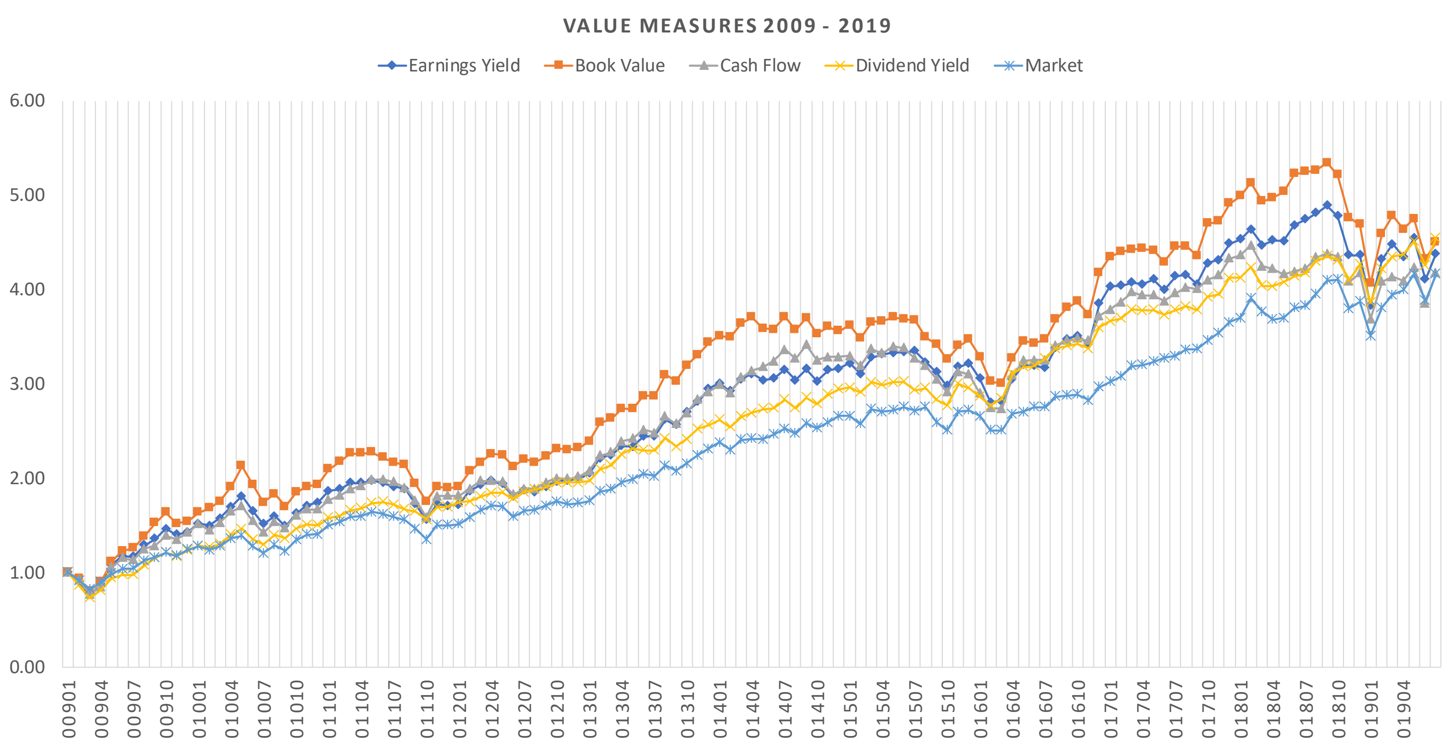

Exhibit 1

Now, let's subject ourselves to some recency bias. Exhibit 2 shows the performance of the same value factors through June 30, 2019, but with a starting point of January 1, 2014. In this scenario, $1 invested would have resulted in a portfolio value of $1.50, $1.29, $1.44, and $1.78, respectively. The broader market over this time period would have resulted in $1.74. Only one value factor, high dividend yields, outperformed the broader market. The rest lagging significantly – the worst of which was Book Value, Fama and French's original value measure.

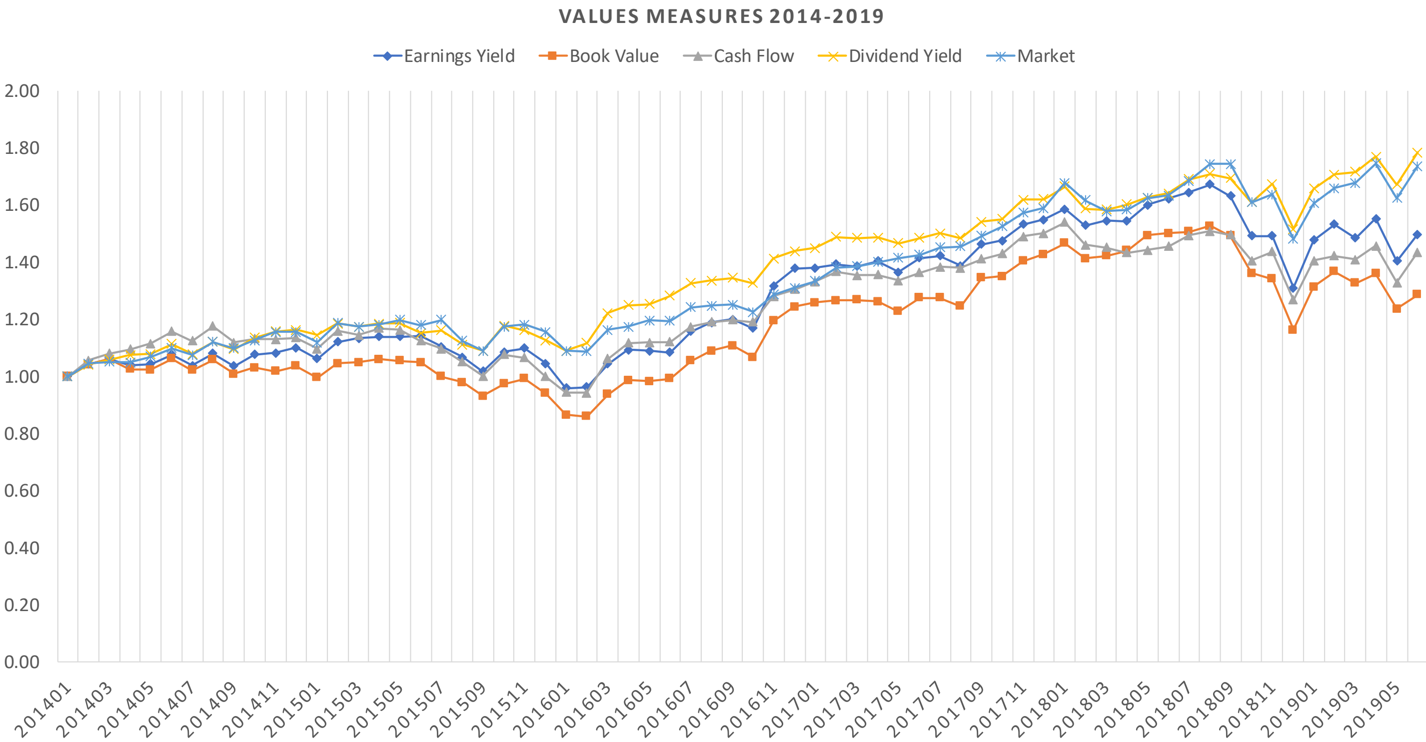

Exhibit 2

Is value really dead then? Maybe for the time being. The last five years have been tough for value investors, and even more recent performance has exacerbated the gap between cheap and expensive stocks.

Why are these two examples important?

First, investment styles are cyclical, meaning they go in and out of favor over time. Keep in mind, factors are measures of risk premium, meaning it rewards those who hold it through the bad times and/or periods of underperformance.[2] It can be tempting to abandon ship when a style is underperforming, but that's exactly why it works! It's supposed to be painful – an investor in any particular factor would do well to remember this cyclicality, however.

Second, it's easy to get caught up in short-term performance, but broadening your time horizon and understanding one's exposures can help create a sense of patience when things aren't working. Sometimes, a successful investment strategy can take years to pay off and selling at the wrong moment can cause one to miss it. The value factor performed very poorly in the 1990s during the Technology Bubble, but those who stuck by it were eventually rewarded.

Third, style diversification is just as important as asset class diversification, for the same reasons. Factors, just like asset classes, don't always work, so having exposure to multiple empirically supported factors (e.g., value, momentum, size) can help smooth out the ride over market cycles, while still providing wanted exposures.

Endnotes

1. Fama, Eugene F.; French, Kenneth R. (1992). "The Cross-Section of Expected Stock Returns," *The Journal of Finance*. 47 (2): 427–465.

2. Ang, Andrew, Factor Investing (June 10, 2013). Columbia Business School Research Paper No. 13-42. Available at SSRN: https://ssrn.com/abstract=2277397 or http://dx.doi.org/10.2139/ssrn.2277397

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