WEST BRANCH CAPITAL REPORT

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Part 2 of 2 – Value Investors: Don't Give Up!

Is value investing over? Should we stop searching among the market's cheapest, least loved companies for hidden investment gems? Historically, this is a strategy that has worked: from July, 1926 to December, 2019 the U.S. market's cheapest 30% of stocks based on the ratio of Price to Book Value – perhaps the most common measure of value in the academic literature -- has outperformed the most expensive 30% by an average of 3.0% per year. When the effects of compounding are considered, this makes a huge difference: a dollar invested in the "value" portfolio above would be worth more than 12.5 times as much today as the "anti-value" portfolio!

Sadly, for value investors at least, these effects have been more modest over the past twenty years and downright abysmal over the last ten. The chart below compares the recent compound annual returns of "value" to "anti-value" – or "growth" -- using two common sets of indices: the bottom/top 30% of stocks by Price/Book Value discussed above and the more practitioner-oriented Russell 1000 Value and Growth indices.

Trailing Performance of "Value" And "Growth" Stocks As Of Year-End 2019

	Full Sample (7/26-12/19)	Past 20 Years	Past 10 Years	Past 5 Years
30% Lowest P/B	12.8%	8.19%	11.32%	8.00%
30% Highest P/B	9.8%	3.46%	15.27%	14.56%
Difference	3.0%	4.7%	-4.0%	-6.6%
Russell 1000 Value Index	N/A	10.52%	13.83%	23.08%
Russell 1000 Growth Index	N/A	5.18%	15.22%	14.63%
Difference	N/A	5.34%	-1.39%	8.45%

Clearly, value investing has had a disappointing run over the last decade for U.S. investors, and it's been just as bad in international markets. Ten years seems like a long time in the world of investing – is the so-called "value effect" dead?

We still believe there is substantial value in value investing. At its core, we view the value effect as a reflection of certain behavioral biases that, taken together, lead us to prefer clean situations where things are working to messier, more complicated situations where things aren't working. In the world of investing, this manifests itself in a clear preference for "good" companies – those with a recent history of strong execution and a seemingly straightforward path to growth – over "bad" companies that have faced recent challenges or whose path to

growth is less clear. This certainly holds some intuitive appeal: who wouldn't rather invest in good companies doing good things? But investing isn't just about identifying strong and weak businesses – frankly, that's the easy part. Valuation forces us to evaluate how strong or weak a business is *relative to expectations*. And this is where we get into trouble: as humans, we seem naturally inclined to overestimate the future prospects of "good" companies and underestimate the future prospects of "bad" companies, resulting in the associated securities becoming over-/undervalued relative to more realistic expectations. If you believe, as we do, that investors are hard-wired to underestimate the future prospects of "bad" companies and/or overestimate the future prospects of "good" companies, it still makes sense to look for investment opportunities among the market's bottom-dwellers. Human nature doesn't change that quickly.

We will go one step further and posit that after the recent draught, value investing should be poised for strong outperformance in the coming years. The reason: *relative* valuation. Relative to "growth" stocks, "value" stocks are currently trading at extremely depressed levels based on historical relationships.

Research Affiliates recently performed a study comparing the relative valuation of the cheapest 30% of stocks to the most expensive 30% of stocks using two different valuation measures: the common Price/Book Value measure, and a more comprehensive measure that included Price/Book Value, Price/Earnings, Price/Dividends, and Price/Sales.[i] They tracked these portfolios starting in 1967 to see how the aggregate valuation measure of the "value" portfolios compared over time to the aggregate valuation measure of the "growth" portfolios. The resulting "valuation spread" was expressed as a ratio: essentially, the average Price/Book Value (or the more comprehensive measure) of the most expensive 30% of stocks divided by the average Price/Book Value (or the more comprehensive measure) of the cheapest 30% of stocks. So, where does the current valuation spread lie? Based just on Price/Book Value, the spread is in the 4th percentile – "value" stocks have only been this cheap relative to "growth" stocks 4% of the time over the last fifty years! Based on the more comprehensive value measure, the spread is in the 14th percentile – still quite cheap. Moreover, the study exposed a strong relationship between starting relative valuations according to the measures above and subsequent relative performance: when "value" started out cheap relative to "growth," it tended to outperform over the subsequent five years, and vice versa. If the historical relationship holds, "value" would be expected to outperform "growth" by nearly 8% a year for the next five years based on the current valuation spread. While we do not expect history to repeat itself exactly, we are big believers in mean reversion when it comes to this type of broad relative valuation. Now is not the time to abandon value investing; if anything, now is the time to tilt portfolios toward value.

Read more about Value & Growth in part 1 of this series.

[i] Research Affiliates: "Reports of Value's Death May Be Greatly Exaggerated." January 2020.

Disclosures

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