Second Quarter 2018 Market Wrap – Is Value Investing History?

There was a lot of noise bombarding the market during the second quarter of 2018 between trade-war posturing and tariffs, rising energy prices and changes in the market's estimation of the Federal Reserve's tightening timelines. Growth and small cap stocks continued their recent outperformance over large cap value stocks as investors piled into tech stocks after positive earnings and strong guidance, and small caps benefited from the perception that they are more insulated from trade issues due to their greater percentage of domestically-generated revenues.

Small Cap versus Large Cap

Small cap stocks were also seen as benefiting more than large cap stocks from the Trump tax plan given that profits on small caps' larger percentage of domestically-generated income would be taxed at 21% under the new tax plan rather than the 35% under the prior tax code. However, this tax savings should have already been baked into current stock prices as the tax plan was approved during the last days of 2017. More importantly, small caps are viewed as less affected by trade issues due to less activity in global markets. However, this advantage is mitigated somewhat since small cap companies are often within the supply chain of larger, global companies and will eventually feel the pinch of any slowdown in international trade. The Russell 2000 index of small cap stocks was up 7.66% (from FTSE Russell Index Calculator) for the first half of 2018 while the S&P 500 index was up only 1.67%.

What is a "Value" stock and why would I want one (or a portfolio full of them)?

There has been much written recently about the underperformance of value strategies versus growth strategies. Growth strategies' returns have been fueled in no small part by the mega-cap tech stocks like Facebook, Apple, Amazon, Netflix and Google (Alphabet). The chart below provides a comparison of the performance of the Russell 1000 Growth and Value indices vis-a-vis everyone's favorite benchmark, the S&P 500 Index.

	S&P 500	Russell 1000 Value	Russell 1000 Growth
3 Mos. Ended 6/30/18	2.93%	1.18%	5.76%
6 Mos. Ended 6/30/18	1.67%	-1.68%	7.56%
2017	21.83%	13.66%	30.21%

**S&P 500 returns calculated from data marketwatch.com and Russell returns from ftserussell.com*

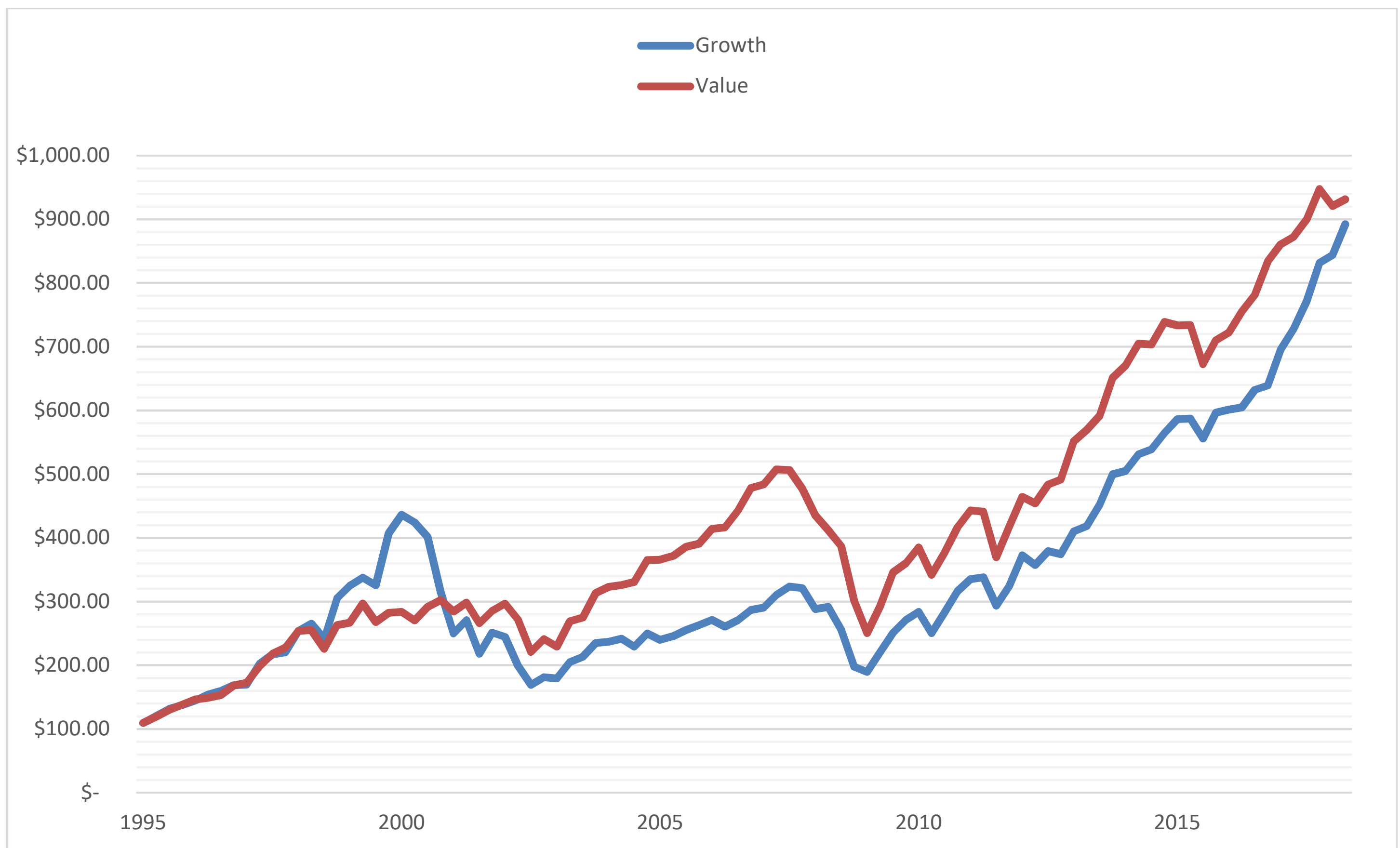
As the chart indicates, for the first six months of 2018, the Russell 1000 Value Index ("RLV"https://www.ishares.com/us/products/239708/?referrer=tickerSearch) was *down* 1.68% while the Russell 1000 Growth Index ("RLG") was up 7.26%, and this on the heels of 2017's huge outperformance. This is a meaningful differential and will again call into question the teachings of Benjamin Graham (considered by many to be the "father of value investing") on value investing versus speculation (more on that layup later).

This disparity also echoes the period leading up to the internet bubble, where any company attaching a "dotcom" or "web" to their name or strategy saw their stock rise to the heavens. Long story short, that didn't end well. The water-cooler braggards had their comeuppance.

WARNING – This next section may cause extreme drowsiness! Unless you want my take on the issues with "Style" indices, the history of Growth V. Value and why active investing still has merit, skip to the last two paragraphs.

Below is a graph (quarterly return data downloaded from http://indexcalculator.ftse.com/ICStep4Series.aspx) charting the performance of both the Russell 1000 Growth and Value indices for each quarter from January 1995 through the most recent quarter-ended June 2018. As you would expect, Growth showed tremendous outperformance from 1995 through the quarter before the internet bubble popped in 2000. From that point through the 2nd quarter of 2007, Value outperformed Growth by an enormous margin as Growth declined by 27% while Value increased by 88%! Although both indices were destroyed during the period from 2007-2009, the rout in banks, insurance companies among other value sectors during the "Great Recession" narrowed the Value surplus until the recovery in stocks started in 2009 and Value started to once again extend its outperformance which continued modestly until the end of 2016.

Since the Trump election victory, growth has dramatically outperformed value (yellow) and narrowed the 1995-2018 performance gap, which makes some sense as companies like Apple, Google, Microsoft and Facebook are among the most profitable and therefore will benefit from tax cut and repatriation relief and they should also be somewhat protected from the effects of our trading partners' retaliatory measures. While the trade policy agenda that was central to Trump's campaign seemed designed to protect companies and jobs in energy and industrial businesses that clearly fall into the Value camp, the retaliation, by intent or coincidence seems designed to hurt the states and industries that have been most supportive of Trump.



As stated on the FTSE/Russell website (http://www.ftserussell.com/index-series/index-spotlights/us-equity-indexes/keep-it-simple-russell-us-style-indexes) *Russell builds the growth and value indexes using three highly representative characteristics: Value as determined by Book-to-Price ratio (B/P), and Growth as determined by I/B/E/S earnings growth rate two-year forecast + Sales-per-share five-year historical sales.* The website also states that many stocks exhibit characteristics of both growth and value so many are included in both the value and growth indices. The total weightings are calculated such that the sum of their weightings will equal 100% of what their market capitalization weighting is in the Russell 1000 Index. Apple (AAPL), as the company with the largest market capitalization would therefore be the largest component overall and happens to be the largest component of the Growth Index while JP Morgan is the largest component of the Value Index. Financial, Healthcare and Energy are the top 3 Value sectors while Technology, Consumer Discretionary and Producer Durables are the top three Growth sectors.

There is clearly a meaningful subset of companies included in the Russell 1000 Index that exhibit sought after qualities of both value and growth investors. A portfolio of 30-50 such securities spread across industries would provide more than adequate diversification to basically eliminate all but general market risk. The issue I have with "Value" being solely a function of "Book-to-Price" ratio, is that book value doesn't tell the story of the earnings capacity of the assets. Items like goodwill and other intangible assets are included in book value and are more prevalent in technology and healthcare companies than industrials whose assets are made up of more property, plant and equipment ("PPE"). At least if the goodwill attached to an acquisition isn't performing, the company must annually determine the fair value of that goodwill. If that fair value is lower than the value currently on the books, they must take an impairment charge resulting in lower earnings for the year and a commensurately reduced book value. Industrial companies whose return on assets (effectively PP&E) are low will normally just continue to depreciate those assets at the same rate they would if those assets were producing great returns. No matter how poorly this type of company performs, they may remain a "Value" investment?

In my estimation, the more compelling and clear reason that Value Indices outperform over long periods of time is that when the indices are periodically reconstituted, the lower the stock price relative to book value, the higher the proportion that will go into the Value Index pursuant to the index's formula. Therefore, stocks that decline in value with no fundamental book deterioration (blowout sale!!!) then fall into the crosshairs of astute value investors. Growth criterium are based solely on growth with no consideration of stock price so overpriced stocks will end up in this basket. In hindsight, owning Netflix and Amazon since 2010 would have been brilliant. These are indeed great companies presenting great value to consumers and they have continually disrupted industries. However, being a great company and being a great investment does depend on valuation. At multiples of over a hundred times earnings, any market correction may prove painful for those holding such richly valued stocks. On the other hand, tech companies such as Apple, Facebook and Alphabet don't trade at extreme multiples of earnings and cash flow, especially considering their history of top and bottom-line growth and balance sheet strength.

CONTINUE HERE!!!

When trying to describe how I select stocks for my clients' portfolios, I tend to use the term "value" quite often. My perception of value is buying a company at materially less than what I believe its intrinsic worth to be relative to the valuation of the overall market (the opportunity set). Market risk can be hedged at a cost, which is usually reasonable when the market is heading up and everyone is fat and happy. As you are aware, you can't buy home insurance during a hurricane and you pay through the nose for portfolio protection when fear takes hold of the markets. Getting back to value, I believe intrinsic value is determined by both what is on the balance sheet and what the income and cash-flow

statements report. If a company can't generate profits from the assets utilized in operating their business, then why should I assign meaningful value to those assets just because the company (over)paid for those assets? That's bad capital allocation and a sign of poor senior management. Proven organic growth and smart acquisitions are clearly evidenced by financial results and while I like to think of myself as an astute analyst able to assess a company's prospects long into the future, that would represent a foolhardy exercise in speculation on my part. Historical financial statements usually don't lie, although Enron, Worldcom et al were cleverly concealed exceptions to that argument, aided by beyond lax and criminal auditing. And that is a natural lead in to my next investment tip: invest in businesses you can understand.

Warren Buffett and other thoughtful disciples of Graham have done much better for themselves and their investors than the dude chasing the shiny object of the moment (Bitcoin or Lotto anyone? Maybe Pets.com?). Buy stocks of companies when they are on sale. Stocks prices are nearly always in motion even when there is no incremental macroeconomic, industry or company-specific information that merits a reassessment of valuation and this movement creates opportunities to enter and exit investments. My thought is that when (not if!) I'm proven correct, markets will realize the grievous mispricing that presented my opportunity and move stocks to a price more in line or even above my view of intrinsic value (the pendulum always swings beyond where you expect in both directions) resulting in profitable investments. If this investment methodology works frequently enough, my asset management services will represent a great VALUE and your portfolios will experience GROWTH! Who doesn't want the best of both worlds?

As always, comments and discussion are welcome.

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