The state of value investing today: Where are we in the cycle, and what do we see ahead?

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Value indices have underperformed growth indices for the past eight years.[1] Naturally, this leads to questions about when the tide may turn back in favor of value. When answering these questions, it helps to look at history. In this paper, I will examine past periods of sustained outperformance for both investment styles – which eventually inflected in favor of the other style – and discuss some of the key factors that I believe will influence performance the next few years.

Three decades of shifting style outperformance

Looking at the past 30 years, we have experienced three distinct periods.

- The first, from 1989 to 2000, was highlighted by the Savings and Loan Crisis at the beginning of the period and the technology momentum boom at the end of the century.
- The second period, from 2000 through 2007, favored value indices as the technology momentum run of the late 1990s fizzled and investors moved back to other traditionally cyclical sectors that were selling at large historical discounts. A few specific sectors that outperformed others during this period were banks and energy, which were left for dead in comparison to the exciting technology stocks of the late 1990s.
- The third period, from 2008 to 2015, preceded the US financial crisis and the energy sector's large run, and was dominated by growth companies and stable companies with less cyclical characteristics.

Value and growth outperformance has moved in cycles
Russell 1000 Value Index, Dec. 29, 1978, to June 30, 2016 (monthly)

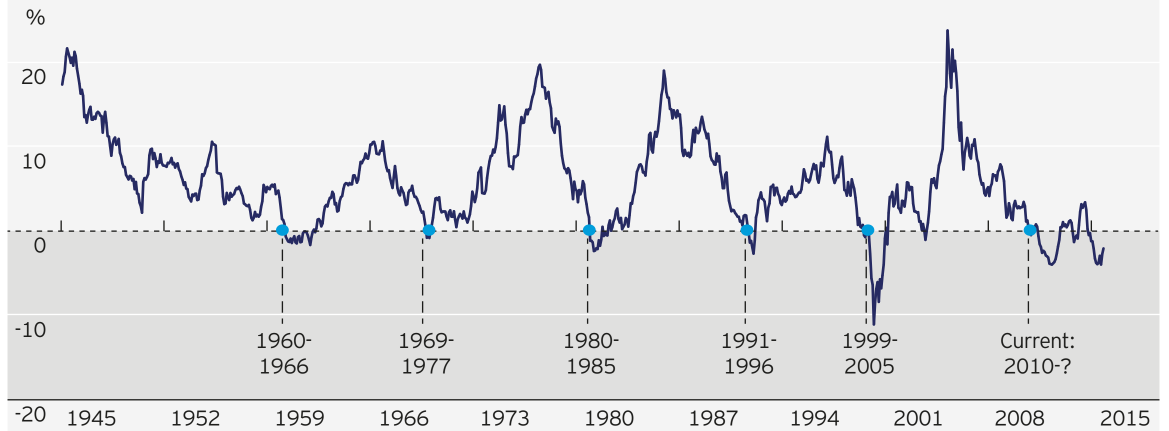
Source: FactSet Research Systems, Inc.

Looking at the data through rolling five-year periods further highlights the cyclicality of style performance. Every time growth has outperformed value, the value style staged a significant recovery.

1 The value index is represented by the Russell 1000 Value Index and the growth index is represented by the Russell 1000 Growth Index. An investment cannot be made directly in an index.

Value comebacks have historically followed growth outperformance
Each time value has had a significant recovery

■ Value vs. growth (annualized five-year rolling value outperformance)



Source: Copyright 2016 Kenneth R. French at http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/ as of Dec. 31, 2015. All performance information is hypothetical and not the actual performance of an investment in a fund. Historical performance is not necessarily indicative of future performance. The chart above plots the trailing five-year annualized return of a hypothetical portfolio. When value stocks outperform, the lines go up. When growth outperforms, the lines go down. A value stock is defined as one having low Book Equity to Market Equity. In this case, we are looking at the relative performance of the 20% least expensive companies in relation to the 20% most expensive companies. All returns are compounded monthly.

Energy and financials: The keys to a value resurgence

Historically, energy and financials have been well-represented in the Russell 1000 Value Index, especially when measured against its growth counterpart. In December 2008, financials and energy accounted for 24% and 17.3% of the value index, respectively. By comparison, their representation in the Russell 1000 Growth Index was meaningfully lower at 4.4% and 8.4%, respectively.

Fast forward to June 2016, and the exposures are even more starkly contrasted. As of June 30, 2016, the Russell 1000 Value Index's respective exposure to financials and energy was approximately 27.4% and 13.4%. The Russell 1000 Growth Index's financial exposure was similar at 4.2%, but its energy exposure was only 0.5%. Simplistically, it stands to reason that any recovery in value investing will be led by a recovery in these two important sectors. The charts below show the historical performance of the sectors relative to the S&P 500 Index.

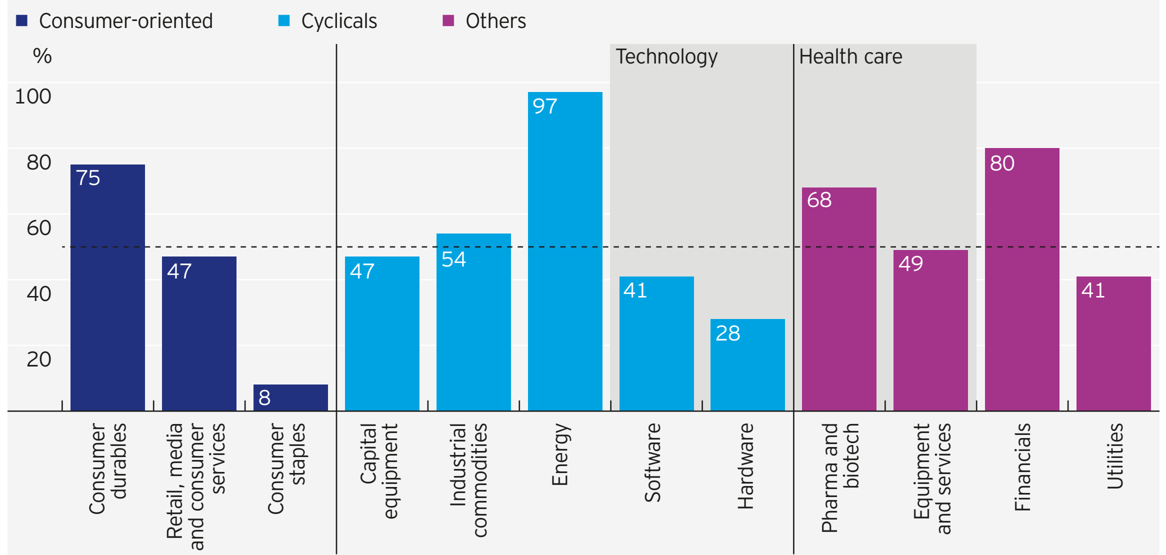
Since 2008, financials have generally underperformed the broad market
S&P 500 Index/financials sector, Dec. 31, 2007, to Aug. 2, 2016 (daily)

■ Relative strength to S&P 500 Index

Source: FactSet Research Systems, Inc. Data as of August 2016. Past performance cannot guarantee comparable future results. An investment cannot be made directly in an index.

Source: FactSet Research Systems, Inc. Data as of August 2016. Past performance cannot guarantee comparable future results. An investment cannot be made directly in an index.

When valuation dispersions widen out within a sector is when extreme value is represented and we see more opportunities present themselves. Looking at sectors through that lens, we see that energy and financials have rarely shown more opportunity than they do today. The chart below examines the valuation spread between the cheapest and most expensive stocks within each sector on a monthly basis from 1950 through July 2016. With energy, for example, the bar is at 97%. That means that energy's valuation dispersion is wider today than it was during 97% of the months in this time frame.



Source: Empirical Research Partners Analysis.

1 Based on an analysis of a 1,500 stock universe. Framework varies across sectors depending on what's efficacious. Data for pharma and biotech is based on the large-cap universe since 2000.

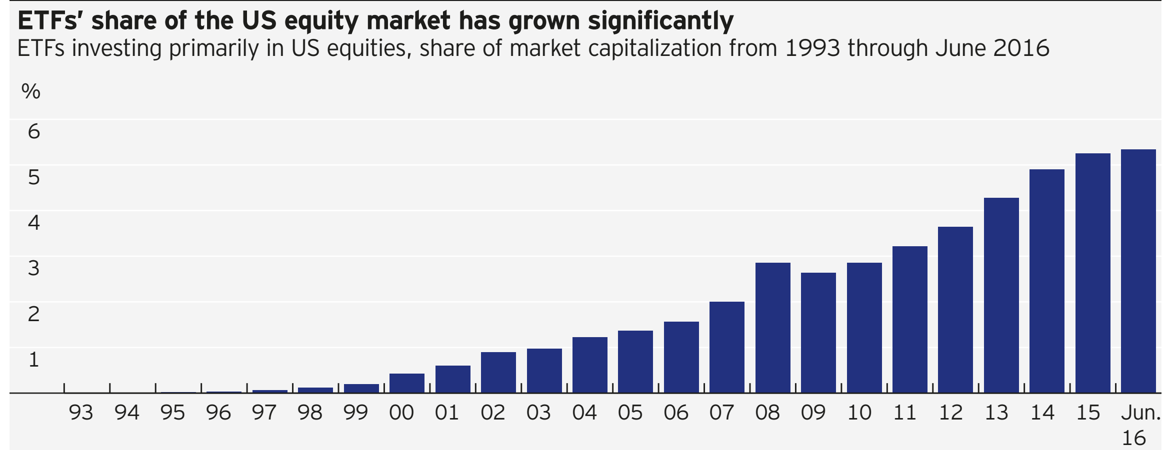
The ‘hedge fund and ETF influence’

The question for investment managers, of course, is why are these sectors trading at wide dispersions and what are the key factors that will determine whether they can revert to more normalized historical valuation levels.

One phenomenon that has been written about recently is the growing influence of hedge funds and exchange-traded funds (ETFs) on the markets. The percentage of investments in ETFs has gone up significantly the last 10 years. Additionally, hedge funds have become a greater percentage of the equity markets as well, and their investments in recent years have moved toward large-cap stocks with strong growth characteristics.

ETFs’ share of the US equity market has grown significantly

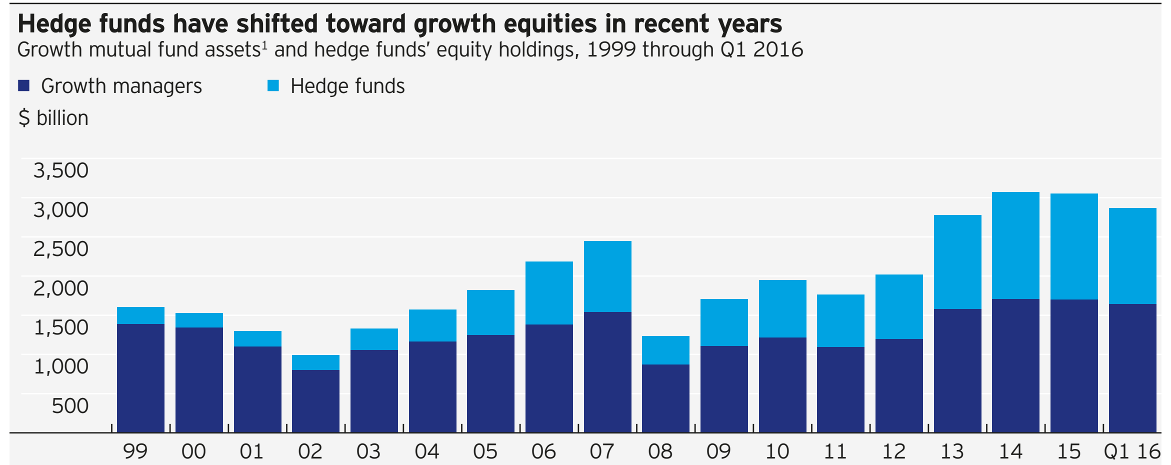
ETFs investing primarily in US equities, share of market capitalization from 1993 through June 2016



Sources: Strategic Insight Simfund, FactSet Research Systems, Inc., Empirical Research Partners Analysis

Hedge funds have shifted toward growth equities in recent years

Growth mutual fund assets[1] and hedge funds’ equity holdings, 1999 through Q1 2016



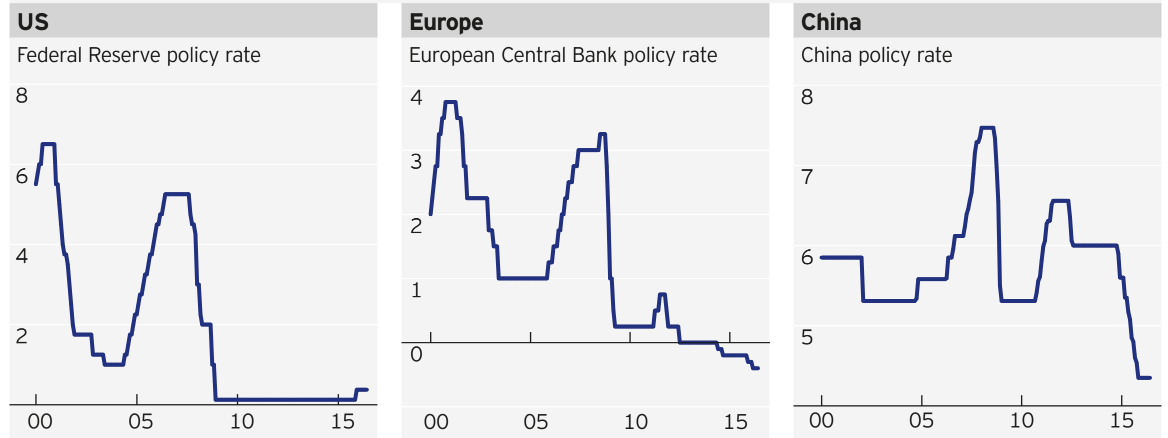
Sources: 13F Filings, Strategic Insight Simfund, Empirical Research Partners Analysis

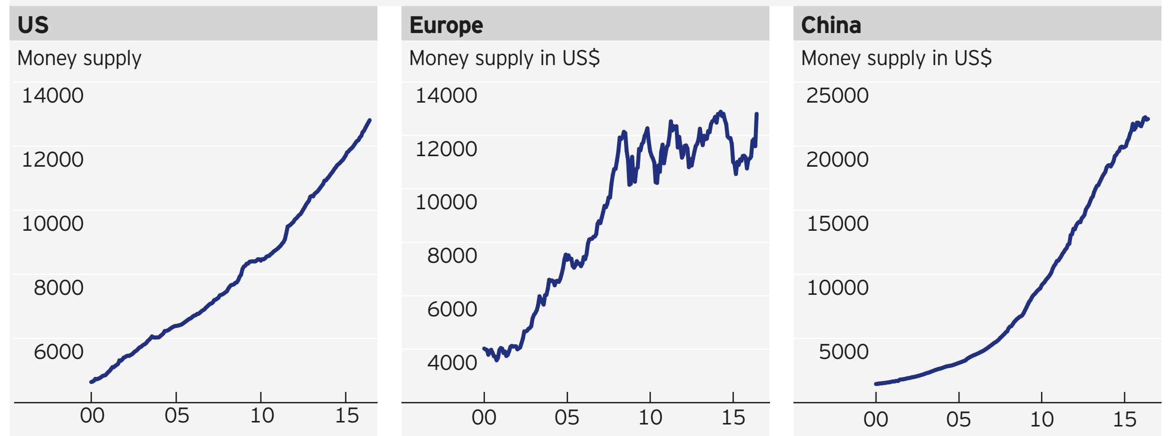
1 Includes growth and aggressive growth equity mutual funds.

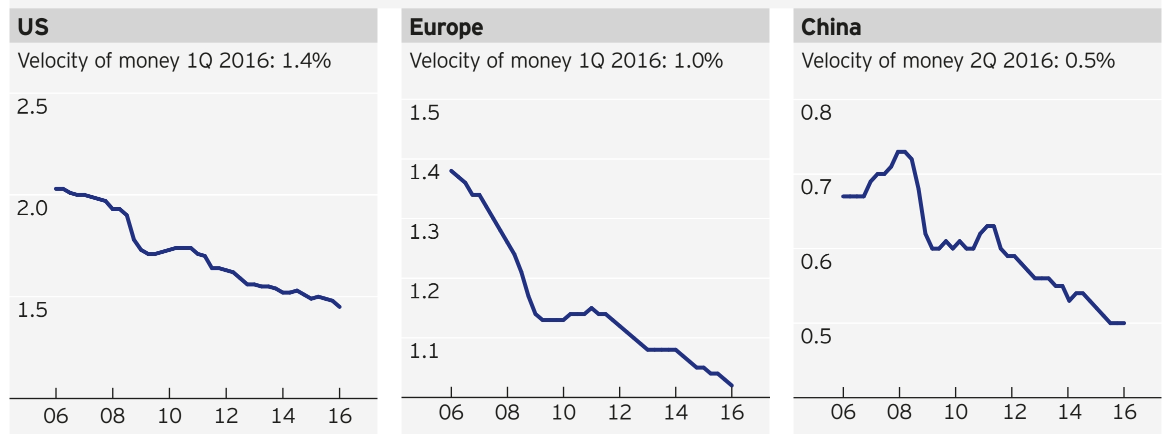
It is our view that all this points to a market that has become even more impatient and short-term focused than it has been in the past. Combine this with the fact that the world suffered through a major financial crisis in 2008 and you have a very nervous investor base looking for safety and less willing to take risk. Intuitively it makes sense that this extreme aversion to risk should create periods where certain stocks and sectors become more undervalued or overvalued than in the past as investors are unwilling to be contrarian. This may create more opportunities for investors, but they must be even more patient and longer-term focused than they were in the past, when the market was less globally influenced and didn’t have the memory of a major financial crisis in the rearview mirror.

Key issues for the next three to five years

As we look to the future and what might happen over the next three to five years, there are several key issues to contemplate. The market is in a period that is not familiar or comfortable for investors. Interest rates are very low across the globe, and so are economic growth rates. We have seen money supply accelerate in many countries since the financial crisis with little effect on inflation — which seems counterintuitive. Additionally, money velocity, which is central to igniting economic growth and subsequent inflation, is near all-time low levels.





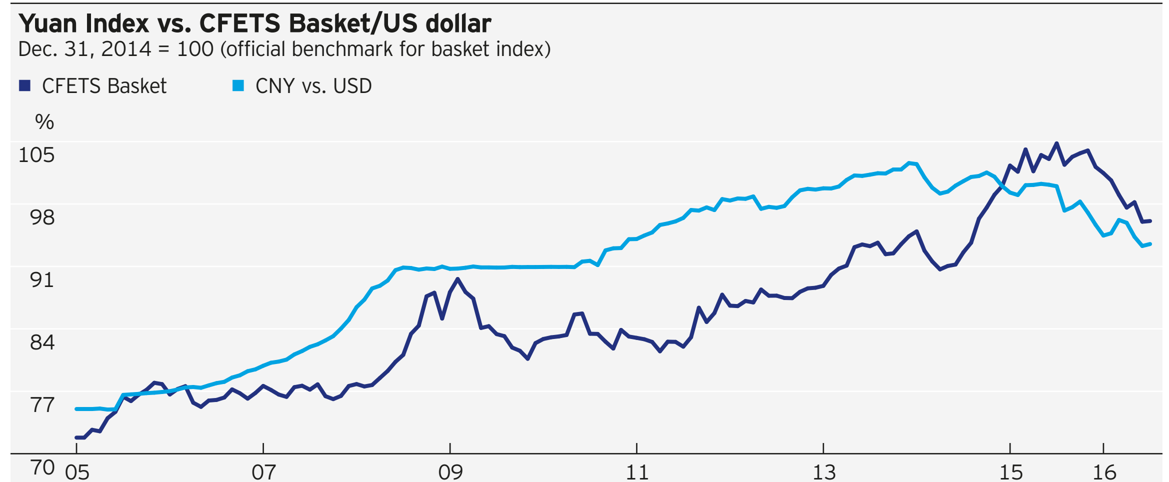


Source: Evercore ISI (EVRISI). Data as of Aug. 1, 2016.

What has become particularly troubling for the US Federal Reserve is its role in the global economy and the effect the dollar has on various other currencies and their economies. The most obvious example of this is China, where historically the yuan had been tied to value of the US dollar. This created problems for China as its exports became more expensive versus other emerging market exporters between 2006 and 2014 due to the yuan-dollar tie. This factor has limited the Federal Reserve's ability to raise interest rates for fear of instigating a currency war and possibly an emerging markets debt crisis.

In December 2015, China began valuing the yuan against a basket of 13 different currencies instead of just the US dollar. The good news is that since 2015, the Chinese government has actively devalued the yuan by about 10% versus the US dollar and its newly targeted basket of currencies.

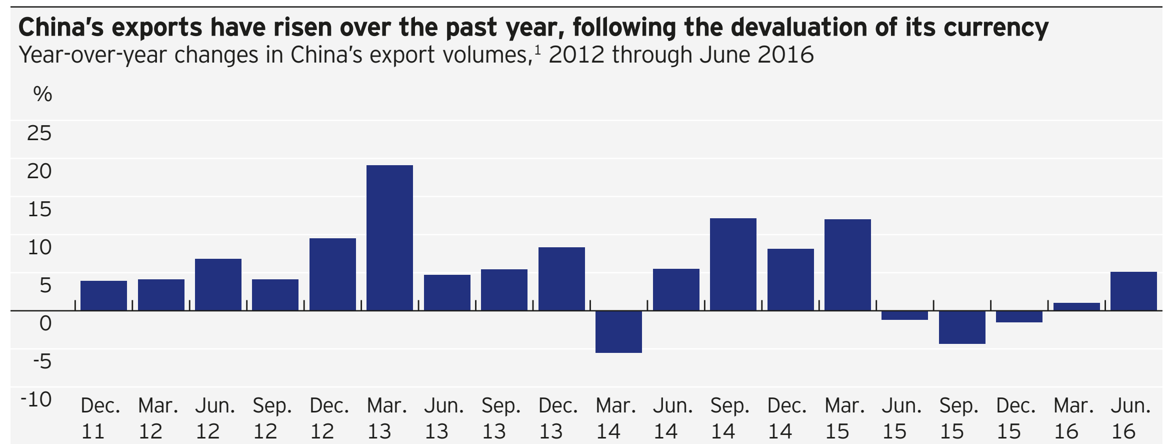
Yuan Index vs. CFETS Basket/US dollar
Dec. 31, 2014 = 100 (official benchmark for basket index)



Sources: State Administration of Foreign Exchange, Bloomberg L.P., EVRISI calculations. Data as of Aug. 1, 2016.

This devaluation has improved China's export share recently, which will hopefully help to stabilize economic growth in China. Only time will tell whether China has devalued enough. If in fact China's export share moves to consistently positive territory, then the Federal Reserve can possibly raise US interest rates without fear of causing further instability in China and potentially inciting an emerging market currency war and debt crisis.

China's exports have risen over the past year, following the devaluation of its currency
Year-over-year changes in China's export volumes,[1] 2012 through June 2016

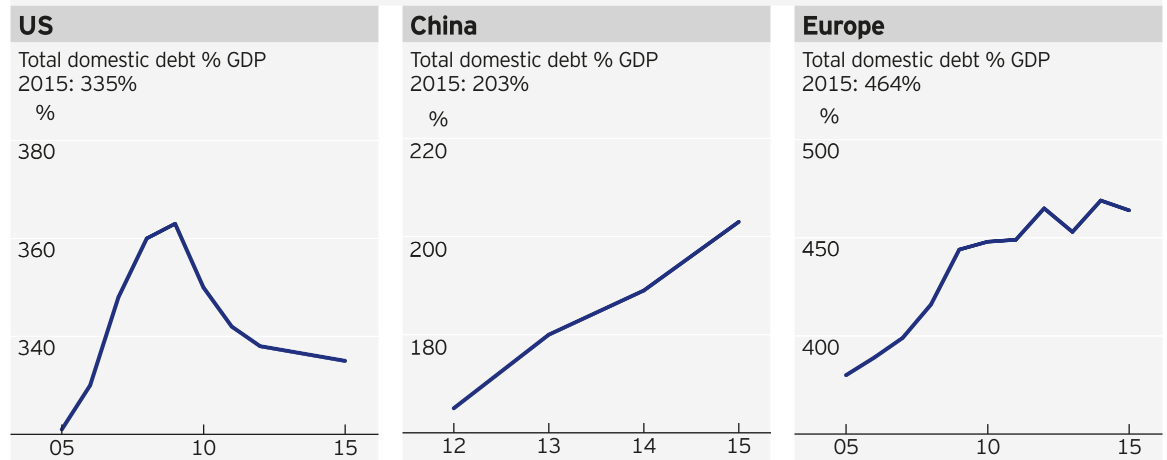


Sources: CEIC, Empirical Research Partners Analysis

1 Three-month average.

The key question now is what governments can do around the world to reignite global gross domestic product (GDP) growth. It appears that central banks have reached the limit of their influence, with very low interest rates in many countries and negative rates in some regions. This points to a severe problem: What can be done to increase money velocity and get the global economy back on firmer footing? The answer lies in the will of governments around the globe to implement fiscal reform. This can take place through infrastructure spending by governments, although many countries are already heavily indebted, or through corporate tax incentives and cuts. Additionally, governments could ease certain regulations so that companies feel confident enough to increase investment and hire additional employees. Hopefully, these stimuli would help incentivize global economic growth through capital investment and new job creation.

Infrastructure spending could help the global economy, but global debt levels may prevent that as a broad solution

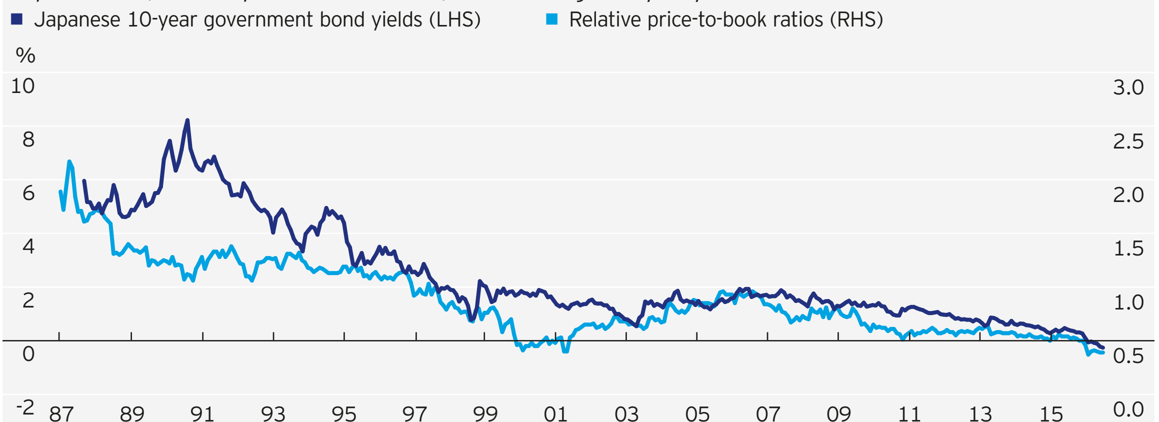


Source: Evercore ISI

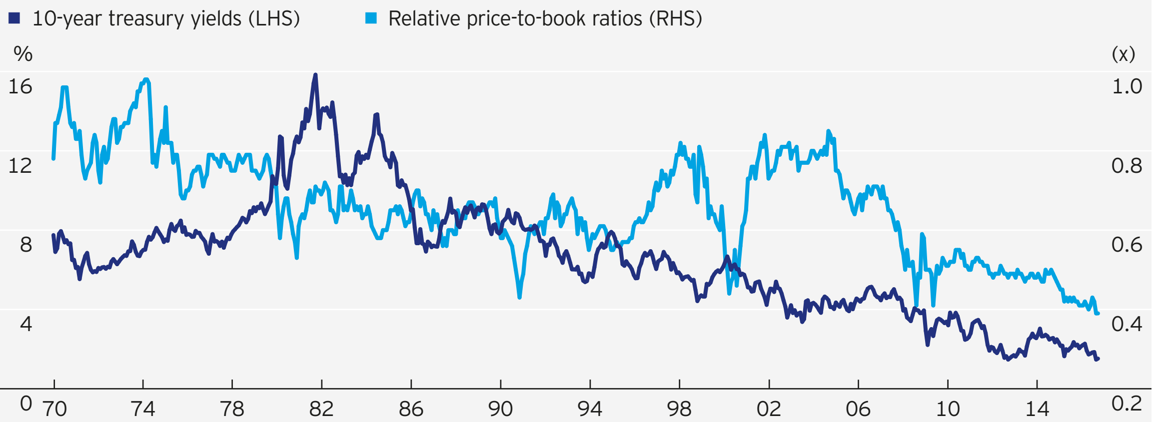
One group that appears numerically inexpensive is US banks. Their profitability has been impaired since the financial crisis, although valuations seem to more-than-reflect the fundamentals. The charts below show long-term interest rates of Japanese banks and US banks and their respective price-to-book valuation multiples versus their local market. Japan has been in a deflationary period for many years as depicted by rates and bank valuations. Now, somewhat surprisingly, US banks are at similar valuation levels even though interest rates are negative in Japan and positive in the US.

Despite disparate interest rate environments, US and Japanese banks are at similar valuation levels compared with their local markets

Japan: Banks, relative price-to-book ratios, 1987 through early-July 2016

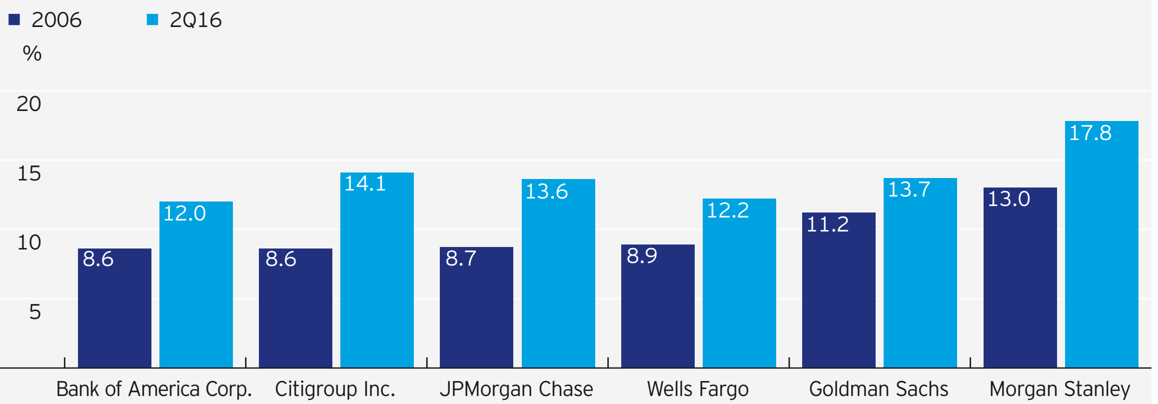


Sources: Corporate Reports, Bloomberg L.P., Empirical Research Partners Analysis



Sources: Corporate Reports, Bloomberg L.P., Empirical Research Partners Analysis

Why is this? The market appears to be discounting the possibility of US rates trending lower and a period of sustained global deflation. This is possible, but there are many differences between Japan and the US in terms of demographics and a more dynamic US economy. One key differentiating point is the relative strength of US bank balance sheets. After the crisis, the Federal Reserve acted swiftly to recapitalize the banking system, require that banks retain more capital, and limit the leverage these institutions could use. Financial stocks are hurt significantly by low rates as their ability to generate income on their bond portfolios is nearly impossible in this rate environment. Each time the global economy has had a negative data point, such as the China devaluation or the Brexit vote, the market fears that the Federal Reserve will need to keep rates lower for longer to further stimulate global growth.

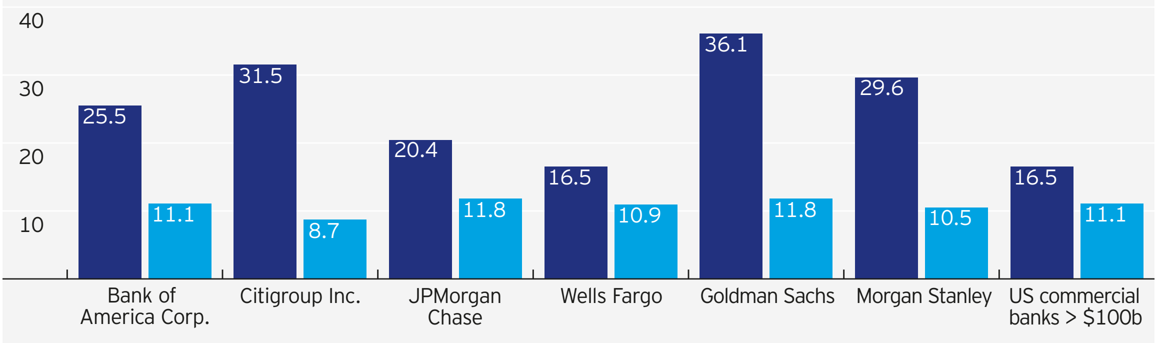


Source: Morgan Stanley. Results for Goldman Sachs and Morgan Stanley exclude the effects of TARP in the first quarter of 2009, and also results in the second quarter of 2016.

US bank leverage ratios are lower now than before the financial crisis

Tangible assets/Tangible equity

■ 2007 ■ 2016



Source: Morgan Stanley

The key now is that US banks are at considerably higher capital levels and much lower balance sheet leverage ratios. This should likely prevent another crisis similar to 2008-2009. In fact, many of the banks are considerably overcapitalized as the Federal Reserve determined in its annual Dodd-Frank Act Stress Test results in June. As seen below, these results show that the four largest banks and two largest investment banks now have enough capital in excess of the Federal Reserve's very high limits that they could repurchase between 16% and 42% of their outstanding equity. Even if the Federal Reserve accesses G-SIB buffers,[1] which is quite likely, these six institutions should be considerably overcapitalized, which creates a very attractive investment assuming the Federal Reserve continues to loosen share repurchase restrictions through the annual Comprehensive Capital Analysis and Review (CCAR) evaluation.

2016 Dodd-Frank Act Stress Test results were positive for large US banks

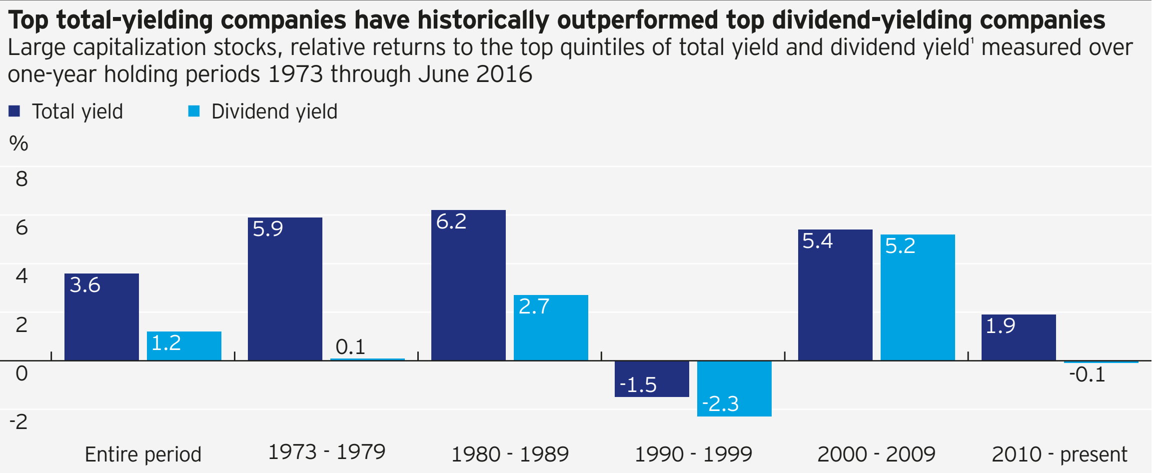
	Excess capital ($ billion)	**Market cap ($ billion)**	**Excess capital % of market cap**
Citigroup	53.5	127.0	42
JP Morgan Chase	56.3	233.0	24
Bank of America	54.8	148.0	37
Wells Fargo	39.3	242.0	16
Goldman Sachs	21.7	66.0	33
Morgan Stanley	16.5	55.0	30

Sources: Morgan Stanley and FactSet Research Systems, Inc.

When studying the market over a very long period, we see that one of the most attractive investment screens historically has been total yield, which combines a company's dividend yield and its annual share buyback as a percentage of total market capitalization. This historically has been more powerful than either capital return measurement used in isolation. At this point, there is a disproportionate number of banks in the top quintile of the US market, which historically has signaled a very attractive entry point. The market appears to be worried that share buybacks will be value-destructive even at stock valuations that look historically quite attractive. We believe this has created an attractive risk/return profile. The downside is if global deflation does get worse, it could take longer for this anomaly to revert to long-term average valuation levels. The good news is the US banks are now cheaper than their Japanese counterparts, which to us further builds their investment case.

1 G-SIB buffers are additional capital that may be required due to a designation as a global systemically important bank.

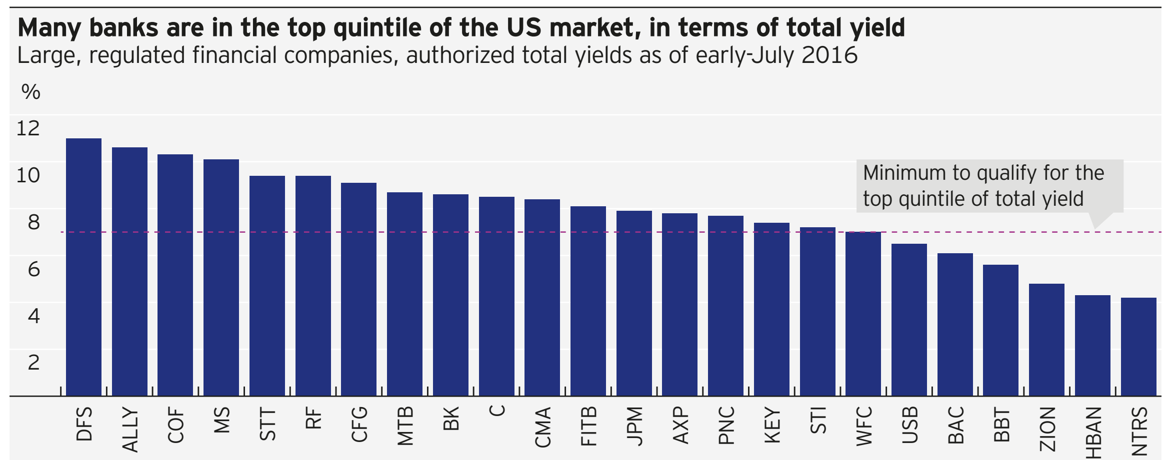
Top total-yielding companies have historically outperformed top dividend-yielding companies
Large capitalization stocks, relative returns to the top quintiles of total yield and dividend yield[1] measured over one-year holding periods 1973 through June 2016



Source: Empirical Research Partners Analysis

1 Equally-weighted data.

Many banks are in the top quintile of the US market, in terms of total yield
Large, regulated financial companies, authorized total yields as of early-July 2016



Sources: Federal Reserve Board, Empirical Research Partners Analysis

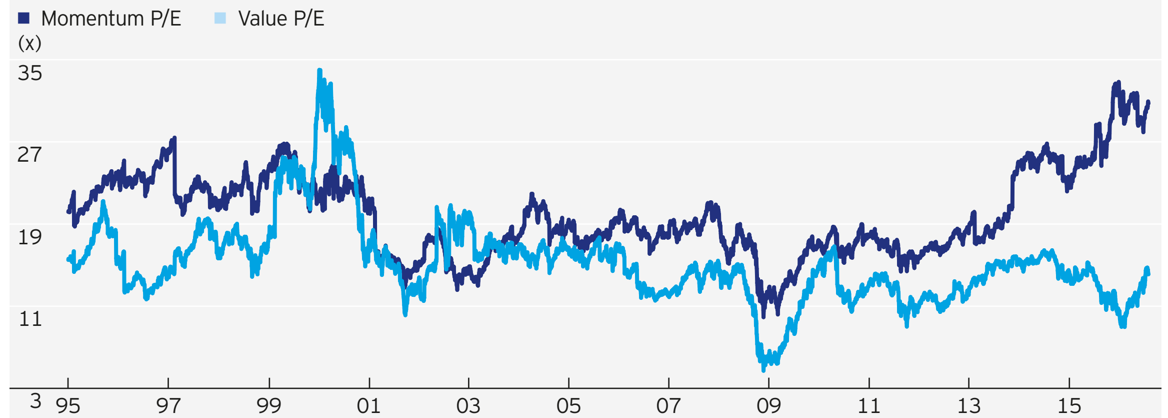
The leadership in the market has resided in stable industries, and they have become quite expensive on a historical basis. These are quality, relatively predictable companies, but with somewhat limited top-line and earnings growth profiles. They are selling at valuations versus more cyclical industries that we have not seen in modern history. This is because we are in a period of very low global economic growth, and investors fear a period of sustained deflation and very low interest rates. Investors now want not only predictability but also dividend yields, which help investors generate the income that is no longer available in bonds due to historically low interest rates. Using history as a guide, economic cycles normally reignite and cause valuations to normalize, but the market fears poor global fiscal policy will cause a long period of suboptimal economic growth. Only time will tell.

Defensive sectors have meaningfully outperformed cyclical sectors

Russell 1000 Index cumulative relative return -- defensive vs. cyclical

Sources: Invesco, Russell. Defensive = consumer staples, health care (ex-biotech), telecommunication services, utilities, REITs. Cyclical = all other sectors/industries. An investment cannot be made directly in an index. Data as of Aug. 1, 2016.

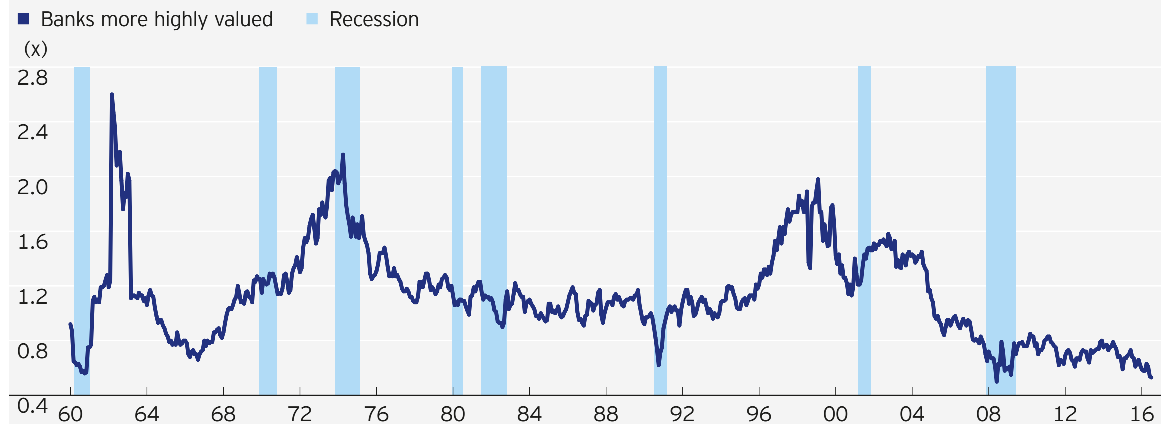
The valuation gap between value stocks and momentum stocks is historically wide



Source: Cornerstone Macro. Data as of Aug. 1, 2016.

Banks are particularly undervalued compared with utilities, illustrating the value/momentum gap

Large-cap banks relative to utilities, ratios of price-to-book ratios,[1] 1960 through July 2016



Sources: Corporate Reports, National Bureau of Economic Research, Empirical Research Partners Analysis

1 Capitalization-weighted data

Conclusion

Low global growth, low interest rates and the memory of the 2008 financial crisis have contributed to a market backdrop that has been very conducive for growth indices beating value indices. Value investors typically are bottom-up stock pickers and are less influenced by global economic cycles or trends. Combine this with the fact that momentum this cycle is defined by stability, low bond rates and fears of deflation, and one can understand why certain stable sectors appear expensive and many cyclical sectors appear inexpensive.

As value investors, we are not here to call the trajectory of the global economy, but only to point out the bottom-up valuation disparities that present themselves today. It's our belief that even with the unsure global economic backdrop facing governments around the world, they will figure out effective fiscal reform to improve the current, very slow economic growth backdrop, and reversion to the mean will turn out to be alive and well in the equity markets. The question is how long must one wait, which requires a level of patience that most investors struggle to accept even though the risk/return relationship appears attractive for those who are patient enough to persevere.

About risk

The risks of investing in securities of foreign issuers, including emerging markets, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.
Growth stocks tend to be more sensitive to changes in their earnings and can be more volatile.
A value style of investing is subject to the risk that the valuations never improve or that the returns will trail other styles of investing or the overall stock markets.

Value investing may experience greater volatility than a more diversified investment.

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