

Brandes

observes:

## Valuations Matter

One of the dilemmas investors face is whether to emphasize “quality” or valuation when selecting securities.

New research from the Brandes Institute reveals over the past 30 years “quality” was a poor indicator of stocks’ return potential. The highest returns were more likely to be associated with stocks that were attractively valued.

### The Difference Between Value and Quality

Institute analysts classified mid-cap and large-cap stocks from 23 countries according to how they measured up to definitions of value and quality, and tracked their performance between 1980 and 2010.

The quality factors included debt to capital, earnings per share (EPS) stability, dividend per share (DPS) stability, return on invested capital (ROIC), return on equity (ROE), and sales growth. Companies were ranked from highest to lowest according to how well they fared for each factor and then divided into 10 groups. Stocks that fell into Group 10 (the top 10%) were the highest quality. The lowest-quality stocks fell into Group 1.

The same stocks also were ranked according to each of four common valuation factors: price-to-book (P/B) ratio, price-to-earnings (P/E) ratio, price-to-cash flow (P/CF) ratio, and dividend yield. Ten groups were formed for each valuation factor, with the most attractively valued stocks in Group 10.

Over the past 30 years “quality” was a poor indicator of stocks’ return potential.

Exhibit A: Valuation and Quality Factors

Valuation Factors			Quality Factors		
	Expensive	Attractive		Low Quality	High Quality
Group	1	10	Group	1	10
P/B	High	Low	Debt to Capital	High	Low
P/E	High	Low	5-Year EPS Stability	Low	High
P/CF	High	Low	5-Year DPS Stability	Low	High
Dividend Yield	Low	High	3-Year Avg. ROIC	Low	High
			3-Year Avg. ROE	Low	High
			3-Year Sales Growth	Low	High

Source: The Brandes Institute.

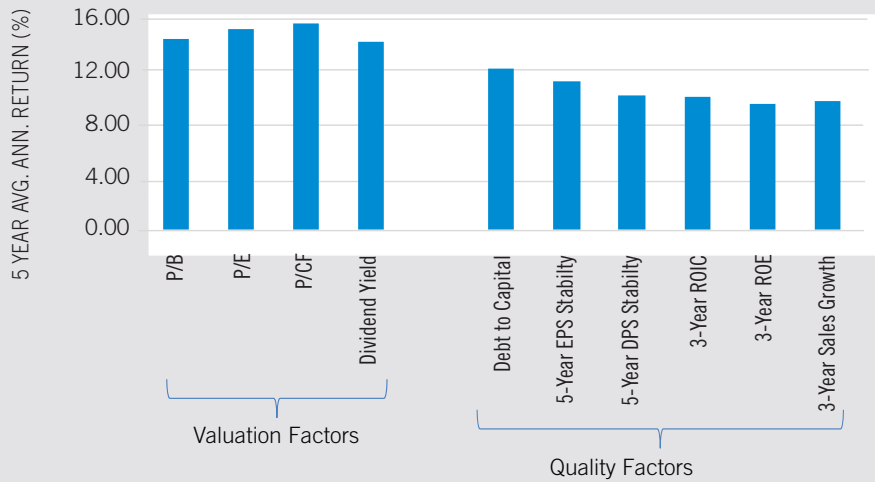


The investment performance of each group was tracked over 5-year periods beginning June 30, 1980. At the end of June each year, analysts re-ranked all available stocks (which grew from 226 in 1980 to more than 5,500 in 2006) according to the six quality factors and four valuation factors, and calculated the average return over the next five years. The final 5-year period ended June 30, 2010.

Exhibit B shows the clear performance advantage the group of most attractively valued stocks delivered. For example, the average of the 5-year returns across the most attractively valued (Group 10) factors was 15.1% versus an average of 10.6% for the high-quality (Group 10) factors.

### Exhibit B: Average Annualized 5-Year Returns for Most Attractively Valued and Highest-Quality Stocks (1980-2010)

Attractively Valued Stocks Had Better Returns Than High-Quality Stocks

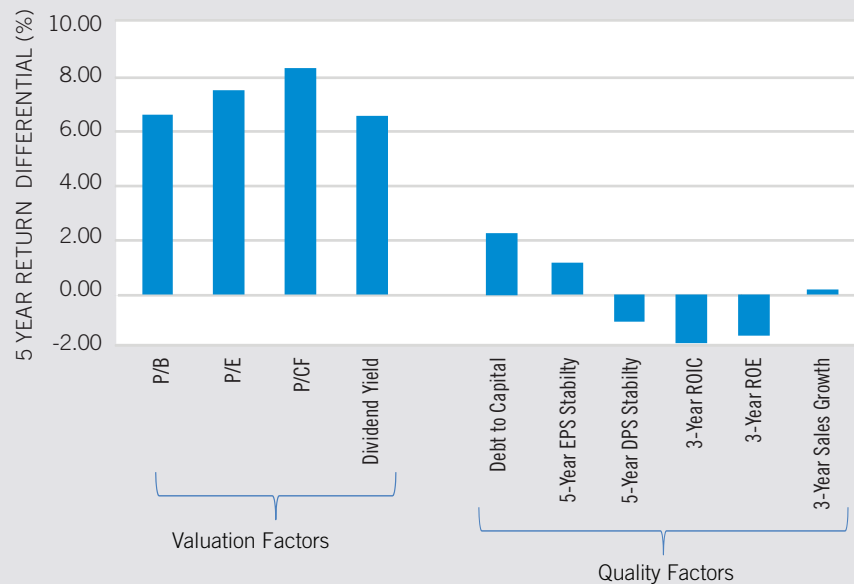


Source: Worldscope via FactSet, the Brandes Institute, as of 12/31/10. Past performance is not a guarantee of future results.

The study went on to examine the difference between how high-quality stocks performed relative to low-quality and how attractively valued stocks performed relative to expensive stocks. Exhibit C shows the difference in 5-year average annualized returns between the top and bottom groups. Here the performance advantage of attractively valued stocks is striking and clear. In fact, the stocks that had the lowest P/E ratio (Group 10) experienced an average 5-year return that was 6.9% greater than the stocks that had the highest P/E ratio (Group 1).

### Exhibit C: Average 5-Year Return Difference: Group 10 Minus Group 1 (1980-2010)

Valuation Measures Were Better Than Quality Measures at Distinguishing Outperformers



Source: Worldscope via FactSet, the Brandes Institute, as of 12/31/10. Past performance is not a guarantee of future results.

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The difference between the performance of high-quality and low-quality stocks was less clear. Notice that the stocks with the highest dividend stability, ROIC, and ROE actually underperformed their lower-quality counterparts— suggesting that buying low-quality stocks could have been a better investment strategy. Put another way, Exhibit C shows valuation metrics were better than measures of quality at differentiating future outperformers from future underperformers.

This research shows that valuations helped drive future returns. It also illustrates the dangers of overpaying for quality. Past performance is not a guarantee of future results, but selecting stocks on the basis of valuation has put the odds in the investor’s favor for delivering excess returns. Investing in high-quality stocks may sound promising, but applying a value-conscious approach over a broad group of stocks has proven to be the more rewarding strategy over time.

Price-to-Book (P/B) Ratio: Price per share divided by book value per share.

Price-to-Earnings (P/E) Ratio: Price per share divided by earnings per share.

Price-to-Cash Flow (P/CF) Ratio: Price per share divided by cash flow per share.

Dividend Yield: Annual dividend per share divided by price per share.

Debt to Capital: A company’s long- and short-term debt divided by its total capital, which includes the company’s debt plus shareholders’ equity.

Earnings Per Share (EPS) Stability: Measures the consistency of earnings growth and is calculated as the standard deviation of operating income over the past five years divided by the average operating income during that same period.

Dividend Per Share (DPS) Stability: Measures the consistency of a company's dividend payments and is defined as the standard deviation of dividends per share over the past five years divided by the average dividend per share during that same period.

Return on Equity (ROE): Net income divided by common equity, averaged over the past three years.

Sales Growth: Percentage increase in a company's sales over the past three years.

Return on Invested Capital (ROIC): Net income divided by debt plus shareholders equity, averaged over the past three years.

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