



Brandes

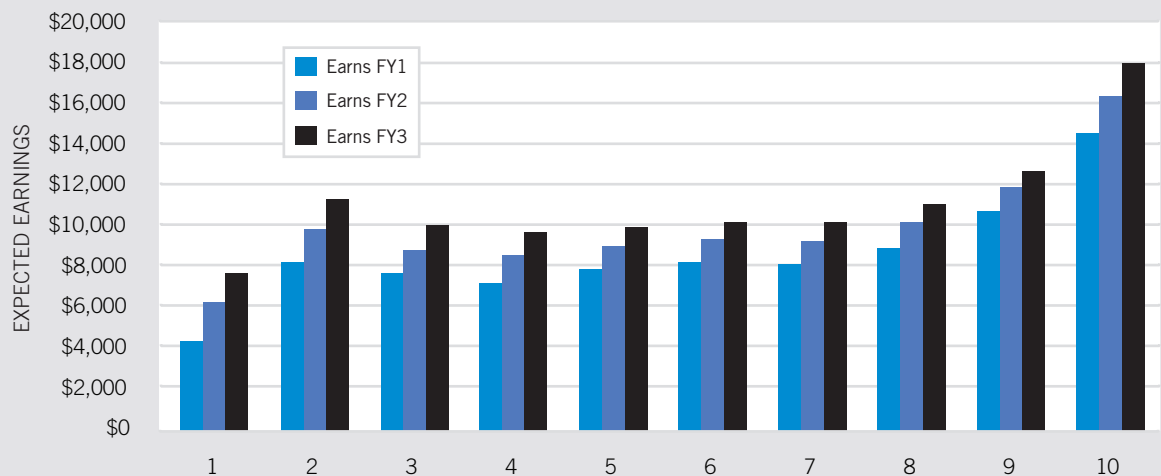
observes:

Value Beyond Expectations: New Evidence: Why Value Investing Works

Anchor on Growth

Below is a chart of the 1-, 2-, and 3-year expected earnings of 10 hypothetical businesses. Assuming all else is equal, which of the following businesses would you rather own?

Exhibit 1: Expected Earnings of 10 Hypothetical Businesses over the Next 3 Fiscal Years



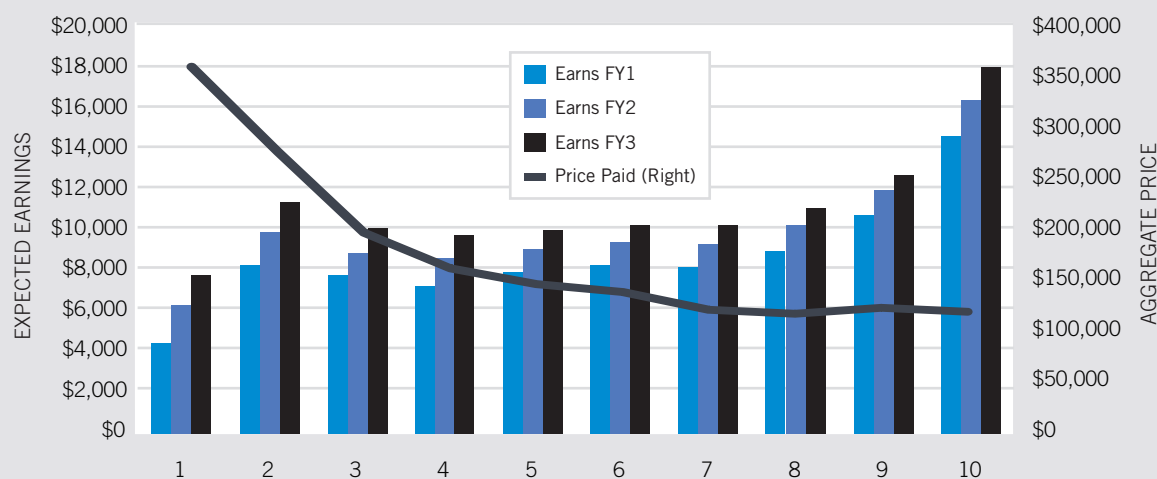
Source: The Brandes Institute. This hypothetical example is intended for illustrative purposes only. It does not represent the performance of any particular investments

The obvious answer is Business #10 – it offers the greatest earnings over the next three years and would logically be worth more. Yet the broader market historically has taken a different view.



These 10 “businesses” are actually not individual companies, but rather represent a single share in a global pool of publicly traded equities sorted by forward price-to-earnings ratio (“P/E”). While total earnings for companies in group 1 are the lowest, the forecast earnings growth rate is highest – their earnings are expected to nearly double within three years. And as seen in Exhibit 2, the market is willing to pay substantially more for companies with higher year-over-year earnings growth forecasts.

Exhibit 2: Expected Earnings and Prices Paid for 10 Hypothetical “Businesses”



Source: IBES via Thomson, the Brandes Institute as of 6/30/09. This hypothetical example is intended for illustrative purposes only. It does not represent the performance of any particular investments.

Why Value Outperforms: Is it Risk or Investor Behavior?

Academics and practitioners have debated why value investing has worked historically. Some propose that the added risk of investing in value securities offers a higher potential for gains. Others suggest that value stocks have delivered superior returns because they exploit behavioral errors, including anchoring, overreaction, and over-optimism.

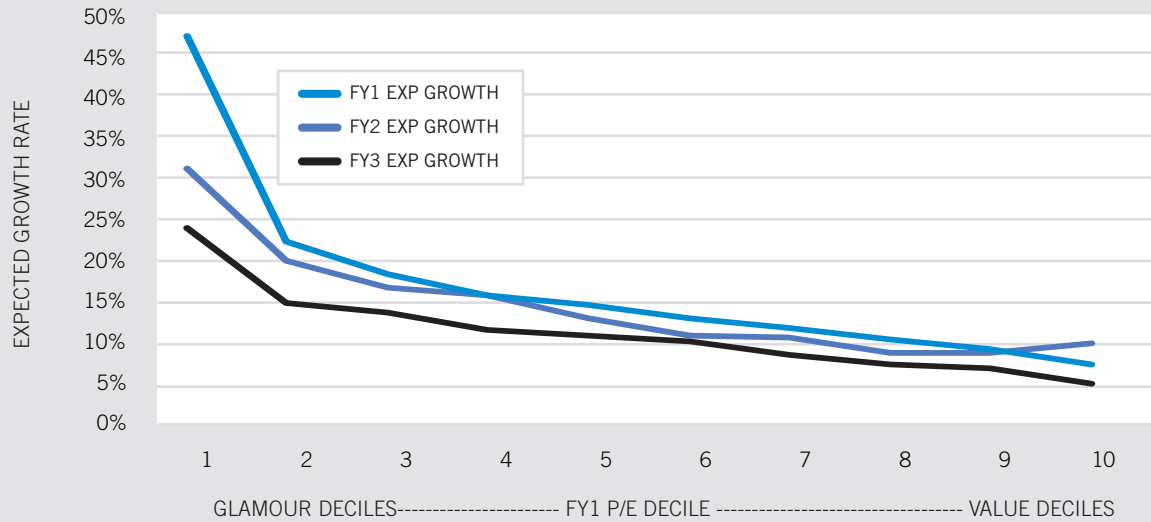
Recently, the Brandes Institute added new support for the behavioral argument with its study, “The Role of Expectations in Value and Glamour Stock Returns.” The study investigated the role that earnings expectations played in investors’ assessment of value and glamour stocks and subsequent performance. The results were compelling: The prices of value stocks increased when earnings expectations were beat and missed. Glamour stocks behaved more predictably, with prices rising after beats and falling after misses.

Earnings Growth Overoptimism Leads to Disappointment

Recalling our earlier example of the ten “businesses,” the market likely was willing to pay a higher price for group 1 stocks because of their forecast earnings growth. In Exhibit 3 on the following page, we can see that group 1 stocks were expected to grow earnings three to five times as fast as group 10.

If this growth continued, aggregate earnings for group 1 would eventually overtake group 10. However, investors’ overoptimism toward earnings growth blinded them of the fact that at this pace it would take more than 20 years to do so.

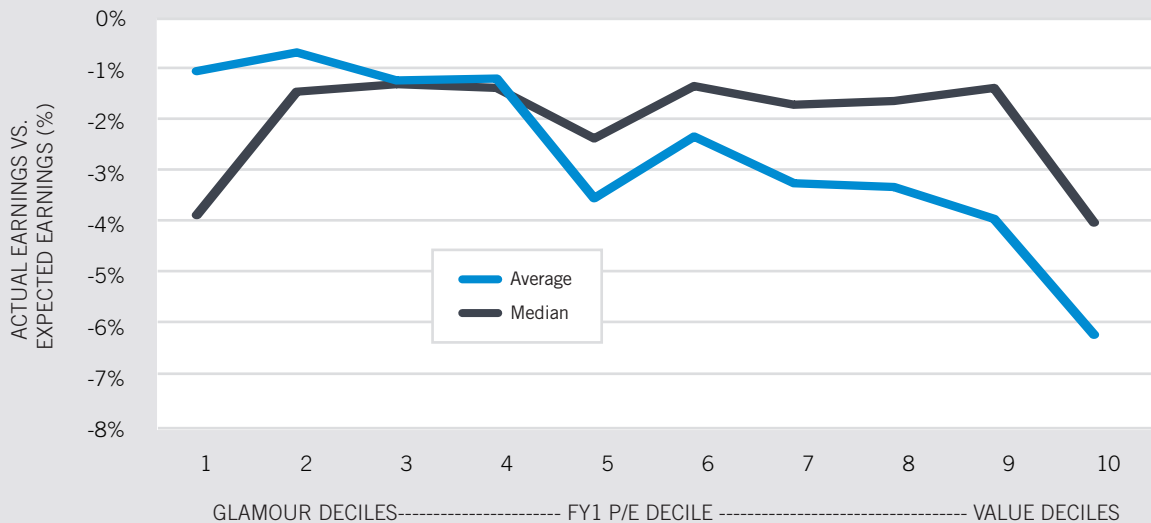
Exhibit 3: Median Expected Earnings Growth Rates, 1990-2009



Source: IBES via Thomson, as of 6/30/10. Past performance is not a guarantee of future results.

Furthermore, these expectations were subject to scrutiny with the release of actual earnings. The Brandes Institute found that actual earnings results yielded disappointment compared to what investors expected across all groups. No matter the valuation, expectations were too high and companies often failed to meet projected earnings. See Exhibit 4.

Exhibit 4: Median & Average¹ Actual Earnings vs. Expected Earnings, 1990-2010



Source: IBES via Thomson, as of 6/30/10. Past performance is not a guarantee of future results.

¹Average calculated by putting a cap on earnings surprises at 100% and floor at -100% to mitigate outliers.

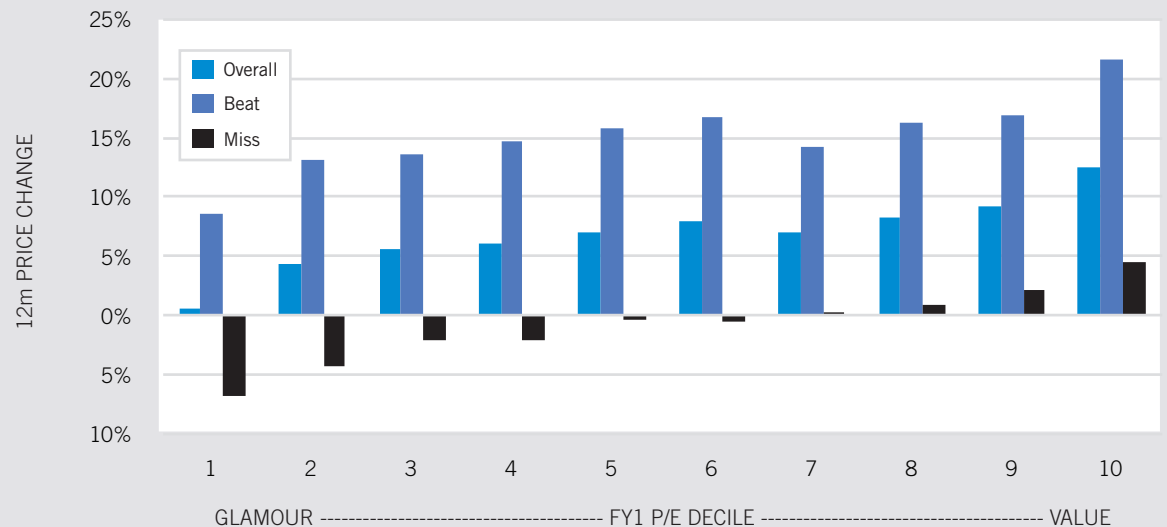
“It is natural and proper to prefer a business which is large and well-managed, has a good record, and is expected to show increasing earnings in the future. But these expectations, though seemingly well-founded, often fail to be realized. Many of the leading enterprises of yesterday are today far back in the ranks. Tomorrow is likely to tell a similar story.”

Benjamin Graham,
Security Analysis

Disappointment Triggers Downgrade for Glamour Stocks

While both value and glamour stocks tended to experience disappointing earnings, their prices in the subsequent months reacted very differently. Prices rose for value stocks when they exceeded expectations and when they missed expectations. Conversely, glamour stocks produced the lowest returns, whether they missed or beat expectations, as shown in Exhibit 5.

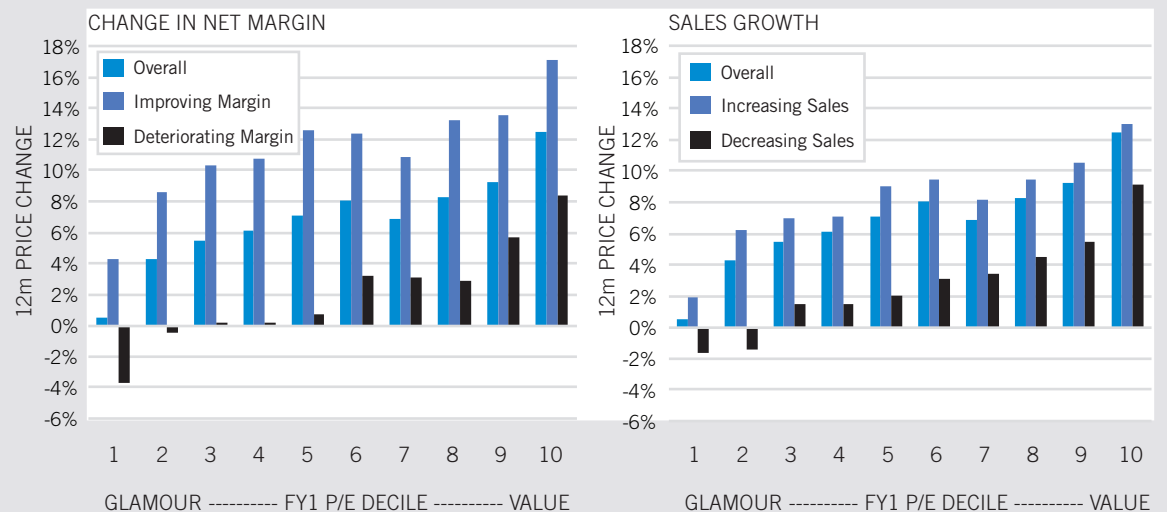
Exhibit 5: Average Subsequent 12-month Price Change, Beats vs. Misses, 1990-2010



Source: IBES via Thomson, as of 6/30/10. Past performance is not a guarantee of future results.

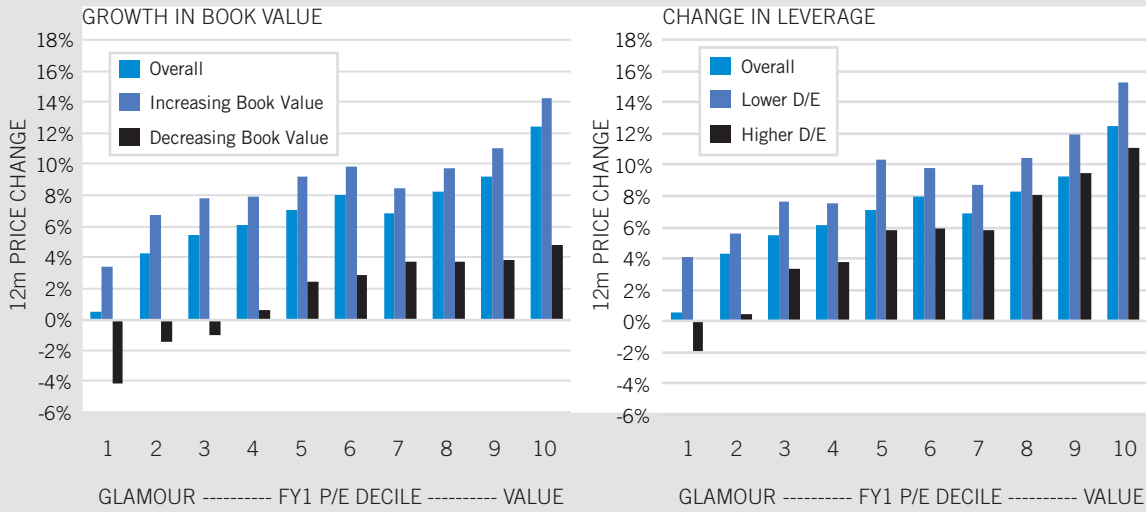
The Institute also studied other measures of business strength, focusing on net margin, sales growth, book value, and leverage. As shown in Exhibit 6, regardless of whether business conditions improved or worsened – the price trajectory for value stocks was vastly superior to glamour stocks.

Exhibit 6: Average Subsequent 12-month Price Change by Change in Fundamental Trait, 1990-2010



Source: Worldscope via FactSet as of 6/30/10. Past performance is not a guarantee of future results.

Exhibit 6: Average Subsequent 12-month Price Change by Change in Fundamental Trait, 1990-2010

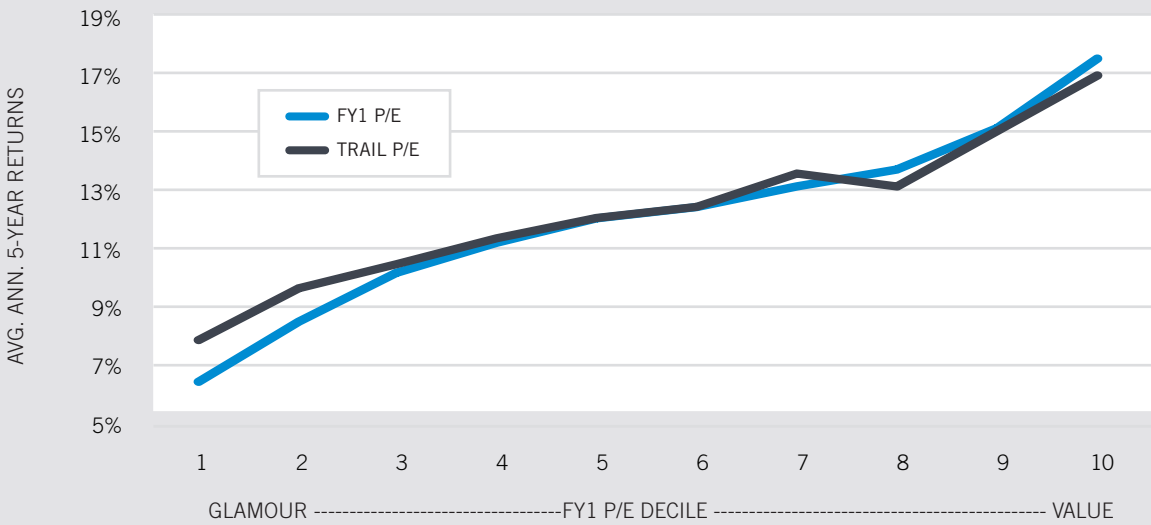


Source: Worldscope via FactSet as of 6/30/10. Past performance is not a guarantee of future results.

Revising Expectations Leads to Price Increase for Value Stocks

Over time, investors were willing to pay more for value stocks and less for glamour stocks as overoptimism (glamour stocks) and overreaction (value stocks) gave way to more rational assessments of fair value. Performance results show a clear value premium. This evidence is even more pronounced when looking at a 5-year holding period as seen in Exhibit 7.

Exhibit 7: Average Annualized 5-Year Returns on Trailing and Forecasted Earnings, 1990-2010



Source: Worldscope via FactSet as of 6/30/10. Past performance is not a guarantee of future results.

Valuations Matter

The results of this study point to the behavioral makeup of investors as an important factor in why value stocks have historically outperformed. Gradual changes in expectations and their manifestation in prices represent how value returns were able to exceed glamour for years.

We believe this study underscores the importance of valuations. And how investing in attractively valued companies may help put the odds in investors' favor for delivering excess returns.

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Brandes Investment
Partners, L.P.
11988 El Camino Real,
Suite 500
P.O. Box 919048
San Diego, CA
92191-9048