

Value vs. Glamour in Non-U.S. Markets: Recent Value Outperformance, Its Drivers and Considerations

In the Brandes Institute research paper, “Value vs. Glamour: The Value Premium in Non-U.S. Markets,” we compare performance of non-U.S. value and glamour stocks between June 1980 and June 2005. While non-U.S. value stocks tend to outperform their glamour counterparts over the long term, their outperformance in the most recent five-year period (2000 to 2005) was greater than any other five-year period we analyzed during the 25 years of our study. In this article, we address the following questions:

- What factors contributed to value stocks’ considerable, recent gains?
- What implications, if any, do these gains have for investors?

The complete version of the “Value vs. Glamour: The Value Premium in Non-U.S. Markets” research paper is available at the Brandes Institute website: www.brandes.com/institute.

VALUE STOCK PERFORMANCE FROM 2000 TO 2005

Before we analyze recent results, let’s recap our methodology for distinguishing value and glamour stocks and measuring their performance. We followed academic precedent consistent with the landmark study, “Contrarian Investment, Extrapolation, and Risk,” published in 1994 by professors Lakonishok, Shleifer, and Vishny (LSV).¹

Like LSV, we sorted stocks into deciles based on price-to-book (P/B) ratios so that the 10% with the highest P/B ratios were grouped in decile 1 (the glamour decile). Stocks with the lowest P/B ratios comprised decile 10 (the value decile).

After segmenting the universe in this fashion, we treated each decile like a portfolio and measured its performance over the five years following its formation. We also formed new sets of P/B deciles each subsequent year (on June 30, 1981, June 30, 1982, and so on). Then we measured the five-year performance of those deciles (1981 to 1986, 1982 to 1987, and so on). We continued to track performance for deciles formed each June 30 up through 2000.

To study the relationship between value and glamour stocks in non-U.S. markets, we aggregated data from six of the 13 countries in our study: the United Kingdom, Japan, France, Germany, Canada, and Australia.

In our opinion, these six non-U.S. markets – which contribute more than 70% of the market cap of the MSCI World Index ex USA as of June 30, 2005 – are representative of developed

¹ Lakonishok, Josef and Andrei Shleifer and Robert Vishny. “Contrarian Investment, Extrapolation, and Risk.” *Journal of Finance* 49 (December 1994): pages 1541-1578.

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non-U.S. markets in the North America, Europe, and Asia/Pacific regions. Additionally, Worldscope data for these markets was relatively robust, which contributed to the statistical significance of our findings.

To sharpen the relevance of our sample, we excluded the smallest 50% of all companies in each country. This removed micro caps, or firms with prohibitively small market capitalizations, and yielded a sample that more accurately represented a truly “investable” universe in our opinion.

After removing micro caps, we divided the remainder of the sample into large-cap and small-cap components. Specifically, we grouped the largest 30% of the remaining companies in a large-cap segment and assigned the smallest 70% to a small-cap segment. This segmentation enabled us to examine differences in the relationship between value and glamour at the large- and small-cap levels.

To gauge relative performance, we subtracted the annualized five-year returns of stocks in decile 1 (glamour stocks) from the annualized five-year returns of stocks in decile 10 (value stocks). This segmented our review of the relationship between value and glamour into 21 rolling, five-year periods. In Exhibit 1, each plot point above zero represents value outperformance; plot points below zero reflect glamour outperformance.

Value stocks, in both large- and small-cap groups, bested their glamour stock counterparts in nearly every one of the 21 rolling, five-year periods studied. In addition, value’s average outperformance margin versus glamour in non-U.S. markets during our study was an annualized 7.5% for small-cap stocks and 9.1% for large-cap stocks.

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EXHIBIT 1: ROLLING, 5-YEAR RELATIVE PERFORMANCE: VALUE VS. GLAMOUR

JUNE 30, 1980 – JUNE 30, 2005



Source: Worldscope via FactSet, 6/30/80 – 6/30/05. Rolling returns are annualized returns for a series of overlapping, smaller time periods within a single, larger time period. For example, the 20-year time period from 6/30/85 through 6/30/05 consists of 21 5-year segments. The first segment is the 5-year period 6/30/80-6/30/85, the next segment is the 5-year period 6/30/81-6/30/86, and so on.

In the most recent period, non-U.S. value stock outperformance was 31.2% for large-cap stocks and 24.7% for small-cap stocks. This recent outperformance nearly doubled the largest differential previously recorded for either market-cap segment during the entire period of the study.

We believe this recent surge in non-U.S. value stocks reflects, in part, the lingering aftermath of the bursting of the tech stock bubble in 2000. Between 1995 and 2000, a five-year period that closely mirrored the global tech-stock boom, glamour stocks delivered one of their greatest periods of outperformance in our study. In the wake of the tech-stock collapse, many glamour stocks fell sharply or languished while many value stocks delivered exceptional gains. Next, we examine additional factors that may have contributed to value stocks' recent outperformance.

Exhibit 2 illustrates the divergent paths the Citigroup PMI World ex-U.S. Growth (PMI Growth) and Value (PMI Value) and EMI World ex-U.S. Growth (EMI Growth) and Value (EMI Value) Indices have followed between June 30, 1995 and June 30, 2005.² This 10-year period (1995-2005) captures the greatest deviation between glamour stock and value stock performance

² While we use the Citigroup PMI and EMI World ex-U.S. Growth Indices as proxies for large- and small-cap "glamour" stocks, we recognize that glamour and growth are not synonymous, nor is the glamour distinction necessarily indicative of the way in which investment managers may build or manage portfolios.

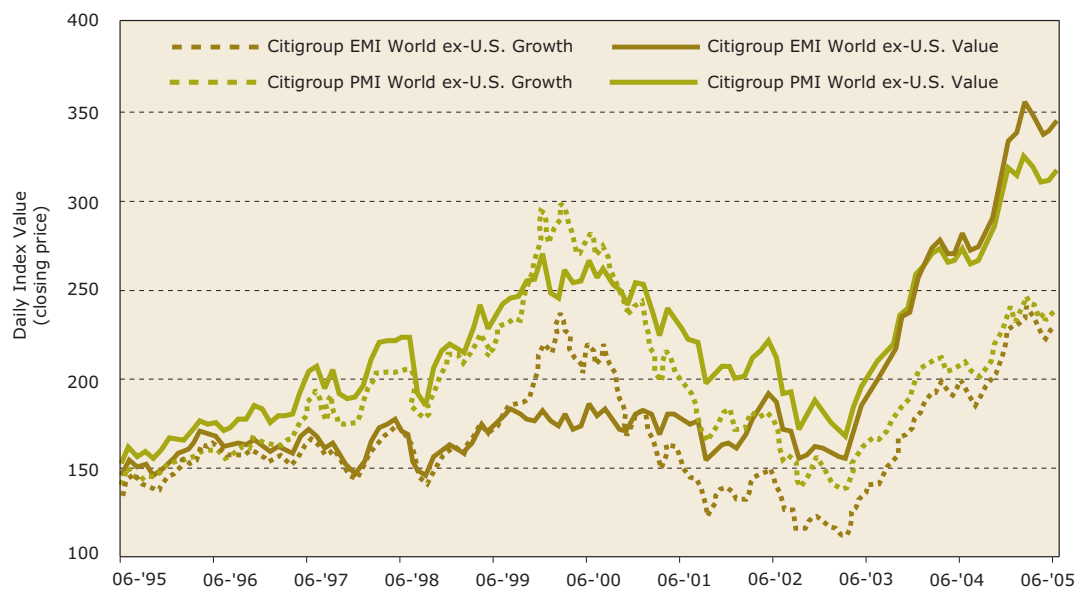
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during our study. The PMI Indices are proxies for larger-cap stocks; EMI Indices are proxies for smaller caps. The PMI Growth Index peaked in March 2000 at 299.261, while the EMI Growth Index peaked a month earlier at 234.808. Since that period, both indices experienced significant declines during the latter half of 2001 and throughout 2002. Conversely, while the PMI and EMI Value indices lagged their growth counterparts during the heights reached in early 2000, in the subsequent five years, the value components of the PMI and EMI indices recently have climbed to record highs.

EXHIBIT 2: CITIGROUP WORLD PMI & EMI EX-U.S. VALUE AND GROWTH INDICES

SHOW DIVERGENT PERFORMANCE PATHS

JUNE 30, 1995 – JUNE 30, 2005



Source: Compustat via FactSet; 6/30/95 – 6/30/05

Investigation into the factors driving non-U.S. value stocks' surge and non-U.S. glamour stocks' swoon during the recent five-year period reveals, not surprisingly, the substantial influence of the technology sector. In fact, 48% of the large-cap stocks comprising decile 1 in our non-U.S. study (the glamour decile), created in 2000, are members of the information technology sector. In our small-cap sample, 51% of the constituents of decile 1 are information technology companies. Another 24% of our large-cap and 14% of our small-cap stocks are consumer discretionary stocks.

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Meanwhile, over 30% of large- and small-cap stocks in decile-set 10 (the value decile) are members of the financials sector. Exhibit 3 shows the sector breakdown for decile-sets 1 and 10, as of June 30, 2000.

EXHIBIT 3: DECILE 1 AND DECILE 10 SECTOR BREAKDOWN

Decile 1 (Glamour)	Large Cap Sector Allocation	Small Cap Sector Allocation	Decile 10 (Value)	Large Cap Sector Allocation	Small Cap Sector Allocation
Information Technology	48%	51%	Information Technology	0%	1%
Consumer Discretionary	24%	14%	Consumer Discretionary	13%	20%
Telecommunication Services	8%	1%	Telecommunication Services	2%	0%
Financials	6%	4%	Financials	31%	34%
Health Care	5%	11%	Health Care	0%	1%
Industrials	5%	14%	Industrials	16%	18%
Consumer Staples	2%	1%	Consumer Staples	7%	7%
Materials	2%	3%	Materials	15%	13%
Energy	0%	1%	Energy	3%	4%
Utilities	0%	0%	Utilities	13%	1%

Source: Worldscope via FactSet, as of 6/30/00

Additional analysis of decile 1 stocks in the information technology and consumer discretionary sectors shows concentrations within the IT services, media, and software industries. See Exhibit 4. The significant allocation within the media industry contributed to increased correlations among returns for non-U.S. and U.S. stocks during the TMT (telecoms, media, and technology stocks) bubble that burst in the late '90s and early '00s. While telecoms and technology stocks were at the forefront of the advance and collapse in the United States, media stocks were among the primary drivers outside the United States. Note the 60% weighting to the media industry in Exhibit 4.

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EXHIBIT 4: DECILE 1 INDUSTRY BREAKDOWN

Information Technology Sector	Large Cap Industry Allocation	Small Cap Industry Allocation
IT Services	30%	24%
Software	27%	23%
Internet Software & Services	13%	18%
Semiconductors & Semiconductor Equipment	13%	7%
Communications Equipment	7%	12%
Electronic Equipment & Instruments	7%	14%
Computers & Peripherals	3%	3%
Office Electronics	0%	0%
Semiconductor Equipment & Products	0%	0%
Consumer Discretionary Sector		
Media	60%	35%
Household Durables	13%	10%
Specialty Retail	13%	15%
Auto Components	7%	0%
Internet & Catalog Retail	7%	0%
Automobiles	0%	0%
Distributors	0%	5%
Diversified Consumer Services	0%	0%
Food & Staples Retailing	0%	0%
Hotels Restaurants & Leisure	0%	20%
Leisure Equipment & Products	0%	15%
Multiline Retail	0%	0%
Textiles Apparel & Luxury Goods	0%	0%

Source: Worldscope via FactSet, as of 6/30/00

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In hindsight, these three industries (IT services, media, and software) were among the worst performers, particularly within their respective sectors over the past five years. While the PMI and EMI Growth Indices (using these benchmarks as proxies for non-U.S. glamour stocks) returned -3.4% and 1.5%, respectively during the five-year period ending June 30, 2005, these three industries sustained losses of -27.9%, -13.1%, and -7.1%, respectively within the PMI Growth Index and -15.3%, -7.6%, and -20.3% within the EMI Growth Index.

Conversely, the financials sector, well represented within the decile-set 10 (the value decile), posted solid gains between June 2000 and June 2005. While the PMI Value Index gained 4.4% and the EMI Value Index advanced 13.9% during this five-year period, the financials sector within these indices was up 6.9% in the PMI Value Index and 13.4% in the EMI Value Index.

Digging a bit deeper within the financials sector, both large- and small-cap decile 10 stocks had significant exposure to the real estate and commercial banking industries. These companies likely benefited from soaring prices for commercial and residential property outside the United States over the last five years.

During the late '90s, institutional and private client investors may have been content to watch their asset allocations tilt more heavily toward the glamour style – provided glamour-stock gains were sustained. The bursting bubble may have hastened an exodus away from the glamour style toward what were perceived to be more defensive value stocks during the earliest years of the most recent five-year period. In our opinion, this shift in asset allocation and its subsequent increased flows into value stocks likely contributed to the value style's outperformance through 2005.

VALUE STOCK PERFORMANCE AND ITS IMPLICATIONS

The surge in value stocks between 2000 and 2005 may raise the following questions for investors:

- Can value outperformance continue?
- Is now a good time to rebalance?

Clearly, the saw-tooth pattern depicted in Exhibit 1 illustrates the concept of reversion to the mean, as non-U.S. value and glamour stocks have alternately shared investor favor. Of course, it is important to note that the “mean” in this case does not suggest a zero-sum game. In fact, during the more than 25 years of our study, the mean is synonymous with annualized, relative outperformance of 7.5% for decile 10 non-U.S. small-cap stocks and 9.1% for decile 10 non-U.S. large-cap stocks over their decile 1 glamour counterparts. Further, mean reversion in this case may reflect growth outperformance or simply continued value outperformance – but only to a lesser degree.

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However, the recent spike in value outperformance well beyond its historical mean may carry implications for investors employing tactical asset allocation strategies. Some may view the current environment as an opportune time to rebalance portfolios to a more neutral allocation between value and growth equities. Indeed, for investors with written investment policy statements (IPS) that contain guidelines for exposure to the value and glamour styles, we believe a close review of these statements now is in order to ensure continued policy adherence. Of course, as with any tactical decision, we invite investors to make thorough considerations and keep in mind the potential long-term benefits and consequences.

Citigroup PMI World ex-U.S. Growth Index: Citigroup Primary Market Index (PMI) World ex-U.S. Growth Index is an unmanaged index that tracks large capitalization companies from developed markets around the world, excluding the United States, that have a growth style. The style is determined by the equal weighted relative magnitude of three growth and four value variables: 5-year historical EPS growth rate, 5-year historical sales per share growth, 5-year average annual internal growth rate, book value per share, price to sales, price to cash flow and dividend yield. It includes the reinvestment of dividends and income but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

Citigroup PMI World ex-U.S. Value Index: Citigroup Primary Market Index (PMI) World ex-U.S. Value Index is an unmanaged index that tracks large capitalization companies from developed markets around the world, excluding the United States, that have a value style. The style is determined by the equal weighted relative magnitude of three growth and four value variables: 5-year historical EPS growth rate, 5-year historical sales per share growth, 5-year average annual internal growth rate, book value per share, price to sales, price to cash flow and dividend yield. It includes the reinvestment of dividends and income but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

Citigroup EMI World ex-U.S. Growth Index: The Citigroup Extended Market Index (EMI) World ex-U.S. Value Index is an unmanaged index that tracks small capitalization companies from developed markets around the world excluding the United States, that have a growth style. The style is determined by the equal weighted relative magnitude of three growth and four value variables: 5-year historical EPS growth rate, 5-year historical sales per share growth, 5-year average annual internal growth rate, book value per share, price to sales, price to cash flow and dividend yield. It includes the reinvestment of dividends and income but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

Citigroup EMI World ex-U.S. Value Index: The Citigroup Extended Market Index (EMI) World ex-U.S. Value Index is an unmanaged index that tracks small capitalization companies from developed markets around the world excluding the United States, that have a value style. The style is determined by the equal weighted relative magnitude of three growth and four value variables: 5-year historical EPS growth rate, 5-year historical sales per share growth, 5-year average annual internal growth rate, book value per share, price to sales, price to cash flow and dividend yield. It includes the reinvestment of dividends and income but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

The MSCI World Index ex USA consists of equities from developed markets around the world, excluding the United States. This index is often used as a benchmark for international equity portfolios and includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

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