

Value vs. Glamour: The Challenge of Expectations

The Brandes Institute (“the Institute”) study, “[Value vs. Glamour: Updated and Expanded](#),”¹ demonstrated that value stocks consistently outperformed glamour stocks in the United States between April 30, 1968 and April 30, 2006. The Institute study, “[Value vs. Glamour: The Value Premium in Non-U.S. Markets](#)” found similar results for non-U.S. stocks between June 30, 1980 and June 30, 2006.² These results may seem intuitive to investors who understand that higher returns generally accompany stocks with higher risk, but is value investing necessarily a riskier proposition? After all, value stocks in the Institute study actually often exhibited lower volatility than glamour stocks.

Despite these results, for some investors, when it comes to making decisions for their portfolios, the lure of investing in popular glamour stocks may be difficult to resist. There are several reasons why investors may let emotions and preconceptions interfere with a rational decision-making process.

First, some may be influenced by impressions of a company, and the optimism surrounding the stock, rather than focusing on valuation. They may be drawn to a premier company, or a company whose sales or growth prospects are rapidly rising. While the historical performance of value stocks relative to glamour stocks suggests against investing in richly valued companies, some may believe a particular company is the exception, an outstanding firm with inexhaustible opportunities and growth. First impressions may be confirmed with glowing mentions of the company in newspapers and magazines.

Second, glamour stocks can *appear* to be better investment candidates than value stocks when looking at recent trends in operating performance. Consider the fundamentals of stocks in the Institute’s Value vs. Glamour studies. Because data for non-U.S. markets is not robust prior to 1980, we include data for all developed markets from June 30, 1980

Confusing Risk and Return

Hersh Shefrin, professor of Finance at Santa Clara University, found a tendency among investors to misapply the notions of “risk” and “reward.” Shefrin found that people generally believe that a company with “better” fundamentals (as measured by income growth, profit growth, return on assets, and other common ratios) is less risky. Yet they also believe this “safer” company should deliver better appreciation than the “riskier” company, contradicting the widely-accepted positive correlation between risk and return.³

The Brandes Institute study of value and glamour stocks showed value stocks’ historical outperformance vs. glamour stocks – often with less volatility (what some may consider risk).

¹ The Brandes Institute. Value vs. Glamour: Updated and Expanded. 2006.

² The Brandes Institute. Value vs. Glamour: The Value Premium in Non-U.S. Markets. 2006

³ Shefrin, Hersh. “Behavioral Finance: Biases, Mean-Variance Returns, and Risk Premiums.” *CFA Institute Conference Proceedings Quarterly*, June 2007. p. 5-12.

Value vs. Glamour: The Challenge of Expectations

through June 30, 2007. Exhibit 1 shows a variety of fundamental traits for the average stock in deciles 1 and 10 over the 27-year period. Decile 1 stocks represent glamour stocks and decile 10 stocks represent value stocks. Note that the fundamental data is as of June 30, 2002 so as to allow a 5-year period to measure subsequent performance.

EXHIBIT 1: TRAITS FOR DECILE 1 AND DECILE 10 STOCKS, AS OF JUNE 30, 2007 ROLLING 5-YEAR PERIODS, 1980 - 2007

	3-Year Average Net Income Growth	3-Year Average Operating Profit Growth	3-Year Average Sales Growth	3-Year Average Return on Invested Capital	3-Year Average Return on Equity	3-Year Average Return on Assets	Prior 1-Year Average Total Return for Stock
Decile 1 Glamour	30.7%	28.7%	21.8%	14.6%	18.2%	7.8%	52.9%
Decile 10 Value	7.2%	6.9%	8.9%	5.7%	6.7%	3.8%	1.2%

Source: Compustat via FactSet, as of June 30, 2007. Rolling periods represent a series of overlapping, smaller periods within a single, longer-term period. A hypothetical example is the 20-year period from 12/31/82 through 12/31/02. This long-term period consists of 16 smaller 5-year "rolling" segments. The first segment is the 5-year period from 12/31/82 to 12/31/87. The next rolling segment is the 5-year period from 12/31/83 to 12/31/88, and so on.

Fundamentals for the average stock in decile 1 *appear* to be more attractive vs. the average decile 10 stock. For each trait shown, decile 1 stock averages are higher than decile 10. In addition, the total return for decile 1 stocks for the 1-year period prior to their inclusion in our universe was far superior to that of the average decile 10 stock. From this perspective, it might appear that decile 1 stocks are better investment prospects – and poised to continue delivering gains.

However, these traits do not account for valuations. For value investors, a company's value relative to its stock price is the essential consideration.

While the growth traits and trends may offer some insight into the value of a business, they do not account for the *price* an investor had to pay to acquire them. The decile 10 value stocks had lower fundamental averages, but they also tended to be far more attractively *valued*. In other words, the stock *price* relative to the business *value* was lower in decile 10, creating the opportunity for significant future appreciation.

Our Value vs. Glamour analysis shows that the average annualized return for decile 10 stocks between 1980 and 2007 was 16.0% vs. 6.8% for decile 1 stocks.

To illustrate the potential pitfalls when choosing between value and glamour stocks, we share the following example of the five largest companies in deciles 1 and 10 during 1998, what we considered a typical market environment since 1980.

Value vs. Glamour: The Challenge of Expectations

Think back to 1998, when:

- Daimler-Benz completed a merger with Chrysler to form Daimler-Chrysler.
- The Chicago Bulls won their 6th NBA Championship in 8 years, as Michael Jordan played his last game as a Chicago Bull.
- The Nasdaq composite was enjoying its fourth consecutive year of 20%⁺ gains.

Now let's look at examples of the five largest companies in decile 1 (highest valuations) and decile 10 (lowest valuations), as of June 30, 1998. Looking at the companies in Exhibit 2 enables us to recall vivid examples of decile 1 companies characterized by widespread optimism, as well as decile 10 companies, whose prospects seemed dim or unexciting. Many of the decile 1 stocks were widely regarded as permanent stalwarts for an investor's portfolio – and their stock prices reflected these high expectations. Many ignored Warren Buffett's admonition from nearly 20 years earlier that, "You pay a very high price in the stock market for cheery consensus."⁴

EXHIBIT 2: TRAITS FOR FIVE LARGEST STOCKS IN DECILES 1 AND 10, AS OF JUNE 30, 1998

Decile 1	3-Year Net Average Income Growth	3-Year Average Operating Profit Growth	3-Year Average Sales Growth	3-Year Average Return on Invested Capital	3-Year Average Return on Equity	3-Year Average Return on Assets
Microsoft	-1.8%	8.2%	12.6%	19.8%	19.9%	15.5%
Wal-Mart Stores	14.5%	15.3%	16.5%	13.9%	21.7%	9.7%
Pfizer	53.6%	47.8%	37.3%	26.7%	37.0%	18.1%
Johnson & Johnson	22.0%	15.4%	11.2%	22.9%	27.2%	16.1%
Coca-Cola	2.5%	2.5%	2.3%	20.2%	29.6%	14.8%
Decile 10	3-Year Net Average Income Growth	3-Year Average Operating Profit Growth	3-Year Average Sales Growth	3-Year Average Return on Invested Capital	3-Year Average Return on Equity	3-Year Average Return on Assets
Vodafone Group	-421.3%	-272.5%	-22.7%	-4.8%	0.4%	42.6%
Time Warner	-286.2%	8.3%	1.8%	17.3%	1.3%	100.0%
Deutsche Telekom	-240.2%	-165.7%	-3.3%	5.3%	0.8%	10.9%
AT&T	-204.6%	-20.2%	12.0%	5.8%	1.0%	-5.6%
Liberty Media	48.0%	-32.7%	-35.4%	-5.6%	1.0%	26.8%

Source: Compustat via FactSet, as of 6/30/2007

⁴ Buffett, Warren. "You Pay a Very High Price in the Stock Market for a Cheery Consensus." *Forbes*, August 6, 1979, p. 25-26.

Value vs. Glamour: The Challenge of Expectations

Now examine the five decile 10 stocks. The average 3-year return on invested capital for these five decile 10 stocks was 3.6%, compared to 20.7% for their decile 1 counterparts. Looking at these statistics, the outlook seemed dim for the five decile 10 stocks. Based on these traits, decile 1 stocks might appear to be better investments.

But how did these stocks subsequently perform? The five decile 1 stocks posted an average, annualized 1.4% return over the next five years (ending June 30, 2003). On the other hand, the five decile 10 stocks returned an average, annualized 14.7% over the next five years – more than 10 times the return of the decile 1 stocks. The five decile 1 stocks may have seemed to have great stories behind them, but subsequent 5-year returns were sobering. Conversely, decile 10 stocks may have previously exhibited disappointing growth rates – for example, four of the five decile 10 stocks had triple digit negative averages for 3-year net income growth – but the subsequent 5-year returns (as mentioned above, 14.7% on an average, annualized basis) suggests that their intrinsic values were not reflected in their stock prices in June 1998.

Based on the subsequent 5-year performance of decile 1 stocks and decile 10 stocks, a great company may not be a great investment, and a poorly performing company may be a sound investment. We believe the difference between the stock prices and fair values of companies in both deciles was a prime reason for stock performance over the subsequent five years.

The results for this 5-year period were not an aberration. During the 23 rolling, 5-year periods between 1980 and 2007, decile 10 stocks outperformed decile 1 stocks 20 times – or 87% of the time!

Glamour stocks often exhibit characteristics – or accompanying stories – that suggest continued high profit levels, incessant stock appreciation, and accelerating growth. Human nature may draw investors to the prospects of these high-profile individual stocks. While many richly valued companies have tended to underperform the broader market in subsequent 3- to 5-year periods, some investors believe the glamour stocks they select will be the exceptions. However, we believe the Value vs. Glamour study affirms that the relation of stock price to a firm's long-term value has driven subsequent returns.

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