Value Investing: Are You Prepared For A Recovery?

Relative to other investment philosophies, value investing has struggled for more than a decade. Some investment professionals may believe value investing is “dead.” But others may view value’s underperformance as part of a long cycle; they might argue value is overdue for a recovery. For investors who think the latter, we believe now is the time to consider positioning your portfolio for a possible value rebound.

Even for those who anticipate a recovery among value stocks, doubts may shadow their conviction. In this short piece, we explore four big questions investors may need to address prior to committing—or re-committing—assets to a value strategy. They are designed to help pre-identify triggers that investment professionals feel they need to see before making a move, addressing operational issues or developing a short list of managers ahead of the actual deployment. For more details on the financial and psychological aspects of such a decision, see our companion presentation, “Value Investing: Are You Prepared for a Recovery?”

The Big 4 Questions

1 Why?

INVESTMENT-RELATED FACTORS

- Historic value to growth dispersion[1]
- Potential diversification benefits
- U.S. value stocks have typically outperformed the U.S. market during/after economic recessions[2]

PSYCHOLOGICAL FACTOR

- **The Hindsight Bias:** *A memory trick that creates the illusion of prior certainty*. When regression to the mean occurs, many stakeholders may be convinced they saw it coming and may cast blame for *not* being diversified. Taking steps now toward a value allocation can stem potential blame for “missing out” if value recovers.

2 When?

INVESTMENT-RELATED FACTORS

- Consider establishing investment criteria now and allocating capital when your criteria are met
- Thinking about the pre-allocation process NOW can help prepare you to take action

PSYCHOLOGICAL FACTOR

- **The Planning Fallacy:** *The systematic tendency to underappreciate how long a task will take*. Conducting due diligence and other preparations well in advance can help make it easier to move expeditiously when an opportunity arises.

3 How?

INVESTMENT-RELATED FACTORS

- Get your “ducks in a row” now (for example, do institutional asset owners face due diligence requirements or approvals from a board before making an allocation?)
- Consider starting with small, incremental moves toward a value allocation

PSYCHOLOGICAL FACTOR

- **The Status Quo Bias:** *The force exerted on decision-makers to keep things the same (inertia)*. Moving from 0% exposure to a 10% weighting can be a much bigger psychological move than moving from an existing 10% position to 20%. Rebalancing may be easier than establishing an entirely new position.

4 What?

INVESTMENT-RELATED FACTORS

- Consider “true” value managers when discussing an allocation to value—not VINO (value in name only)
- Ask now about a manager’s investment philosophy and process, and review holdings relative to a benchmark or value peers

PSYCHOLOGICAL FACTOR

- **Mental Accounting:** *The mental separation of money based on its purpose*. Allocation models/portfolios may be thought of as a picture with interconnected pieces. To manage them with confidence, there should be clarity regarding what the holdings are and the purpose they serve.

[1] Source: MSCI via FactSet. MSCI World Value Index vs MSCI World Growth Index for period December 31, 1974 to September 30, 2020; based on price/book, price/earnings, dividend yield, price/cash flow, forward price/earnings, enterprise value/sales, and enterprise value/earnings before interest, taxes, depreciation, amortization.

[2] Source: Bank of America "US Equity Strategy in Pictures," June 8, 2020. Fama-French Value Factor stock universe vs S&P 500. Outperformance of value stocks measured during/after 14 peak-to-trough recessions in US GDP growth identified by National Bureau of Economic Research, from August 1929 to June 2009. Outperformance does not necessarily indicate positive absolute performance. Fama-French Value Factor stock universe includes the top 30% of NYSE, AMEX, and NASDAQ listed firms by book value to market cap. Past performance is not a guarantee of future results. One cannot invest directly in an index.

The MSCI World Value Index captures large and mid cap securities across developed market countries exhibiting value style characteristics, defined using book value to price, 12-month forward earnings to price, and dividend yield.

The MSCI World Growth Index captures large and mid cap securities across developed market countries exhibiting growth style characteristics, defined using long-term forward earnings per share (EPS) growth rate, short-term forward EPS growth rate, current internal growth rate, long-term historical EPS growth trend, and long-term historical sales per share growth trend.

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The S&P 500 Index measures equity performance of 500 of the top companies in leading industries of the U.S. economy.

Price/Book: Price per share divided by book value per share.

Price/Earnings: Price per share divided by earnings per share.

Price/Cash Flow: Price per share divided by cash flow per share.

Yield: Annual income from the investment (dividend, interest, etc.) divided by the current market price of the investment.

Forward Price/Earnings: Price per share divided by earnings per share expected over the next 12 months or next fiscal year.

Enterprise Value: Market capitalization plus debt, minority interest and preferred shares, minus total cash and cash equivalents.

Enterprise Value/Sales: Enterprise value divided by annual sales.

Book Value: Assets minus liabilities. Also known as shareholders' equity.

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