GRANT'S
INTEREST RATE OBSERVER®
Vol. 37, No.18c 233 Broadway, New York, New York 10279 • www.grantspub.com SEPTEMBER 20, 2019

Renaissance of value?

"This is massive," the *Financial Times* quotes Yin Luo, head of quantitative strategy at Wolfe Research, concerning last week's break in growth stocks and reciprocal surge in value stocks. "This is something that we haven't seen for a long time. The question is why it's happening, and what it means."

Now in progress is a speculation on the future of value, meaning "desirable, because under-priced." It's the opposite of "desirable, because over-priced" and the distant runner-up, in terms of many years of investment performance, to "desirable, because fast-growing, big, cash-generative, popular, world-beating and transformative." In preview, *Grant's* is bullish on what the late Marty Whitman, famed value-stock investor, called "safe and cheap."

The quest for value comes instinctively to shoppers but only cyclically to investors. The same individual who trundles home grocery bags filled with store-brand bargains may think nothing of logging on to Charles Schwab to buy shares in Netflix.

Ultra-low interest rates partly explain the disconnect. So do the fluctuations of technological innovation and adaptation, the genesis of the kind of dominant business for which many are willing to pay any amount and the rise of passive investing. Low inflation, doubts about the relevance of established valuation metrics and the bullish expectations conditioned by America's longest business expansion likewise figure into value investing's exile. All promote the conviction that you can safely pay fancy prices today for the hope of growth tomorrow.

The value-vs.-growth competition is a Wall Street perennial. Your grandfather argued the question in the language of value vs. "glamour." Nothing was so glamorous as the so-called one-decision stocks of the early 1970s, the so-called Nifty Fifty, whose constituents included not only Eli Lilly & Co., McDonald's Corp., Procter & Gamble Co. and Walmart, Inc., but also Sears, Roebuck & Co., Simplicity Pattern Co., First National City Bank (now Citigroup) and the Eastman Kodak Co.

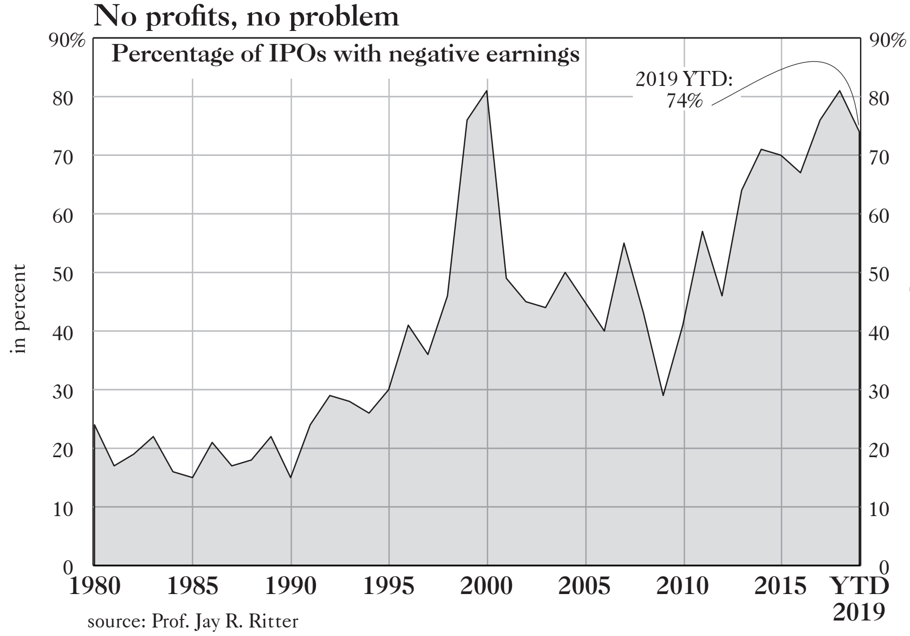
Since 2007, standard value indices have returned an average of 6.2% a year (115% in total), standard growth indices an average of 10.5% a year (256% in total, in both cases with dividends reinvested).

Value, though it's given a respectable account of itself in absolute terms, has positively crashed in relative terms. Since mid-2017, manfully concedes the value-minded investment firm of O'Shaughnessy Asset Management, the Russell 1000 Value index has trailed the Russell 1000 Growth index by no less than 21%.

The confounding problem for value-seekers is that paying a prudently low price is their reason for being. By refusing to overpay, they believe, they armor themselves and/or their clients with an indispensable margin of safety. Now safety itself, as defined, has become the principal source of their misery. It isn't a pleasant irony to take home at night.

"What has been abnormal," Dan Rasmussen, founder and portfolio manager of Verdad Capital Management, tells colleague Fabiano Santin, "is the re-

No profits, no problem



source: Prof. Jay R. Ritter

markable performance of growth stocks. That has really been driven by the very large-cap tech companies, which have had this amazing combination of high growth, high profitability, high and sustained growth, high and sustained profitability (and starting to actually dividend out money). That historically is very, very anomalous. You don't typically see the largest stocks grow the fastest."

No wonder the tenders of the flame of Benjamin Graham are giving up, or wish they had surrendered a decade ago. In August, for the first time ever, assets of passive equity funds in the United States surpassed those of active ones, $4.271 trillion vs. $4.246 trillion. Certainly, the value-themed portion of the active-management business has fully participated in the long-running asset cull.

"You're at this point," Rasmussen goes on, "where the spread between the valuations of growth stocks and the valuations of value stocks is near all-time highs. The two times it has been this high in the past 50 years are 2000—the height of the tech bubble—and 1973—the height of the Nifty Fifty boom."

Suffice it to say that value has been in and out of the wilderness before. It lagged behind glamour in the otherwise glamour-deficient 1930s, specifically over the 15 years ended 1941, according to O'Shaughnessy's Deep History database.

From July 1926 to December 1941, relates Chris Meredith, O'Shaughnessy's director of research, stocks that met the definition of cheap by the test of a low price-to-earnings ratio underperformed high p-e stocks by 4.8% a year. Wouldn't you have expected the opposite in the bleak persistent aftermath of the 1929 crash?

But the trouble with the seemingly under-priced stocks of the day were the very businesses that issued the share certificates. The once dominant utilities and railroads were beset by economic and regulatory pressures. The dynamic new industries, e.g., autos, oil refining and chain-store retailing, got off lighter.

Drawing on the work of British-Venezuelan scholar Carlota Perez, Meredith splits the grand cycle of technological adaptation between "installation" and "deployment." Deployment, in the case of the automobile and associated products, was well under way in the 1930s. Not surprisingly, General Motors Co. was the growth stock of the cycle. Value dropped for a decade and a half.

But investing is nothing if not cyclical, and the rails, making a post–World War II transition to diesel from steam power, led the value revival of the 1950s. Thus, Meredith reports, Southern Railway Co., the fastest mover to diesel, gained 8,876.3% between January 1942 and December 1958; it had given up 78.3% in the 15 years to December 1941.

Perhaps the FAANGs, now in the sweet spot of the deployment phase of the technology cycle, will themselves suffer a regulatory wing-clipping or be brought down to earth by some other commercial or political force. And maybe a normalization of interest rates will release the lagging financial stocks from their cyclical purgatory to lead a future recovery in value.

If not, as Rasmussen observes to Santin, Amazon must "do better relative to its expectations over the next 10 years than it did over the last 10 years. Netflix must do better over the next 10 years relative to expectations than it did over the last 10. Apple must do better. . . .

"You go through these names," Rasmussen continues, "and say, 'Holy smokes! This company has had an amazing run. The expectations are that they are going to have another amazing run in the next decade and they have to beat those expectations.' I just think that is so unlikely and so improbable relative to traditional industrial companies or international companies returning something that looks like their dividend plus GDP growth, which is basically what is priced into these value stocks. I suspect that the odds are much, much better with value."

To find the present value of future cash flows, just plug in a discount rate. The lower the rate, i.e., the weighted average cost of capital, the higher the net present value of projected cash flows. Only one of the reasons why value investors have a special aversion to radical monetary policy is that ultra-low rates invite fanciful extrapolations of corporate earnings power.

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The same rage for duration that's crowned the 30-year Treasury (which, with an 89% total return over the past decade, has nearly lapped the 10-year Treasury with its 48% total return) likewise favors growth equities. By definition, every common stock is a perpetual security. But growth issues carry a longer imputed duration than value names, because so much more of their anticipated payoff lies over the temporal horizon. The bond bull market has not smiled on fixed-income investors alone. It's showered its riches on Silicon Valley, the private-equity business and the venture-capital community as well.

So it was probably no accident that value stocks surged and growth stocks shuddered last week as the 10-year Treasury yield leapt by 33 basis points (on Sept. 9, momentum-type shares, including cloud-computing issues, took a 4% header). The snapback rally in value indices was the strongest two-day performance in that beleaguered sector since at least 2002. The afore-quoted Yin Luo likened the action to the Aug. 10, 2007 "quant quake."

You may not remember that unexpected, savage liquidation of crowded speculative positions that had been concentrated in quantitatively managed portfolios a dozen years ago, but Gary Chropuvka may never forget it. "All this worked academically, and for a long time it worked in practice," Chropuvka, co-head of Goldman Sachs's Quantitative Investment Strategies team, told the *Financial Times* in 2017, "and then all of a sudden you have this horrible event. It was the most humbling experience of our lives."

Instructively, recalls Rob Arnott, founder and chairman of Research Affiliates, what crashed in 2007 was value, not growth (in the wake of the dot-com bubble, value was a refuge). "Value," Arnott reminds Santin, "had become such a crowded trade that people were actually buying hedge funds that took leveraged long/short exposure on long value, short growth."

Maybe the recent bond sell-off is only one more correction in a rampaging multi- generational bull market. And perhaps the 2.4% rise in core CPI for August, the highest reading since September 2008, is likewise a statistical anomaly. And the new oil-supply shock just may prove nothing worse than an inconvenience. The answers are in the womb of time.

Current events to one side, we judge that cyclicality and mean reversion are still the ways of the financial world. If we are right about that, normalcy is only a recession or an election or an equity bear market or a supply shock or a bond liquidation away.

We've all become accustomed to abnormality. For instance, according to Jay R. Ritter, a chaired professor at the Warrington College of Business at the University of Florida, 81% of firms that went public in 2018 showed GAAP losses. To date in 2019, 74% of companies debuting in the public-equity market have been similarly loss-making. Each figure is substantially higher than the 39% average of profitless new public companies that IPO-ed between 1980 and 2018.

"Thus," notes Santin, "the market has been rewarding loftier valuations to software, electronic and biotech firms on the assumption that recent sales growth from often unproven business models will capture market share from incumbents."

The predisposition to believe in a brilliant future is no mass delusion but rather a reasoned response to the future that's already arrived, growth-stock adherents insist. What you have to remember, they patiently tell their slow-learning value-minded friends, is that the miracles of the age have more to do with brands and patents than with time-honored (but practice-discredited) price-to-book multiples.

In fairness, value investors, too, have made their peace with the times, adjusting earnings and book value to account for nonrecurring income and expenses. They likewise often incorporate off-balance-sheet assets and liabilities and weigh qualitative issues that fail to register in the audited financials.

The trouble, notes Ted Aronson, a first-class paid-up subscriber and founder and CEO of the quantitatively-driven investment manager AJO Partners, is the ever-present temptation to invent and implement the valuation metrics that justify prevailing prices. Witness "price-to-eyeballs" in the dot-com era or, we would add, "price to adjusted Ebitda" (or to adjusted-adjusted Ebitda) in the current private-equity era.

In the past five years the returns on invested capital of Alphabet, Inc. and Facebook, Inc. averaged 12.5% and 18.4%, respectively, according to Bloomberg data. Compare and contrast Exxon Mobil Corp.'s 5.7% or Office Depot, Inc.'s 5.4%, earned over the same span.

"However," as Santin points out, "as firms grow, they typically become less productive, and their returns eventually decline to approach those of the rest of the economy. The fall of returns on invested capital from mid-double digits is obviously steeper and more painful than it is from mid-single digits."

The Russell 1000 Value index beat its peer Growth index by 29.8% in 2000 and by 14.8% in 2001, but there was no such repeat performance in the Great Recession. What looked statistically cheap in 2008 were, in good part, the brokerage firms, banks and insurers that starred as the anti-heros of the credit and mortgage crisis. As those companies and their shares suffered their richly deserved comeuppance, value barely edged growth in 2008 (by just 1.6%) and actually lagged, by 17.5%, in 2009.

Come the next business-cycle downturn (if such a thing is ever in the cards again), we speculate that the 2000–01 precedent is likely to prove more applicable than the 2008–09 episode, with the FAANGs changing places with the hum-drum financials and the cast-off oil drillers.

Quoted in the aforementioned *FT* article on the quant quake of yesteryear was a wise man who observed that leverage and crowding make most of the mischief in finance. Certainly, technology has drawn a crowd. As to leverage, please refer to the "Seeking Alpha" article dated Friday the 13th of September that enjoins us sticks-in-the-mud to "Stop Investing Like It's 1950." Yes, contends the author, D.M. Martins Research, equities are the play, but don't waste time trying to pick stocks. Rather make hay with the tools that your forebears never had the opportunity to wield. Buy leveraged ETFs. Go long Micro E-mini S&P 500 Index futures contracts. Yes, the ride will be bumpier than that which conventional, unleveraged exposure would provide, and the losses (should they come) would be more dramatic, but think of the fabulous upside. Such thoughts are not the usual sign of a stock-market bottom, reader Paul Isaac observes.

"I think investors, even sophisticated ones, have had it [with value investing] and they're giving up," says Aronson. "And they don't see why they take the risk with active managers in the value front, they don't think it's worth it because maybe the world has changed.... Well, I say it has changed, but these value stocks can't be marked down forever.... The rubber band is stretched and when it stretches, you can stretch it a little more and a little more, but then it snaps and it hurts. So, it's going to be fascinating to watch this play out."

The headline over this essay exactly quotes (except for the question mark) the one under which Benjamin Graham himself argued the case for value in early 1975, in *Barron's*, a few short months after the autumn 1974 stock-market lows. Even before the bottom was in, late in August, a *Barron's* analysis found that the "average stock" was down by 70% from 1968. Many an issue showed a higher dividend yield than p-e ratio.

Today's renaissance, if indeed it's upon us, would start from a very different level of valuation. For instance, the $49.9 billion Vanguard Value ETF (VTV on NYSE Arca) trades at a not-so-cheap 16.3 times earnings and 2.2 times book value. It holds positions in 349 stocks, among which are Berkshire Hathaway, Inc. (quoted at a trailing p-e ratio of 21), Johnson & Johnson (15), International Business Machines Corp. (10.4) and General Motors Co. (6).

Value investors, too, deploy computers, and the Vanguard fund tracks the CRSP U.S. Large Cap Value index, which blends price-to-earnings and price-to-book ratios with dividend yields and price-to-sales ratios. "Value" may reflect one such factor more than the others, a relatively high p-e ratio perhaps offset by a generous dividend yield or low price-to-sales ratio. Though hardly a bargain, the Vanguard portfolio is more affordable than the rest of the large-cap universe.

Deeper value is also on offer. The iShares Russell 2000 Value ETF (IWN on NYSE Arca), with assets of $9.6 billion, trades at 12.8 times earnings and 1.3 times book; it charges a 0.24% expense ratio, 20 basis points more than Vanguard. The portfolio comprises 1,388 names, so over-concentration is not at the top of an investor's concerns. Among the biggest holdings: utility provider Portland General Electric Co., insurer Radian Group, Inc. and financial-services company Stifel Financial Corp.

"The skeptical few that would rather have real people managing their money might consider the $657 million-in-assets Heartland Value Fund (HRTVX)," Santin writes. "It's been around since 1984, and has returned 11.2% a year versus 9.9% for the Russel 2000 Value index. At the end of June, the fund carried 101 stocks with an average market cap of 12.1 times forward earnings and 1.4 times book value. Management charges 1.09% a year in total operating expenses in the "investor," or retail, class.

"Another possibility," Santin continues, "is the Wasatch Small Cap Value Fund (WMCVX). It was founded in 1997, and has returned 11.8% a year versus 8% for the Russell 2000 Value index. At mid-year, the fund held 50 stocks with an average market cap of 13.9 times forward earnings. Assets summed to $839 million and total operating expenses to 1.2% a year for retail clients.

"And another," Santin goes on: "the $14.2 billion, institution-only Dimensional Fund Advisor's U.S. Small Cap Value Portfolio. The fund has returned 11.0% a year versus 9.6% for the Russell 2000 Value index since its founding in 1993. There were 998 names in the portfolio that, on average, changed hands at a price-to-book ratio of 0.98. Operating expenses amount to 0.52% a year."

You must leave the comfort of the 50 states to secure really deep value in all but micro-cap size. "Yes," Arnott emails this office, "we can now buy the entire EM (half the world's GDP) for less than 10 times earnings, less than five times cash flow and a yield of almost 4%, as long as we weight the stocks based on their fundamental economic footprint."

"You sell the stocks that have soared," Arnott adds, "and you buy the stocks that have tumbled. Simple mean reversion."

Pimco's RAE Emerging Market Fund implements more or less this strategy. It deploys $2.8 billion in assets spread among 628 stocks. The average price-to-earnings ratio of the fund is 7.3 times, and the price-to-book multiple is 0.7 times. Sound fetching? China is the top country exposure, with 25.0% of total assets, followed by South Korea (16.4%) and Russia (11.7%). Still interested?

Top single-name holdings include Gazprom Pao (5.4%), China Construction Bank Corp. (3.6%), Samsung Electronics Co. Ltd. (2.7%), Industrial & Commercial Bank of China Ltd. (2.2%) and Bank of China Ltd. (2%). Since its inception in 2006, the fund has returned 5.8% a year versus 5.2% for the MSCI Emerging Markets Value index. Institutional investors pay 0.76% a year in management fees, retail stumps up 1.11%.

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Final word goes to Rasmussen, a speaker at the star-studded Fall *Grant's* Conference (*advt.*). "Risk," he points out, falls broadly under two categories: bankruptcy and overvaluation. "So what you want to buy are cheap things that don't go bankrupt, and you want not to buy overvalued things. If you just look at valuation multiples, you'll see that the riskiest thing is the S&P 500."

It's the index that goes up—or, rather, a correction—the index that *has* gone up.

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