Value
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Beware the Price of Fashion

If you had a shareholding in a company that tripled revenues and profits over a decade, would you expect to be well rewarded? This is not a trick question. It seems intuitively straight forward that a successful business would reward its shareholders.

One of the world's largest companies reported a 45 per cent year-over-year increase in profits in its most recent quarter (to June 2010). Over the past decade, its revenue and profits nearly tripled. Yet its stock price is down roughly 15% in the last ten years. Which company am I referring to? Staggeringly, it's **Microsoft**.

Briefly in 2000 **Cisco** became the largest company in the world, following a meteoric rise in its share price. At its peak it accounted for nearly 4 per cent of the S&P 500. Its price, with hindsight, was far too high. Cisco might have warranted its status as the largest stock in the world if it subsequently grew its earnings at the rate implicit in its valuation. It was priced for absolute perfection, but only ended up being really good. Shareholders got hosed nonetheless.

There are many more examples of companies whose businesses are very successful, but whose share price trails far behind. Why is this?

For individual stocks or sectors there are always specific reasons but, without wishing to trivialise the issue, the simple answer is that expectations for these companies ten years ago was too high. Don't forget, a company's share price is implicitly reflecting an expectation of future earnings. If expectations turn out to be too optimistic then, like the bribed boxer, share prices will drop.

There is a long history of stock market evidence suggesting investors overpay for the 'glamour' of growth stocks and underpay for 'ugly' value stocks. The performance of these so-called 'glamour' stocks ultimately tends to lag the 'value' stocks due to this systematic mispricing.

A recent paper by *The Brandes Institute* set out to explore the question of whether value or glamour stocks have performed better. There are numerous studies on the topic, most coming down on the side of value, though qualified as being simply a reward for extra risk. The Brandes report found value to be the clear winner, a result which was remarkably consistent across geographies, sectors, market environments and company size.

The essential characteristic of a glamour stock is very strong earnings growth, which in turn makes these stocks especially popular with investors. Though not a defining characteristic, they tend to have high or expensive valuation metrics like price-to-book, price-to-earnings

or price-to-cash flow ratios.

Value stocks are the antithesis of their growth counterparts, with valuation metrics at the opposite end of the spectrum. The industries are typically low growth and companies tend to be disliked by investors.

There are numerous statistics in the Brandes report, but one of the headline figures shows that value stocks (as defined by low price-to-book ratios) outperformed glamour stocks over rolling 5-year periods by an average of more than 9% per annum (based on data from 1968 to mid 2008).

Its conclusion is significant in two respects. First, the extent to which value outperforms glamour is remarkable. Secondly, and arguably more significant, is that the higher returns were delivered with lower risk (as measured by the volatility of returns). This presents a real challenge to accepted finance theory, which maintains that the value premium (outperformance of value stocks) is simply reward for extra risk.

What the Brandes study didn't set out to explore was why the value premium is evident. If investing successfully is as easy as just concentrating on value stocks, then in a competitive market surely everyone knows this and the opportunity will be short-lived?

In his book *The General Theory of Employment, Interest and Money* (1936), economist and investor John Maynard Keynes tried to explain the existence of the value premium by observing that many investors do not look at long-term values. He famously likened the stock market to a beauty contest in which entrants are asked to choose the most 'beautiful' six women from a set of 100 faces. The winner is the person whose choices are closest to that of the average. According to Keynes, *"It is not a case of choosing those [faces] which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be."* Instead of judging beauty (fundamental value of a company), each potential entrant (investor) is trying to second-guess what the market will do.

Keynes' analogy is persuasive. If investors spend more time concentrating on 'price' with little focus on 'value', it is clear how anomalies (like the persistence of a value premium) can exist.

How do you as an investor exploit this opportunity? Long-run superiority of value as a group doesn't guarantee results in any particular period, or for any particular stock. Of course, there are going to be periods when glamour stocks do better than value and vice versa. However, the Brandes report is fairly conclusive in dealing with this episodic nature of value and glamour returns. Its data, though limited in terms of time period, finds value outperforms in the vast majority of five-year periods under review.

Rather than focussing on the timing of the value / glamour trend, as an investor you will be better served being more alert to the dangers of picking the wrong companies. There will be stocks that are cheap for a good reason, sometimes referred to as the value-traps (which

tend to remain cheap and unloved). Similarly there will be plenty of glamour companies that ultimately justify their lofty valuation multiples by growing earnings at or above expected levels. Too much of what passes for excellence in investing is the result of a combination of luck and the ebb and flow of style. For this and other reasons, I don't advocate buying stocks directly. Exploit the value premium through diversified value funds.

If you are determined to buy stocks directly, you should narrow down the universe from which you choose. Investing is as much (if not more) about avoiding the turkeys as it is catching the stars. Only include stocks with a sufficient 'margin of safety' in terms of price to value multiples (cash flow/ earnings/ book value). You may well miss out on the next **Google**, but will hopefully be spared the pain of another **Enron**.

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