Value stocks are not the underperformers you've been told they are

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Academicians call the lowest P/E stock portfolio 'value stocks' and the highest P/E stock portfolio 'growth stocks.'

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Academic studies have shown that, since 1980, value stocks have beaten growth stocks by an average of about six percentage points a year in the United States. The figure is much lower at about three percentage points since 2000, but still significantly positive. Such findings are corroborated by Lyrical Asset Management, which examined the performance of the lowest quintile of U.S. stocks based on price-to-book – the so-called value stocks – vis-a-vis the performance of the so-called growth stocks over the 1979-to-2025 period.

But this evidence does not square with the differences in returns between U.S. value and growth ETFs reported in the financial media. For example, in the U.S., annual compounded returns for the value (IUSV) and growth (IUSG) ETFs are 5.6 per cent and 8.3 per cent, respectively, since their inception in 2000. Similarly, since 1979 the S&P 500 growth ETF had an average return of 12.4 per cent whereas the S&P 500 value ETF had an average return of 11.4 per cent, according to data provided by Lyrical Asset Management. No matter how you look at it, the growth ETFs have performed better!

What is going on? Does value investing work or not? It all depends on how one defines value and growth investing.

Investors widely use the terms value stocks and growth stocks, but many don't know what they mean. Academic researchers sort stocks by price/earnings (P/E) or price-to-book (P/B) or other valuation metrics and form a number of portfolios from the sorted stocks. They call the lowest P/E stock portfolio "value stocks" and the highest P/E stock portfolio "growth stocks." While academicians don't know which stocks from the value group that value investors will eventually buy, they do know that value investors mostly choose stocks from the lowest P/E group and avoid stocks from the highest P/E group. ETFs only roughly adhere to this rule.

But value investing is more than that, even though many investors believe that the only thing value investors do is sort stocks by P/E and invest in the lowest P/E stocks. That could not be further than the truth.

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Sorting by P/E (or examining other metrics) is just the first step in the value-investing process. Next, value investors value each of the lowest P/E stocks to find these stocks' intrinsic value. Finally, they compare the intrinsic value of each stock to the market price. If the stock price is less than the intrinsic value by at least the so-called "margin of safety" (normally around 33 per cent of the intrinsic value), the stock is considered truly undervalued and is worth investing in.

Value ETFs do not meet the value requirements for either value investors or academics. They do not have trailing P/E, say, less than 14 to 15 times, P/B less than 1.3 to 1.4 times, and market a cap less than US$1.5-billion to US$2-billion. For example, of the 697 stocks included in IUSV, only about 37 per cent of constituent stocks have a P/E less than 15 times, while only 20 per cent have a P/B less than 1.5 times.

Finally, only 0.3 per cent of constituent stocks have a market cap of less than US$1.5 billion – even under US$5 billion, there are only 14.8 per cent of stocks in the ETF. IUSV's average P/E is 19 times, P/B is five times and market cap US$54.3-billion. The medians are smaller, but still the figures are way off the academic metrics or metrics many value investors would feel comfortable with. The top three holdings of IUSV are Apple, Microsoft and Amazon, amounting to 15 per cent of the ETF's stocks – hardly value stocks!

Why is this important?

As indicated above, value investors start their analysis with a search process to identify possibly undervalued stocks. This involves looking for stocks which are neglected and/or undesirable owing to bad performance. Neglected are stocks that are small cap, have low analyst coverage and low liquidity. Undesirable are stocks with low P/E ratio (or low P/B ratio).

Low liquidity and/or small-cap stocks are normally avoided by institutional investors who have too much money to invest in, and low liquidity, or small-cap stocks do not provide enough depth to make investing worthwhile and cannot absorb enough flow. Smaller-cap and/or low-liquidity companies also tend to be followed by fewer analysts, and be less in the public eye than larger companies. That is, these are stocks which are not viewed as the glamour stocks everyone wants to own. Because of that, the stocks of such companies are more likely to be undervalued.

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The P/E and P/B multiples, on the other hand, are a function of the growth rate of earnings going forward. This relationship can be found in a mathematical formula derived from the equity valuation model taught at every university. Companies have low (or high) multiples because markets expect low (or high) earnings growth. However, the way the growth rate comes into the mathematical formula implies growth for ever.

That is, a high-multiple company is forecast to sustain a high growth rate forever; vice versa for low-multiple companies. The markets tend to be overoptimistic about growth for high-multiple companies and overpessimistic about growth for low-multiple companies. As a result, investors overvalue high-multiple firms and undervalue low-multiple companies.

Value investing is all about finding undervalued stocks, and these tend to be stocks that are smaller-market cap, with low analyst following, and low P/E and P/B. But this is not how ETFs are structured because they need stocks that are larger and with a lot of liquidity; these tend not to be potentially or truly undervalued stocks. And the results bear this out.

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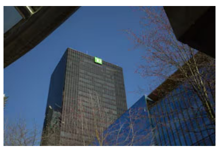

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