The secret behind the outperformance of value stocks

GEORGE ATHANASSAKOS ›

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In the midst of the problems experienced with growth stocks over the past year and a half, investors have proclaimed that "value is back" – but a careful examination of stock returns over long periods shows that value never really went away.

Value does not beat growth, its rival strategy, every year. In fact, there are many years in which value stocks (low price-to-earnings or price-to-book) underperform growth (high P/E or P/B).

But on average, over the long run, value does outperform.

In Canada, between 1983 and 2018, the average value outperformance (or value premium, defined as value minus growth stock returns) was about 3 per cent, with the median about 4 per cent.

The average value premium in the U.S. between 1966 and 2019 was a bit more than 5 per cent. Similarly, large global value stocks outperformed large global growth stocks by about 7 per cent over the 1985-2014 period, according to the Brandes Institute.

Having said that, however, value outperformance was markedly higher for low priced stocks. In Canada, for example, the lowest priced value stocks outperformed the lowest priced growth stocks, on average, by 9 per cent in the 1983-2018 period. In other words, value beats growth, especially for low priced stocks.

But what is the secret for the outperformance of value stocks?

To answer this question, I start by examining what happens to the value premium when companies announce earnings that surprise to the upside, compared with what occurs when earnings disappoint. More precisely, a positive (or negative) surprise must have exceeded (or fallen short) of expectations by at least 10 per cent. I focused on U.S. stocks for the period 1980-2018. I find that when value and growth companies announce earnings that surprise in a positive way, the value premium (based on P/B ratio) is 2.34 per cent three months following the earnings announcement and 6.69 per cent over the following year. When value and growth companies announce earnings that disappoint, the value premium is 6.04 per cent three months following the earnings announcement and 21.51 per cent over the following year.

What could be the reason for these results?

The P/E and P/B ratios 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 universities around the globe. Companies have low or high multiples because markets expect low or high earnings growth. However, the way growth comes into the mathematical formula implies that high multiple firms are expected to sustain high growth forever, and vice versa for low multiple firms. That is, the markets tend to be overly optimistic about growth for high multiple firms and overly pessimistic about growth for low multiple firms.

If we are overly optimistic about growth stocks and we get good (or better) numbers, we sort of expected it. But if we are overly optimistic about growth stocks and we get bad numbers, we are very disappointed and react negatively. Similarly, if we are overly pessimistic about earnings growth and we get bad (or worse) numbers we sort of expected it. But if we get good numbers, we are exuberant and react positively.

While the value premium is positive irrespective of whether the earnings surprise is positive or negative, it is much larger when the earnings surprise is negative. Growth stocks react much more negatively vis-a-vis value stocks when news is bad. For growth stocks, investors expect good numbers. The good numbers are baked into stock prices and so there is little reaction to good (or better) news. But when numbers are bad there is a downward overreaction, leading to the sharp increase in

the value premium as growth stocks react much more negatively to negative news than do value stocks.

I also looked at the period 20 years prior to the study period (i.e. 1960-1998), and the picture is similar, although notably, when the surprise was negative, I found the value premium was much larger in the later period. The significant increase of high tech and fast growth stocks in the more recent era helps explain the more dramatic reaction of the annual value premium to negative news.

It now becomes more clear why value beats growth in the long run. Investors are overly pessimistic about value stocks. Some of these stocks indeed go bankrupt, but most do not, and those that do not tend to do better in the future as investors were excessively pessimistic, and vice versa for growth stocks.

In other words, value beats growth not necessarily because value does so well, but rather because in the long run growth does so poorly.

The demise of growth stocks over the past year is a good proof of that.

George Athanassakos is a professor of finance and holds the Ben Graham Chair in Value Investing at the Ivey Business School, University of Western Ontario.