A Good Time for Value Investors

Hotchkis & Wiley

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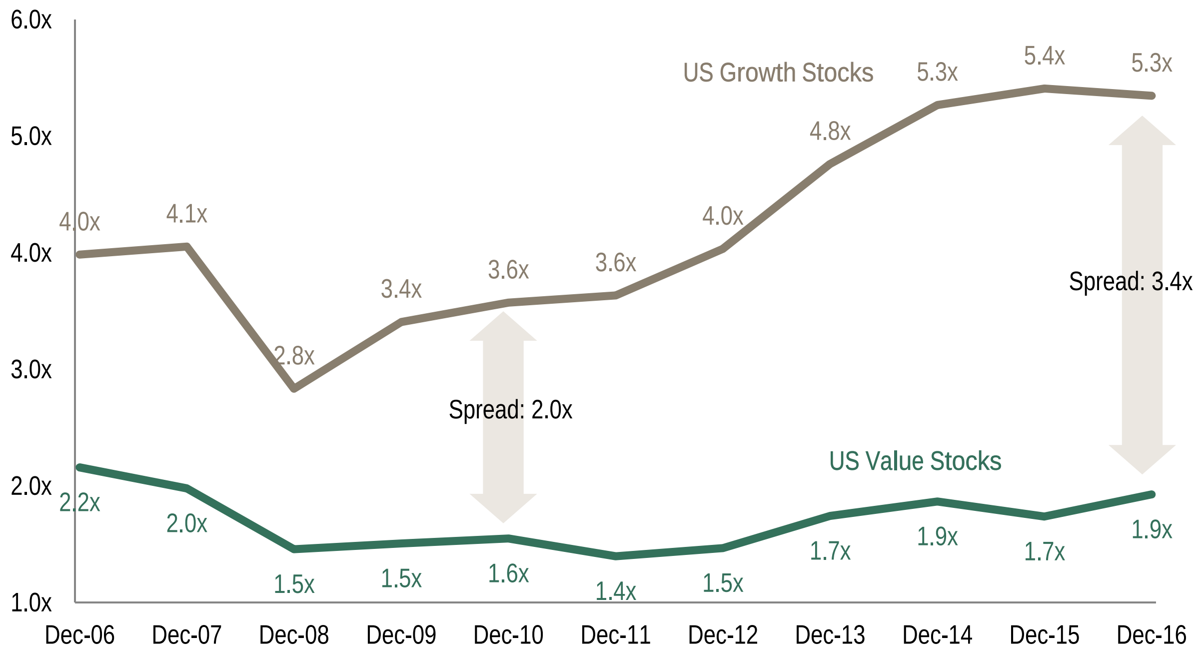
Innumerable studies have demonstrated that value stocks have outperformed growth stocks in the long run. The market moves in growth and value cycles; however, growth stocks do outperform intermittently. The duration of these intermittent periods can vary tremendously, and attempting to time cycle turning points can be a futile effort. The most recent growth cycle has persisted for an unusually long period, with growth stocks having outperformed value stocks in the US by more than 45 percentage points cumulatively over the past decade (the Russell 1000 Growth has returned +121%, the Russell 1000 Value has returned +75%). This differential between value and growth in other developed countries has been comparable. As a result, the valuation premium of growth stocks relative to value stocks has widened considerably. As shown in the chart below, the price-to-book ratio for value stocks has remained rather stable while the price-to-book ratio for growth stocks has ballooned. The premium, or spread, has widened by a large magnitude. We do not know when value dislocations will revert, nor are we certain that these dislocations will not widen further before reverting. We have learned from past experience, however, that these cycles inevitably do normalize and we believe that value investors are well-positioned to reap the rewards.

Price-to-Book Ratio



Source: Bloomberg, US Growth Stocks: Russell 3000 Growth Index, US Value Stocks: Russell 3000 Value Index

One of the causes of value dislocations has been what many pundits have described as “risk off”, “flight to safety”, “low volatility”, “bond proxy” etc. Investors have flooded to non-cyclical businesses at the expense of cyclical business, regardless of valuation. Macroeconomic shocks like Brexit have only exacerbated this divergence. True to Benjamin Graham, we view stocks trading at discounts to intrinsic value as having a margin of safety. Ironically, it has become difficult to identify a margin of safety in businesses currently perceived as “safe” because their valuations have become stretched. Investing in the stock of a stable business is not a safe investment if you have to overpay for the value of the underlying enterprise.

Again, timing cycle turning points is difficult at best. By definition, however, all cycles revert and the value dislocations in the current market cannot widen indefinitely. As such, the current environment has presented value investors with some uncommon opportunities. The valuation discrepancy between our portfolios and their benchmarks is rather striking in today's market, and we believe prudent investors should be increasing allocations to value given the attractive prospects.

All investments contain risk and may lose value. Equity securities may have greater risks and price volatility than U.S. Treasuries and bonds, where the price of these securities may decline due to various company, industry and market factors. Investing in value stocks presents the risk that value stocks may fall out of favor with investors and underperform growth stocks during given periods.

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