Value investing – where did the value go?

"Value investing has underperformed Growth and Passive strategies since the millennium." – *George Cliff MBA*

It's no secret that the last 20 years have been a troubling time for Value investors. Historically championed by some of the best and brightest in the industry, and the base formula behind Warren Buffet's eye-watering success, it would sadly seem the strategy has lost its way of late, leaving many investors wondering "where's the Value!?".

Whether hunting for Value in the UK or the US since the turn of the millennium, you would have underperformed not only your Growth investor counterparts (by almost a half) but also the market itself, or the passive investor. If anything, Value funds, Value strategies and Value stocks have been nothing more than a detractor from performance on the whole, leaving many investors disillusioned and discouraged at the thought of overpaying for the privilege of underperformance.

What is Value investing?

To be a traditional Value investor, and to follow a traditional Value investing strategy, is to buy into businesses that are currently cheap and perhaps unloved by the market but that you believe to be fundamentally good companies with great long-term potential. The market may have simply overreacted to recent news or financial data and priced the stock far lower than necessary, giving you an opportunity to get in before the market realises its mistake and prices them back up.

In principal, this methodology makes perfect sense but as the last two decades have proven, shopping for stocks in the bargain bin has cost investors dearly.

So, what happened?

How could a strategy that has made many investors so incredibly wealthy historically suffer such a sustained period of underperformance more recently?

There have been many explanations but it all really comes down to two things:

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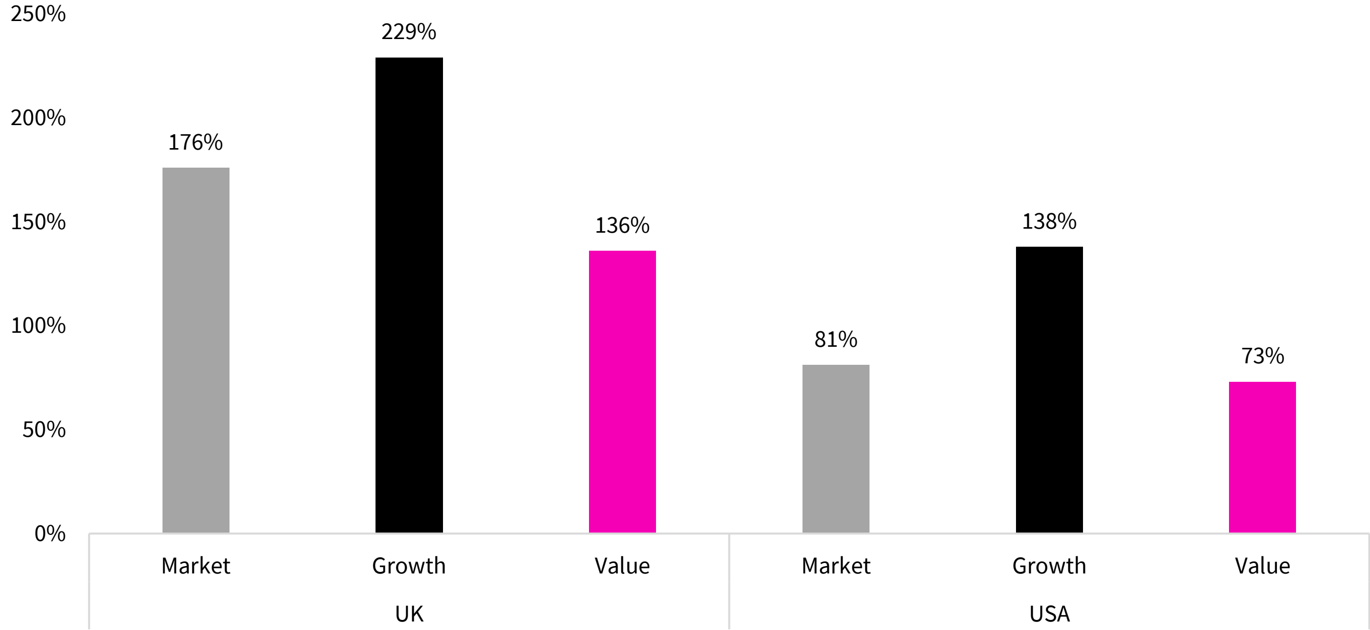
20 year performance of Value, Growth and Passive (market) investing

Source: FE Analytics, 01 September 2000 – 31 August 2020



IMPORTANT INFORMATION

Past performance is not a guide for future performance. The value of investments, and the income from them, can fall as well as rise. You should not rely on this information in making an investment decision and it does not constitute a recommendation or advice in the selection of an investment.

Clever.

Clever Adviser Technology
Watergate House, Watergate St.
Chester, Cheshire CH1 2LF

T 01244 346 343
E mail@cleveradviser.com
W cleveradviser.com

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1. The types of businesses Value investors buy

Value investors generally tend to invest in businesses with balance sheets full of big, predictable, easy to value tangible assets like warehouses, machinery etc. Examples would be manufacturing businesses (consumer products, construction, automotive etc), as well as banks and other financial institutions where the tangible assets include client deposits, loans and mortgages. These businesses are very easy to value and given the ease of assessment, more accurate cost / value assumptions can be made. Remember, Value investors are looking for a bargain, a business trading below its intrinsic value and so the easier it is to determine the intrinsic value of a business, the more likely it will be looked at and perhaps picked.

The problem with this methodology, and investing in such businesses as those above over the last two decades, is they are not profitable and the stock market has punished them for it. The market likes (and rewards) profitable businesses and punishes those who are not - because profits lead to business growth and business growth drives stock price. A lack of profits has dire consequences on price.

In the case of manufacturing, perhaps the most fiercely competed and saturated of industries, there are now more businesses than there are profits. This has forced many firms to automate or move overseas in search of cheaper labour. As is the case with any market, if there are profits they will eventually be competed away by new businesses wanting a piece of the action.

In the case of banks and other lenders, their profits have suffered at the hands of an almost 0% interest rate environment since 2008 – a victim of their own wrongdoings but Value investors have also bore the brunt. These institutions make almost all of their revenues from interest payments on loans and mortgages and with rates at almost 0 (or lower in some parts in the world) their profitability, growth prospects, and as a result stock prices, have suffered tremendously.

It is because they are so easy to value that these businesses are picked by Value investors, not because of the value they can deliver.

2. The types of businesses Value investors don't buy

Value investors buy banks and manufacturing businesses because they are predictable and easy to value. These are known as 'traditional Value stocks'. Unfortunately, in limiting your universe to these types of businesses, you have missed out on some of the greatest businesses of the last 20 years. Firms such as Microsoft, Apple and Google. Firms that use technology and people to drive value instead of warehouses and product lines. These asset types, otherwise known as intangible assets, are much harder to value which makes the assessment of the intrinsic value of the company and the 'cheapness' of its stock price also very difficult.

For the most part, perhaps because of the outdated methods used by Value investors in assessing cost, these businesses are referred to as expensive which would infer that the cost to invest does not justify the value potential. Apple has been called expensive since the early 2000s yet has grown over 2000% since 2010. So too has Microsoft yet it has still returned over 600% for investors since 2010. Based upon these results, were these businesses not bargains? Does the value here not dwarf the cost?

These businesses may seem expensive because we can't yet properly evaluate their future value potential, but does this mean we shouldn't buy them? If Value investors want to compete they will need to find ways to better evaluate these new types of business, businesses that are set to pave the way and write the next chapter of investment as we know it.

This rough patch should be seen as an opportunity to learn, adapt and evolve, something every great investor will do time and time again in pursuit of success.

George Cliff MBA
Pre-Sales Technical Manager
Clever