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‘Reports of Value’s Death May Be Greatly Exaggerated’

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In the wake of a losing streak that dates back to 2007 in which value investing underperformed growth investing, many investors are questioning the strategy’s future. Is it different this time? Have the financial markets undergone a structure change and entered a new normal brought about by low interest rates, an increasing number of private-market investments, and a decrease in the number of publicly traded stocks? Have crowded trades distorted asset prices? Was value investing’s historical success a product of data mining? Researchers Robert D. Arnott, Campbell R. Harvey, Vitali Kalesnik, and Juhani T. Linnainmaa (hereafter Arnott et al. 2020) don’t think so, and they make a case that value’s struggles can be largely explained by three factors. The first is the ascendency of technology companies and the resulting increased focus on intangibles such as research and development rendering the historical method of evaluating value-oriented companies obsolete. The second is the historical decline in relative valuation between value and growth stocks. The third is simple bad luck in the form of out-of-favor stocks becoming cheaper and oversampling of negative returns.

The researchers’ efforts began with “the examination of the question of adequacy” of the standard Fama and French (1993) book-to-price (B/P) definition of value in light of the economic transformation away from agriculture and manufacturing and toward service and technology. Arnott et al. (2020) observed “that B/P … tends to misclassify stocks as value and growth by failing to capture a company’s investments in intangible assets.” Arnott et al. (2020) base their assertion on the idea that “a company presumably undertakes the creation of intangibles (e.g., research and development, patents, and intellectual property) because management expects these investments to enhance shareholder value. These investments, however, are typically treated as an expense and are not accounted for as an amortizable asset on the balance sheet, effectively lowering—we would argue understating—book value by the amount invested in the intangibles. … This accounting treatment leads the stocks of many companies to be classified as growth stocks because of low—sharply understated—book values.”

Arnott et al. (2020) also decomposed “the returns of value relative to growth” by attributing “the relative performance to three components:” migration (which takes place when value stocks appreciate and are reclassified as growth stocks or when the reverse occurs as growth stock prices fall and former growth companies become value plays), profitability (growth stocks are typically more profitable than value stocks), and change in relative valuation. Arnott et al. (2020) assert that: “*Since 2007, well over 100% (116%) of the shortfall of value relative to growth is a consequence of value becoming cheaper relative to growth* … In the most recent 13-year period, the revaluation component appears to be the key to understanding why growth stocks outperformed value stocks.”

To explore the role of bad luck, Arnott et al. (2020) conducted an analysis of the likelihood of observing a drawdown of -54.8 percent using the bootstrap method detailed by Arnott et al. (2019). The results suggest that the probability of observing a drawdown equal to or greater than this magnitude is 2.3 percent, “even when based on past returns that exclude the drawdown period, using historical data from 1963 through mid-2007, a span in which value beat growth by 6% per year.” This outcome, while unlikely, is within the range of feasible results. Accordingly, the amount of bad luck required to explain value’s performance is not out of the ordinary range of expectations.

Arnott et al. (2020) support their assertion that value as an investment strategy remains alive and well by pointing out: “As of mid-2020, relative valuations for value relative to growth are in the extreme left tail of the historical distribution. If, as history suggests, there is any tendency for mean reversion, the expected future returns for value, by almost any definition, should be above historical norms. Indeed, we show that even if the relative valuation remains in the current bottom percentile, the structural components (migration and profitability) should offer a positive overall return."

In recognition that the timing of mean reversion can be difficult to predict, Arnott et al. (2020) acknowledge that the backward-looking nature of the analysis and the noisy nature of return data "create a wide distribution of outcomes over shorter spans, even over the next five years. Although value strategies seem as attractive as they have ever been, an elevated *expected* return is not a guarantee that value *must* outperform growth over shorter spans …" They also note that intangibles-adjusted book-to-price, while an "improved measure of value has also recently suffered a large drawdown" may still be "missing something important."

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