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By Baruch Lev and Anup Srivastava

Reviewed by James E. McWhinney

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'Explaining the Recent Failure of Value Investing'

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Value investing, which researchers Baruch Lev and Anup Srivastava define as "going long on low-valued ('value') stocks and shorting highly valued ('glamour') equities," delivered impressive results for decades. That time-tested approach worked until 2007, at which point Lev and Srivastava (2019) assert that it "appears to have lost its magic." The researchers believe the strategy's failure can be attributed to: "(1) accounting deficiencies causing *systematic* misidentification of value, and particularly of glamour (growth) stocks, and (2) fundamental economic developments which slowed down significantly the reshuffling of value and glamour stocks (mean reversion) which drove the erstwhile gains from the value strategy."

They argue that extensive data analysis demonstrates that "flaws in the accounting for intangibles, combined with fundamental economic shifts, have undermined the value strategy." Noting that "there is no universally accepted way of implementing the value strategy," they chose to base their analysis on "market-to-book ratio, since it is the most frequently used indicator by researchers (Lakonishok et al. 1994; Fama and French 1992, 1993; Kok et al. 2017; Ball et al. 2020), and by investment institutions (Russell Value Stocks, S&P, and MSCI Value indexes)." They also examined "another popular value indicator—the Price-Earnings ratio."

In terms of accounting deficiencies, the researchers note that "book value (equity)—the denominator of the market-to-book ratio—is measured with considerable error." They cite "the immediate expensing in income statements of all investments in internally-generated, value-creating, intangibles, such as R&D, IT, brand development, and human resources" as an "increasing source of book value mismanagement" and "a major contributor to the failure of value investing." In earlier eras, they note, "corporate investments were primarily in *tangible* (physical) assets," but "from the late 1980s" corporate intangibles saw significant growth, rising to twice the rate of tangibles. Accordingly, "a firm investing heavily in R&D, IT, brands, or business processes … may appear to be an overvalued company, due to its understated denominator of the market-to-book ratio, whereas in reality its valuation isn't excessively high when book value is properly measured. Furthermore, two similar companies, one generating its intangibles internally by developing patents, for example, whereas the other acquiring patents from other firms, will have substantially different market-to-book values because the former's book value is significantly smaller than the latter's. Same with the Price-Earnings ratio … due to the immediate expensing of intangibles" resulting in overstated PE ratios.

With regard to mean reversion, the researchers note a "a substantial slowdown of the mean reversion of both value and glamour stocks in the past 12 years, accounting for much of the decline of the profitability of value investing." They highlight that the "failure of value investing started in 2007—the first year of the recent financial crisis." The crisis, they note, resulted in a "combination of the prolonged contraction of bank lending and the falling of consumer demand" that pushed industries and firms into the ranks of value stocks "and largely kept them there for the past 10–12 years." The researchers explain that these firms "experienced exceptional operational difficulties: their profitability plummeted relative to previous periods (and relative to glamour companies)." The "poor profitability precluded most value firms from improving their performance by investing in innovation and growth (R&D, IT, brands, acquisitions)" thereby keeping them trapped in their low valuations and making investing in them "a losing proposition during 2007–2018." Glamour firms, on the other hand, had the opposite experience. Seeking to short these firms "was obviously a futile exercise."

For investors seeking true value stocks, Lev and Srivastava (2019) suggest that the following attributes can be used to evaluate investment candidates:

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- Higher intangible investment relative to total assets
- Higher net capital investment relative to total assets
- Steady sales growth
- Higher levels of debt raised relative to total assets
- Smaller size in terms of total assets
- Reported gains instead of losses
- Recapitalization via share repurchases

They state: "Overall, internal investments in traditional intangibles, like R&D, brands, information technology, and tangible investments, as well as the lesser visible investments in organization capital, or management, were the main drivers of growth in market value."

As to whether or not value investing will ever come back into favor, they explain that "some investors pin their hopes of a value rebound on believing that value stocks are now much cheaper than in past periods" but that "the annual differences between the median market-to-book ratios of large value and glamour stocks" suggest that they are not. Similarly, they see no reason for an "unusual improvement in the performance and valuation of financial institutions … or non-financial value firms."

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