The Outlook for Value

DECEMBER 2019

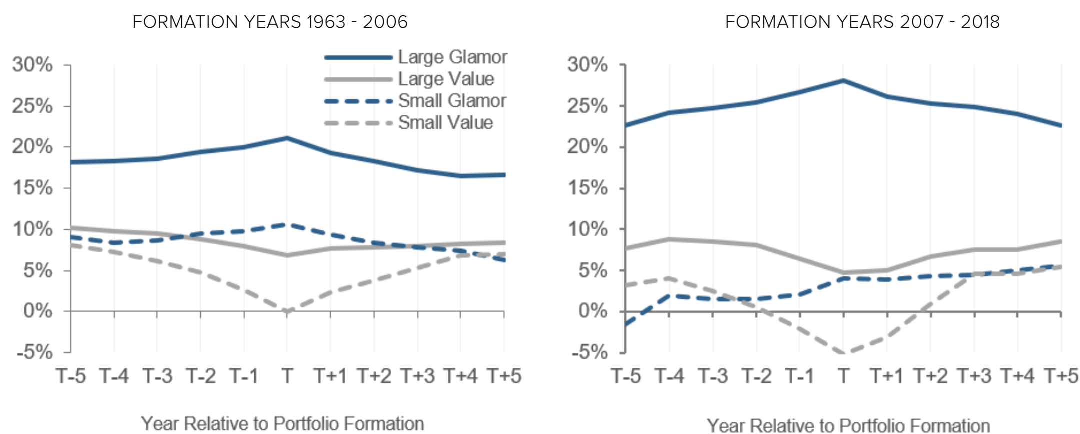
- In assessing the outlook for value, we see no reason to abandon value as a long-term component of a multifactor investing approach.
- From a tactical perspective, we advocate maintaining a value allocation in light of the market's current "one-factor bet on growth."
- We believe that refined value implementations informed by ongoing research are more likely to succeed going forward as the investing environment continues to evolve.

Value's underperformance has spawned a wave of financial media and practitioner discussion questioning its relevance as an investment approach. But, as we pointed out in recent research, "Returns to Value: A Nuanced Picture," prevalent narratives tend to gloss over aspects of value's performance that are germane to its interpretation, including material variation in efficacy across regions and market segments, asset versus income-based signals, and refined versus simple implementations.[1] Informed by these observations, we examined how macroeconomic conditions, investor thirst for long-term growth opportunities, and evolving economic structure and accounting practices all have influenced value's performance. The key question arising from that prior analysis is: what is the outlook for value going forward?

A pivotal issue is whether value investing has become obsolete as a concept. We do not believe that it has. In our view, as we discuss in our paper "Acadian's Approach to Value Investing," the long-term value premium results from investors' mis-extrapolation of fundamentals.[2] We are skeptical that investors have somehow become much better at interpreting and forecasting them than in the past, and we continue to see patterns in fundamentals that we would associate with mis-extrapolation. For example, Figure 1 shows that glamour and value stocks' profitability still tend to reverse their prior trends.[3]

Figure 1: ROE Trajectories for Hypothetical U.S. B/P Glamour and Value Portfolios

U.S. universe.



Each trace displays a time series average across the indicated portfolio formation dates of the trajectory of aggregate ROE within the portfolio from five years before to five years after portfolio formation. On each formation date, value and glamour portfolios are created from top and bottom terciles of stocks as ranked on the basis of B/P. Large-cap versus small-cap breakpoint is the NYSE median market capitalization. Portfolio constituents are held constant over the window from five years prior to five years after formation. For formation years after 2013, times series averages for T+1 through T+5 only include whatever observations are available through 2018. As a result, the sample size differs appreciably across each of those points on the righthand chart. Universe contains NYSE, AMEX, NASDAQ common stocks. Sources: Acadian calculations based on data from COMPUSTAT and CRSP® (Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. Crsp.uchicago.edu.) For illustrative purposes only. Past results are no guarantee of future results. They do not represent actual trading or actual accounts.

[1] See also "Returns to Value: A Nuanced Picture," Acadian, November 2019.

[2] See also "Acadian's Approach to Value Investing," Acadian, November 2019.

[3] Specifically, as Fama-French originally noted, earnings for glamour stocks grow faster than book in years prior to formation and fall in the years following formation. On the other hand, earnings for value stocks recover faster than book in the years following formation.

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From a more tactical perspective, we advocate maintaining a value allocation as part of a multifactor approach. While, as we've described in our recent research, the tepid macroeconomic climate has weighed on value efficacy, producing neither robust-enough growth to reward exposure to companies with fragile fundamentals nor a washout that punishes expensive valuations and/or generates panicked selling that is blind to valuation, economic conditions can change quickly. It's worth recalling that the U.S. Federal Reserve was still hiking rates in December 2018. Six months from now, we could be discussing the outlook for value in the context of a vibrant global rebound or a pronounced cyclical downturn.

Even if a middling economic climate were to continue, for much of past ten years the efficacy of income flavors of value held up relatively well, particularly in DM ex-U.S. and EM. As well, multifactor strategies benefitted from the efficacy of other factor groups, including momentum, quality, and growth. Diversification of alpha exposures across factor groups is one of the central tenets of Acadian's multifactor implementation of value, based in part on an expectation that individual factor groups will experience downdrafts, some severe or protracted, that are at best difficult to time. (See "Acadian's Approach to Value Investing," Acadian, November 2019 for an articulation of the principles and key design choices of our implementation.)

Beyond macroeconomic conditions, we see headwinds to trends that have contributed to increasing U.S. large-cap B/P glamour profitability and challenged investment strategies that are underweight this segment. Globalization and technological disintermediation of labor have sparked political backlash around the world, both nationalist and populist. The FAANGs and other technology, communications, and consumer giants have come under increasing regulatory scrutiny regarding privacy concerns and the disruptive impact of their business models. These considerations raise questions as to whether evolving government policies will prevent investors from harvesting endless streams of outsized earnings associated with insurmountable leadership or monopolistic power in emergent or evolving industries.

Further, we would expect high and seemingly secure profit margins among these companies to generate strong incentive for new entrants. Rapidly evolving technologies may afford opportunities for a new generation of competitors to quickly challenge incumbent business models based on what now seem like dominant approaches. Moreover, some already large, persistently profitable firms may reach a scale where they cannot consume their cash flows with R&D and instead turn to acquisitions to source growth, a behavior which would resemble a more traditional glamour-stock profile associated with historically familiar book value trajectories. Such developments might help to reverse deterioration in relevance of even simple asset-based value formulations.

We believe that value's struggles over the past few years resemble a market capitulation with respect to profitability, effectively the capitalization of historically high and rising ROEs among already expensive large-cap stocks. Strategies that have been underweight this market segment, including those tilted towards value or small-cap stocks, have underperformed. But reversion or even stabilization of those ROEs could remove a material headwind.

In summary, we conclude that there is no reason to abandon value as a long-term component of a multifactor investing approach, although simple and static implementations, e.g., smart beta, are vulnerable to degradation. We believe that sophisticated approaches, like Acadian's, that embrace both nuance in signal design and adaptivity in response to changes in the investing environment are more likely to succeed going forward. Tactically, we advocate maintaining a value allocation in light of risks to the market's current one factor bet on growth.

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