Invest Differently

30 September 2015

Value and Growth Investing in Perspective

If value investing works so well over the long term, why has the performance of value shares been so dismal over the past five years? In this paper, we look at the historical relationship between and value and growth shares and the implications for the current stockpicking environment.

Summary

- On average, value shares have outperformed growth shares over long periods.
- Growth shares typically offer better fundamentals, but often fail to live up to the high expectations built into their valuations.
- In recent years growth has outperformed for a number of reasons, one being quantitative easing, which has compressed discount rates, disproportionally benefitting growth shares.
- We can't predict when this will change, but value shares as a group currently look better than average.

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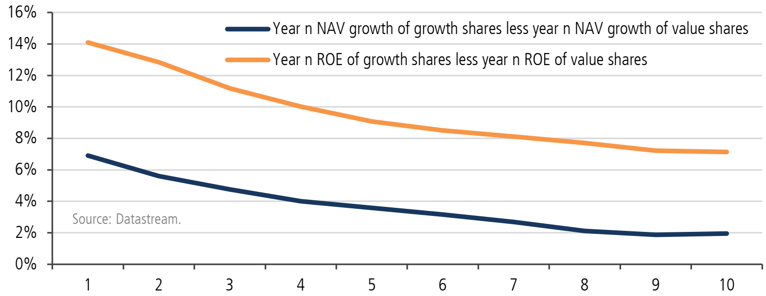
The "growth" and "value" buckets into which managers often get categorised have never made much sense to us. In our eyes, a good investment is one that is priced at a significant discount to our assessment of its intrinsic value. Simplistic criteria such as a low price-to-book ratio mean very little in isolation, as both low- and high-growth companies have the potential to be mispriced. Historically, we have found investment opportunities across the growth and value spectrum, and continue to do so today.

That said, the value category has, on average and over the long term, generated more pleasing performance than the growth category. More than a few academics and practitioners have studied this effect and have tried to explain it. We have dug into the data ourselves and can see a number of possible contributing factors. Perhaps the most interesting among these is evidence suggesting that the value bucket typically contains a greater concentration of undervalued shares. As an illustration, we separated US shares into growth and value buckets based on price-to-book value criteria using data going back to 1990. We then asked how well that simple classification explained the actual fundamentals realised by those companies in subsequent years. In other words, do "growth" stocks actually deliver the superior growth characteristics that their starting valuations would suggest?

Growth outgrows value, but the advantage erodes over time

Difference between the realised return on equity (ROE) and net asset value (NAV) growth of high price-to-book (growth) and low price-to-book (value) shares



The chart at right shows the difference, on average, between high and low price-to-book shares according to the subsequent growth of shareholder equity (net asset value) and the return on that equity (ROE) in the years following their classification into the growth or value bucket. It is clear from the chart that the market does a good job differentiating between high and low-growth companies in the short term. Realised growth and profitability are far higher for growth shares than for value shares in the immediate years following classification. Over time, however, the fundamentals begin to converge. Both the profitability and equity growth rate gap suffer meaningful erosion even though the growth bucket's profitability advantage appears to persist.

The key question for investors is determining what's already reflected in the price. On average, the market rightly ascribes a meaningful price-to-book discount to value versus growth shares. However, in order to justify the magnitude of their premium over value stocks, growth stocks must maintain their superior net asset growth and profitability for longer than has been realised on average in the past. Said differently, so-called growth stocks indeed offer better fundamentals, but this is often not enough to live up to the expectations built into their valuations.

As bottom-up stockpickers, we actively look for this type of mismatch between fundamental prospects and market expectations when analysing individual companies. We believe that a greater concentration of these mismatches amongst lower-growth shares is one reason why Orbis has historically exhibited a tangible skew toward "value" areas of the market, and it also provides a possible explanation for the long-term outperformance of the value category as a whole. Exciting, innovative companies in growing industries are great to own when you can buy them at attractive prices—and sometimes we are able to do just that—but those opportunities are generally hard to come by. At the opposite end of the spectrum, value shares tend to be boring, ignored, unloved or even troubled businesses—the type of investment that you'd be embarrassed to mention at a cocktail party. These seemingly unappealing traits attract fewer enthusiastic buyers, create greater potential for mispricing, and therefore produce a larger concentration of mispriced investment opportunities in the value bucket.

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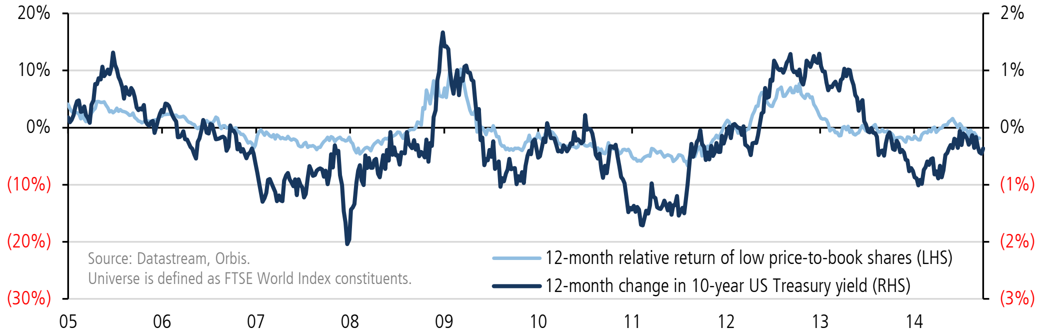
Taking advantage of those opportunities, however, requires patience. In the most recent cycle, we have witnessed an abnormally prolonged period of underperformance for the value category. During that period, Orbis' skewed exposure toward value shares has created a stiff performance headwind.

If value tends to outperform growth over the long term, why has it done so poorly in recent years? Are investors now more measured when assessing the long-term prospects for high-growth businesses? We don't think so. One reason for the underperformance of the value category (and therefore outperformance of the growth category) has been falling sovereign bond yields. The reason is simple: lower bond yields feed into lower equity discount rates, and lowering discount rates disproportionately benefits valuations of growth companies because it increases the value of cash flows received further into the future. This is once again something that can be seen in the data. As shown in the following chart, the correlation between changes in sovereign long bond yields and the relative performance of value stocks has been high for a number of years.

Through its impact on sovereign bond yields, quantitative easing (aggressive central bank purchases of government bonds) has hindered value stocks and helped their growth counterparts. In one sense this is entirely rational because lower discount rates should lead to disproportionately higher valuation multiples for growth stocks. But if you believe that bond yields are not reflecting economic reality at current levels, or you simply believe that yields will stop falling (noting that in many regions they are not far above zero), then you might also expect the prolonged headwind for value shares to eventually ease. We don't think this dynamic is well appreciated. Investors appear to be both bearish on sovereign bonds and bullish on growth stocks, which seems inconsistent to us.

The relative performance of value shares has been correlated with changes in bond yields

Subsequent 12-month relative return of low price-to-book shares vs the FTSE World Index and subsequent 12-month change in the 10-year US Treasury yield, 2005 through September 2015



We have seen cycles like this before, in which macroeconomic factors cast a larger-than-normal shadow on the pricing of assets. While these periods can be frustrating, especially when we find ourselves on the wrong side of the trend, they can also create the type of meaningful mispricings that are the lifeblood of our investment approach. According to our data, the average value stock now trades at a meaningfully wider-than-normal discount to the average growth stock. This holds true in most regions and isn't surprising given the recent performance differential between the two categories. This divergence is one reason why our bottom-up analysis has led us to hold more of the type of investment that one is a little embarrassed to admit one owns, but we believe this is the price we must pay for seeking superior long-term returns.

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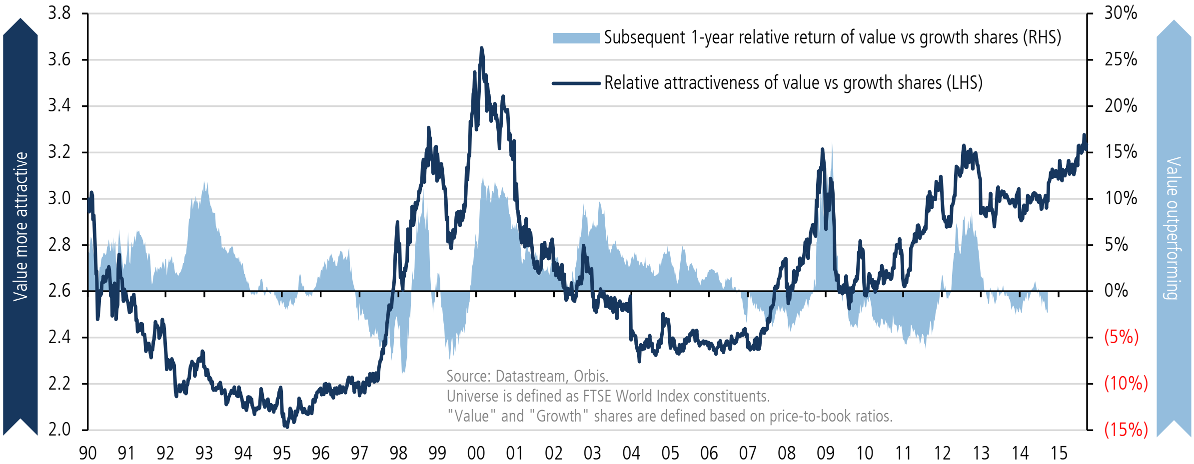
Value shares look increasingly attractive relative to growth shares

Relative attractiveness and subsequent 1-year relative return of value vs growth shares, 1990 through September 2015



Source: Datastream, Orbis.
Universe is defined as FTSE World Index constituents.
"Value" and "Growth" shares are defined based on price-to-book ratios.

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