The Case for Active Value Investing

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Important Information

- The value of investments and the income from them can go down as well as up and investors may not get back the amount invested.
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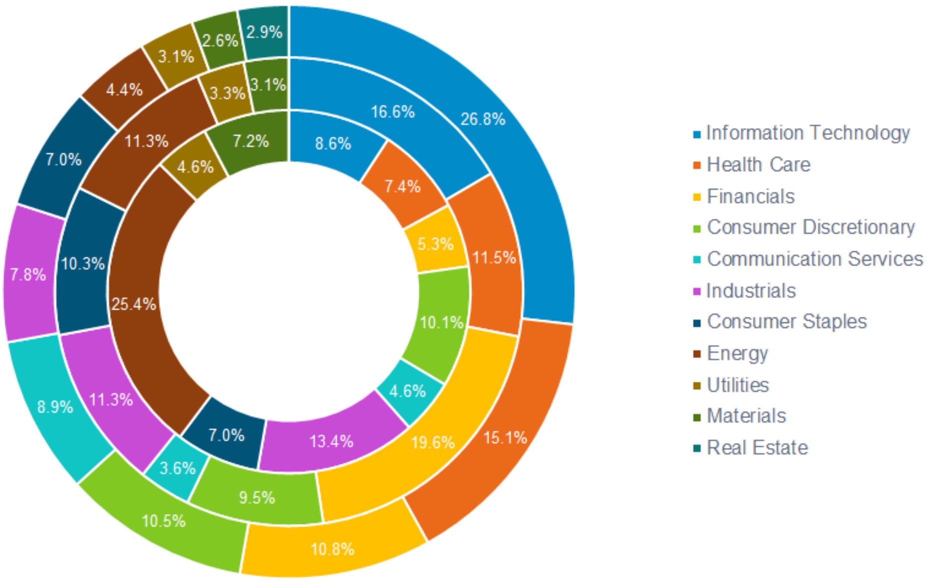
Summary

Value investing (an investment strategy that focusses on identifying stocks that are trading below their intrinsic value) has been revitalised after a decade of underperformance. This about turn poses challenges to some of the beliefs which have become entrenched in an investor's psychology. After a decade of money printing and soaring tech valuations, the orthodoxy that passive investing tends to deliver optimal results over time may now be under threat, creating a dilemma for investors. This perspective note aims to evidence why some of these widely held beliefs may prove less ironclad than previously believed, why investors should be more discerning when allocating capital and why now is the time to review the case for active value investing.

Belief 1: Passively held investments in a diversified index like the S&P 500 are the best option for investors

This has been true for a long time, the investment thesis has been well-supported, and importantly this style of investment has worked well for investors. However, this is now creating a unique set of challenges due to the dramatically changed composition of S&P 500. With the dominance of mega cap tech companies, S&P 500 has now essentially become a 'hyper growth index'. It has disconnected from the true economy, and no longer reflects the broad US economic mix, which is what investors are typically looking for when investing in a diversified index.

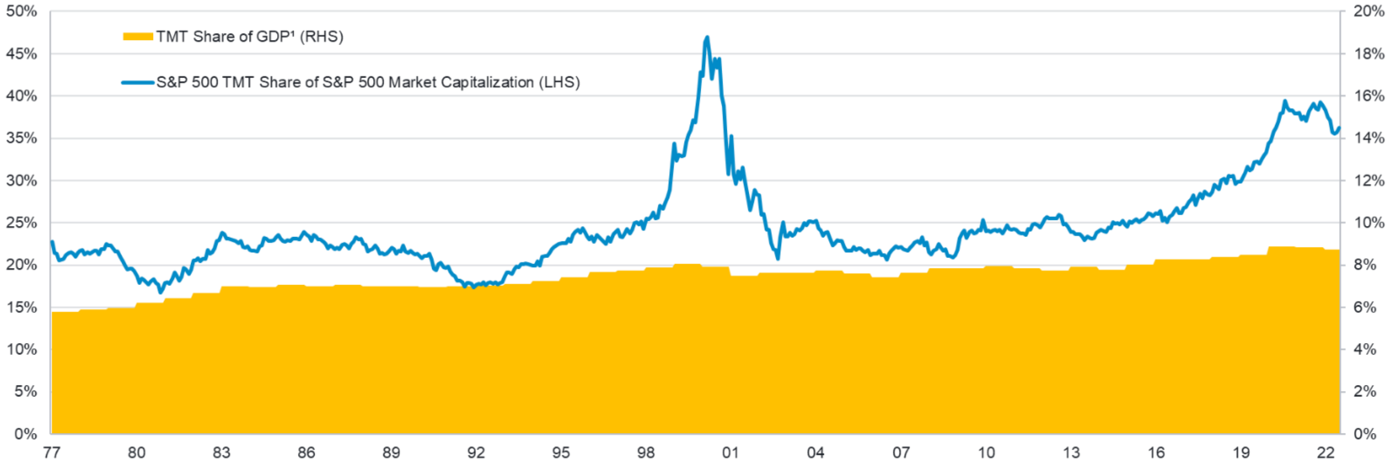
Chart 1: S&P 500 sector composition by market cap - 1980 vs. 2007 vs. 2022



Source: Fidelity International, 30 June 2022. Compustat, DWS Investment GmbH.

This problem has been exaggerated by the valuations of these mega cap tech companies. The speculative mania resembles the nifty fifty bubble of the '70s, when all investors wanted to buy were high quality growth companies regardless of valuation. Today, indices dominant in mega cap tech stocks, may not offer the same investment opportunities as they did 10 years ago. Valuation justifications for these growth companies are now only supported by an unrealistic cash flow calculation extended to infinity, despite historical evidence indicating that the disruptive nature of the tech industry results in each technology being disrupted by a new one every few decades.

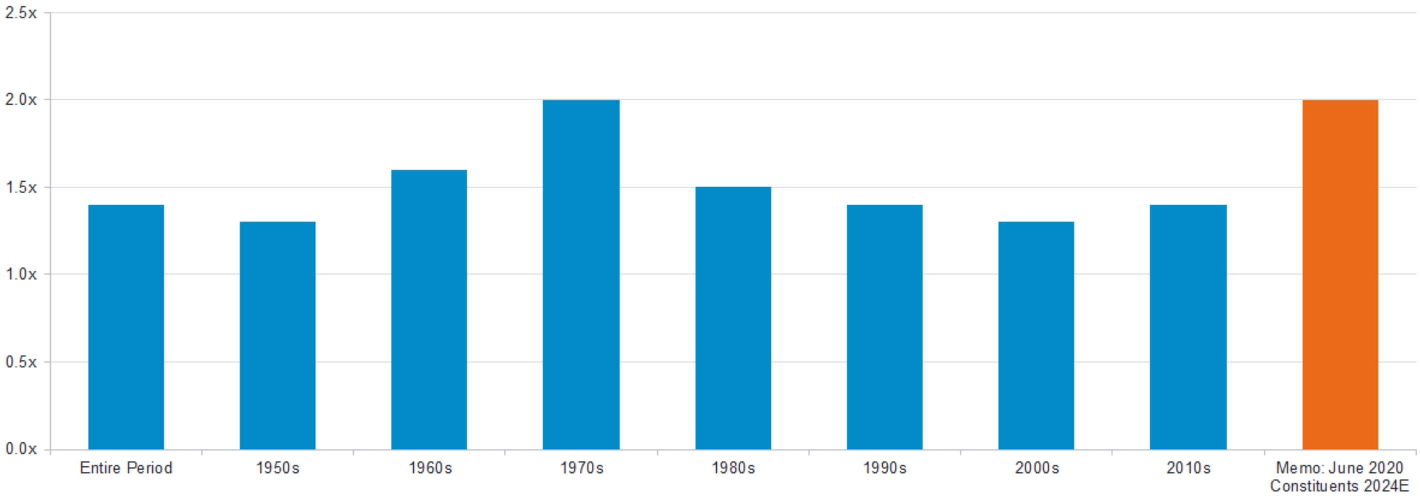
Chart 2: TMT as % of S&P 500 and as % of GDP over time



Source: Bureau of Economic Analysis, Empirical Research Partners Analysis, 1977 Through Mid-July 2022. [1]Computer and electronic products manufacturing, information, and computer systems design and related services. As best as possible, the current sector map is applied backwards in time (so, EBAY is not tech before 2018, for example. TMT = Technology, Media, and Telecom (TMT) Sector.

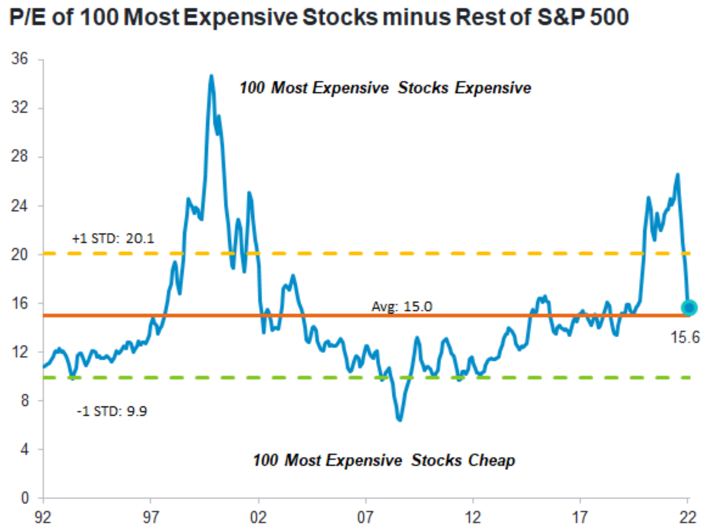
Moreover, when we extrapolated the same kind of growth for mega cap tech companies (which are different every decade) for the next 5 years and calculated their median relative PE, in June 2020 their relative PE had reached the same level as in the 1970s.

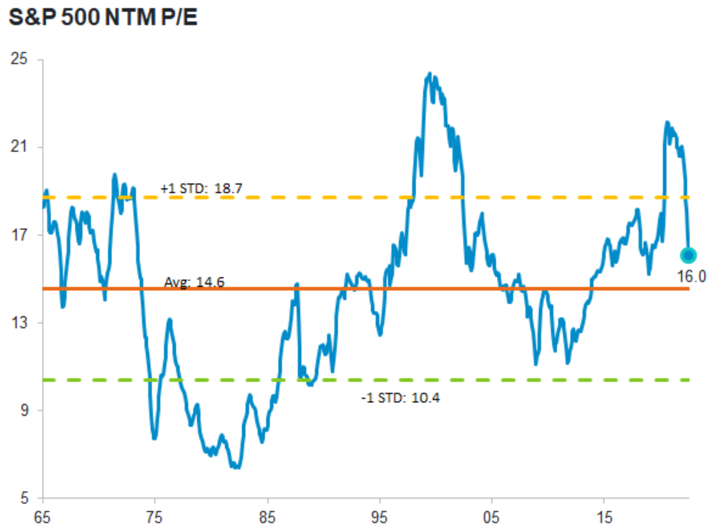
Chart 3: The Big Growers Median Forward Relative-P/E Ratios Based on Actual 5-Year Forward Earnings – 1952 through June 2020



Source: Visible Alpha, Empirical Research Partners Analysis.

Charts 4 & 5: Valuation ratios





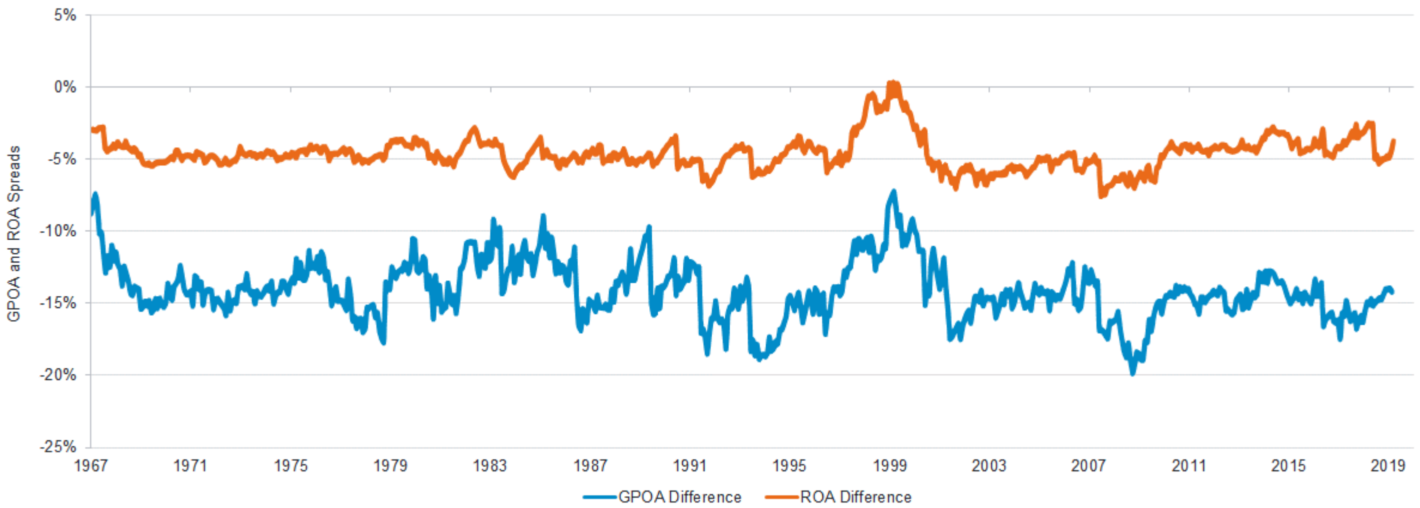
Source: Source: Fidelity International, Standard & Poor's, FactSet, Refinitiv, Credit Suisse US Equity Strategy, July 2022.

This problem gets resolved through two factors, firstly by investing with an active approach and secondly, building a portfolio that is more diversified than the S&P 500.

Belief 2: Value stocks are junk quality, are declining businesses and not even worth considering

This could be a fair comment, if taken with a broad view. Value stocks, on average, are slightly lower quality than the broader market, but the differential in returns of assets for example has not increased over time, as shown in chart 6, and there are still hundreds of very decent businesses which can grow, compound and are trading at perfectly reasonable valuations in all parts of the market.

Chart 6: Gross profitability and return on assets - Spread between a cheap and expensive portfolio



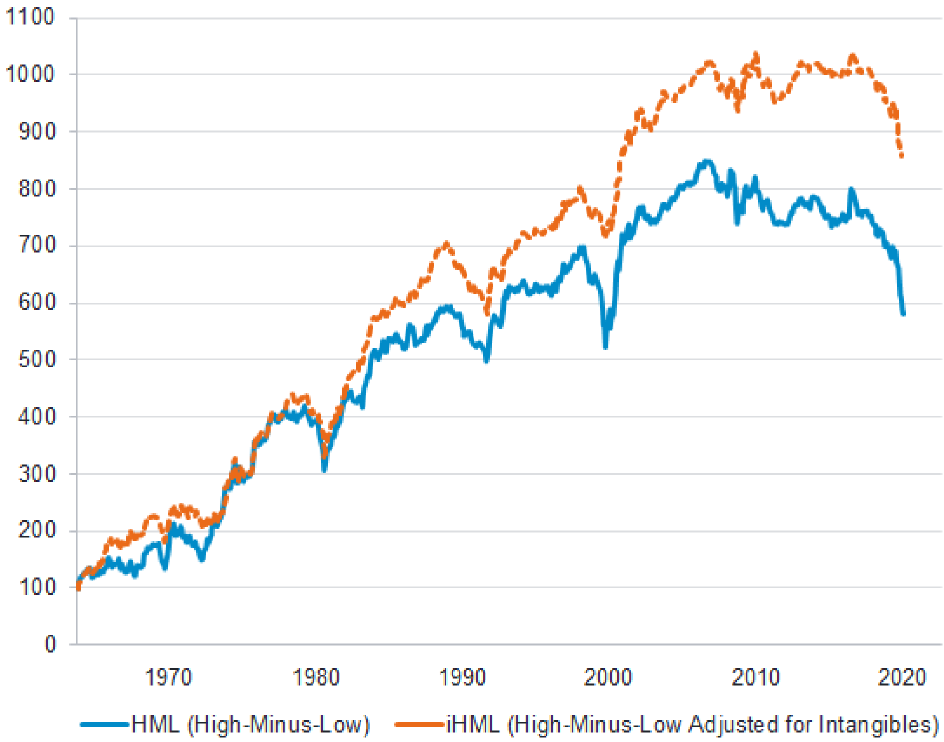
Source: AQR, CRSP, XPressFeed, 31 December 1967 – 31 March 2020. Portfolios based on Equal-Weighted Top 1000 Stocks, Industry-Neutral, Price-to-Book Sort. For illustrative purposes only and not representative of any portfolio that AQR currently manages. The exhibit above plots the gross profitability of the cheap portfolio minus the gross profitability of the expensive portfolio (and the same for ROA).

There are some GDP+ growers with high returns, good cash conversion, barriers to entry, which are undervalued right now. They just don't grow 50% a year. This doesn't make them low quality, declining or bad investments. Given current valuation discrepancies, right now, they are superior investments.

Belief 3: We can replicate a good value index very easily by screening for low multiples

In fact, this is very difficult. Simplistically, one way to do this is to quantitatively screen for low Price/Book (P/B), low Price/Earnings (P/E), low Price/Cash Flow (P/CF) or any other multiple and include these stocks in a large value index. However, there are many obvious problems with this approach. This explicitly ignores the intrinsic value of an organisation calculated using the long-term earning power of a company, as we know near-term earnings can be very volatile for many companies and don't always reflect the mid-cycle earnings power. Low earning-based multiples can provide misleading signals. Even asset-based multiples, like P/B and Enterprise Value/Invested Capital (EV/IC), are problematic because they don't include all the investments made by US corporations in intangibles like Research and Development, sales and distribution, brand, etc. This can only be done by qualitatively analysing companies and manually adjusting their asset values for all the intangible assets created by them, which are not accounted for on their balance sheet and can't be captured by a quantitative screen reviewing the book value on the balance sheet. As shown in chart 7, adjusting asset values for intangibles results in improved performance.

Chart 7: Adjusting for Intangibles improves value - US Total Return (1964-2020)



Source: Robert Arnott, Campbell R. Harvey, Vitali Kalesnik, and Juhani T. Linnainmaa, "reports of value's deaths may be greatly exaggerated", Financial Analysts Journal, 77-1(44-67),2021. Series rebased to 100 on January 1964.

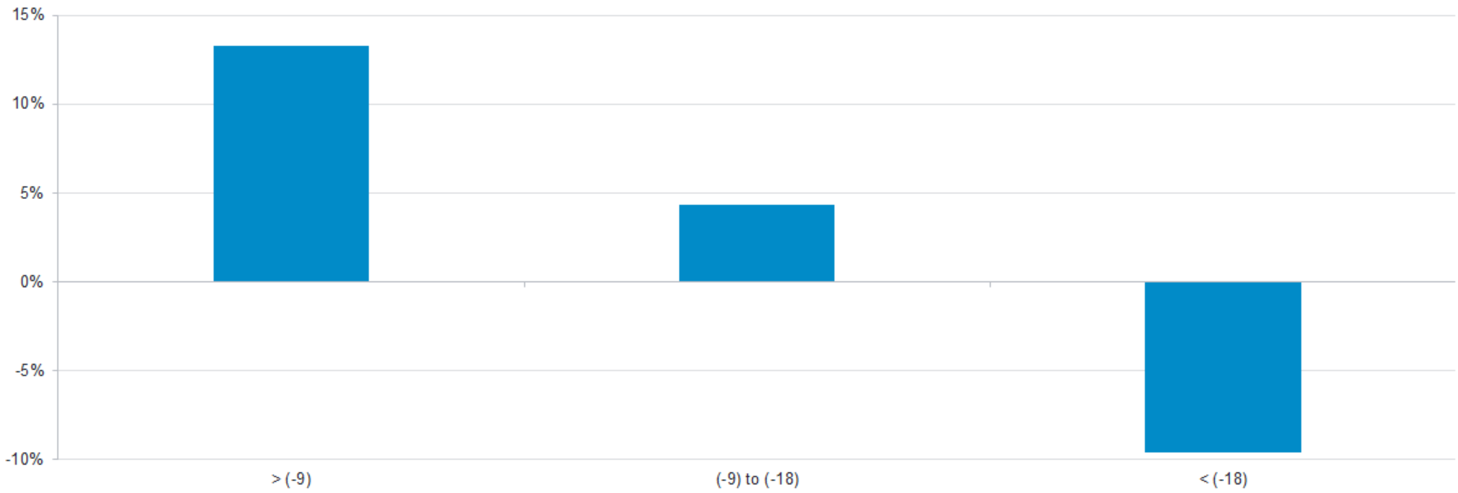
Table 1: Top 10 companies that score Good or Above Average in HOLT's Accounting Quality, Special Items, and Intangible categories

Security name	Sector	Intangibles[1] as % of total book assets
Apple	Information Technology	1%
Microsoft	Information Technology	18%
Alphabet	Communication Services	7%
Meta Platforms	Communication Services	13%
ExxonMobil	Energy	0%
Lowe's	Consumer Discretionary	2%
Deer & Co	Industrials	7%
AutoZone	Consumer Discretionary	3%
Nucor	Materials	15%
PACCAR	Industrials	0%

Source: HOLT Lens™ Screening Date: June 20, 2022. Universe: USA > $5B market cap. Screening criteria: Companies that score Good or Above Average in HOLT's Accounting Quality, Special Items, and Intangible categories; >0% upside in HOLT. Top 10 companies shown sorted by market cap (limit 2 per sector); Intangible and NON-GAAP data shown is based on LFY. A 'good' score in HOLT's Accounting Quality indicates the company quantitatively ranks in the top quintile on a size & region-relative basis. [1]Can include HOLT estimated amounts.

Another issue with value indices constructed of companies with low valuation multiples is that they struggle to adjust for quality. The common perception that value stocks are low quality is not without merit, as value stocks overall are slightly lower quality and there are many value stocks with significantly lower quality. How do investors avoid these parts of the market? Studies have been done indicating that if investors focus on the higher quality end of the value universe, the probability of outperformance is much higher than if quality is not taken into account. Typically, value indices don't tend to pay attention to quality, which is why an active approach to value investing is key to achieving outperformance. An evaluation of quality for value stocks is a very subjective process which requires a deeper understanding of business model, intangibles and cyclicality which are hard to capture via a screen-based model. Therefore, just like valuation, even quality for value stocks is better evaluated through painstaking fundamental analysis of each company one by one, rather than an easy convenient screening tool.

Chart 8: Performance of higher quality stocks - 1 Year annualized forward returns of cheap minus expensive DM stocks at different levels of the quality gap



Source: BCA Research, December 2021. Note: Cheap (expensive) stocks are those in the top (bottom) 30% of the value score. The average quality score of cheap (expensive) stocks is the market-weighted average quality of all the stocks in the top (bottom) 30% of value. Quality gap is the 12-month smoothed difference in quality score between expensive and cheap stocks. Based on data from S&P Global.

Conclusion

We would suggest that unlike investing for a broad core exposure, an active investment approach supported by qualitative evaluation of business's quality and value makes the most sense for value investing.

In our US value offering, this belief is front and centre of our investment approach and we work hard to analyse the market and achieve our goal of a true value quality fund built for the long-term.

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