MV CAPITAL MANAGEMENT

Weekly Market Flash

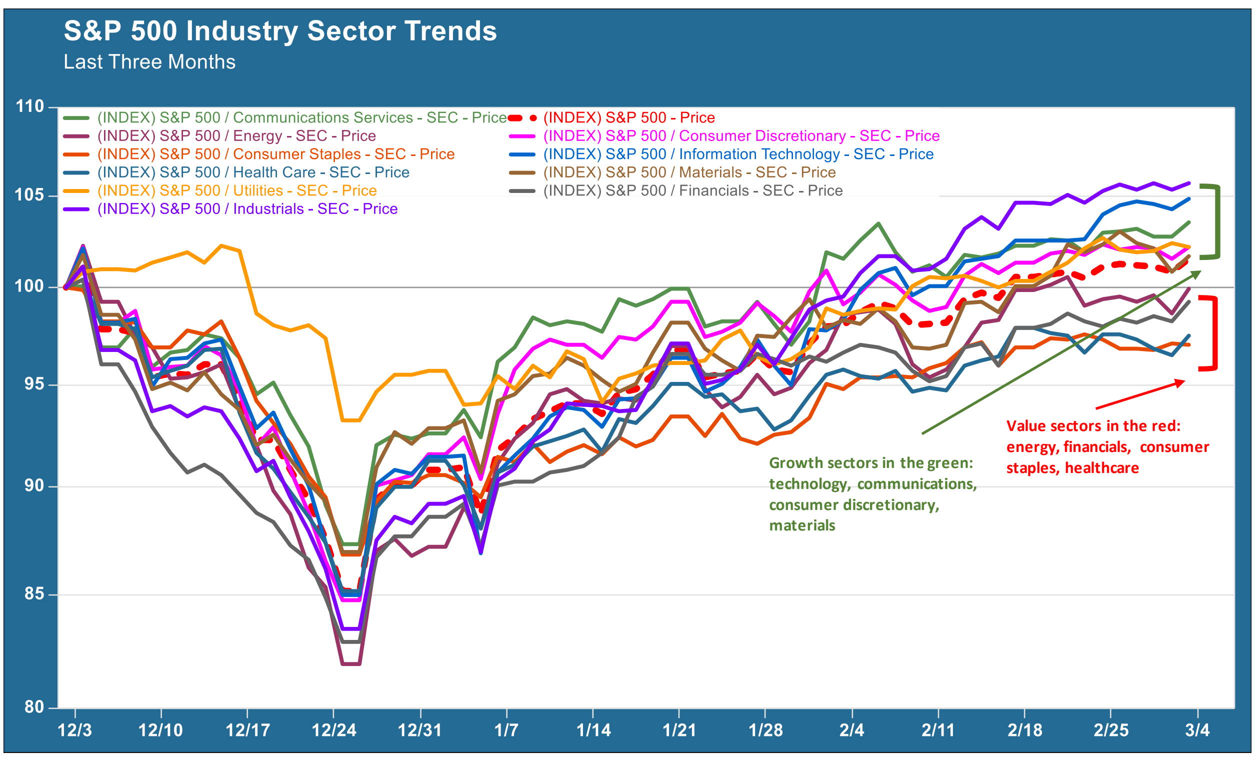
The Value Investor's Lament

March 1, 2019

Happy meteorological spring! Not that the calendar's third month is bringing much in the way of springlike conditions to many parts of the US, including our own Chesapeake Drainage Basin Region. There's not a whole lot of warmth in the world of value investing either – and there has not been for a very long time. Why exactly has one of the most time-tested old chestnuts of investing – the value effect – gone so completely pear shaped? We ponder this question in today's missive.

Another Rotation Forestalled

For awhile it seemed that the tide had turned for the beleaguered legions who continue to swear by the Graham & Dodd value formula. Last fall's comeuppance in equity markets dealt particularly harshly with the high-flying tech stocks and other growth sectors that had led performance for much of the recent phase of the bull market. But a snapshot of the last three months reveals how fleeting that value rotation was. As shown in the chart below, all four S&P 500 industry sectors trailing the overall index on a three month trailing basis are traditional value sectors: consumer staples, health care, financials and energy.



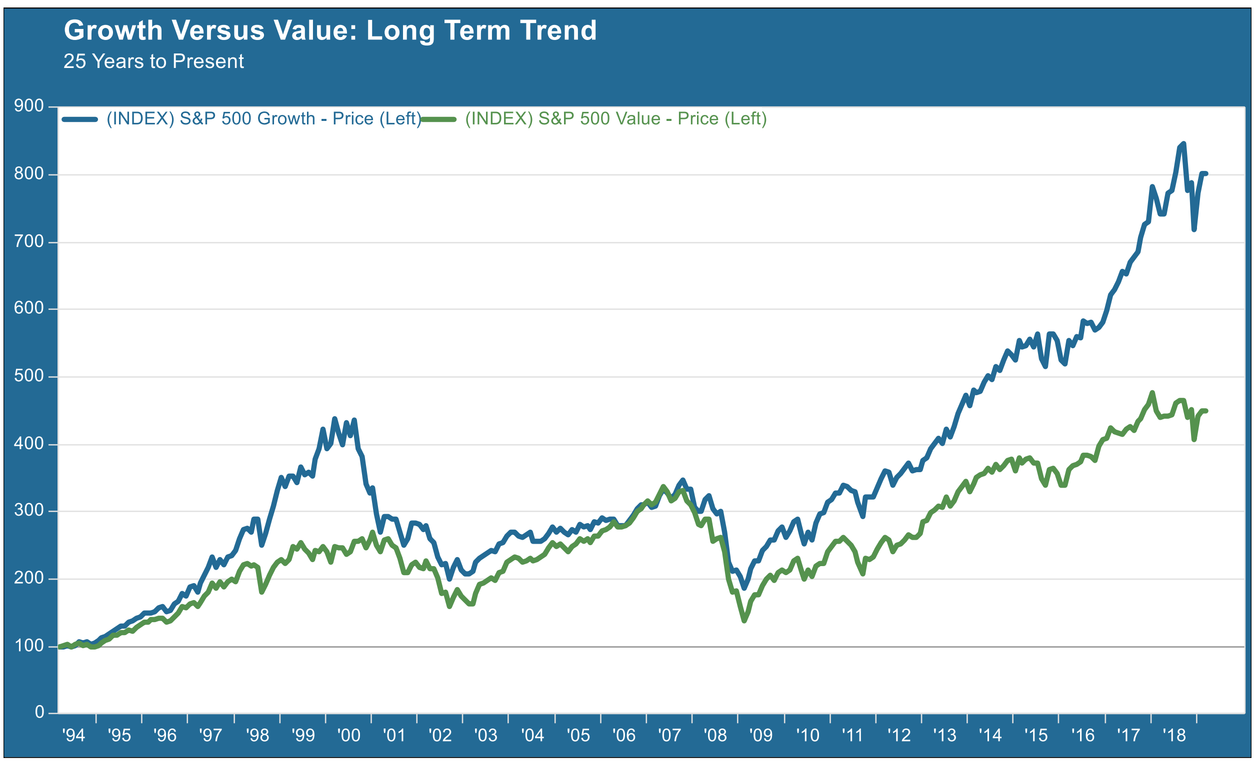
Source: MVF Research, FactSet

The dichotomy is not perfect: the utilities sector, generally considered a dividend/value play, continues to outperform the overall index. And the top-performing sector over this period is industrials (the purple trend line on the chart), which is cyclical but typically not an overweight component of growth stock indexes. Otherwise, though, the traditional growth cohorts of technology, communications services and consumer discretionary have been at the leading edge of the extended relief rally we have witnessed since late December last year (along with materials, which is a sort of growth-y cyclical sector).

The Long View Looks Even Worse

Now, the traditional value investor's response to any short-term snapshot like the one we provided above goes thus: "sure, there are those irrational periods where starry-eyed investors flock to pricey growth stocks. But in the long run, value always wins. That's why there is such a thing as a value effect enshrined in the scriptures of modern portfolio theory."

Er, not so much. Consider the chart below, which shows the relative performance of the S&P 500 Growth Index versus the S&P 500 Value Index over the last quarter century going back to 1994. A quarter century that encompasses bubbles, crashes, growth cycles and bear cycles – a veritable kitchen sink of equity market conditions. A quarter century in which growth – the blue trend line – outperformed value (the green line) by nearly double.



Source: MVF Research, FactSet

You can call a quarter century a lot of things, but you can't really call it "short term." To say that "value outperforms growth in the long run" is simply to ignore the glaring evidence supplied by the data that there is actually no such thing as a value effect any more. It is dead, *requiescat in pace*. But why?

Nothing Stays the Same Forever

There probably will not be a settled conclusion about the demise of the value effect for some time to come. For one thing, there will continue to be value stock fund managers whose livelihood depends in some part on there being a value effect, just like there will always be fossil fuels company executives whose compensation structure benefits from a belief that there is no such thing as climate change. We might posit an idea or two about what has caused the long term malaise in value, though.

If you think about our economy in the sweeping scale of the last quarter century there are two trends we would argue rise to the level of tectonic shifts. The first is the downfall of the financial services industry as the lead engine of economic growth. From the early 1980s through the middle of the 2000s, the share of total S&P 500 corporate profits claimed by the financial sector more than doubled, from around 20 percent to 44 percent just before the crash of 2008. Financial services, in a variety of consumer and commercial guises, powered the economy out of the doldrums of the 1970s and into the halcyon days of the Great Moderation.

The second trend, which started roughly in the mid-1990s but really gained traction in the 2010s, was the encroaching by the technology sector into just about every other facet of commerce – and of life itself, if one wants to extend the argument to the rise of social media and the like. Not a single industry sector exists wherein competitive advantage does not derive in some meaningful part from technology. In this environment those who sit closest to the servers – i.e. the megacap tech firms who own the platforms and the attendant network effects – reap the lion's share of the rewards.

Now, it just so happens that financial services companies typically have the characteristics of value stocks (low price to book ratios and similar metrics) while enterprises in the technology sector are more likely to sport the sales & earnings growth traits that screen into growth stock indexes. At the same time, the economic growth cycle of 2009 to the present has been dominated by one gaping anomaly when compared to any other growth cycle – near-zero interest rates for a large percentage of the time. Low rates have been particularly harmful to financial firms that make money based on profiting from the spread between their financial assets and their financial liabilities. They have been a boon for companies looking to leverage their growth prospects through cheap external financing.

This is by no means a complete and comprehensive explanation for the vanishing of the value effect. And from a portfolio management standpoint there should always be a rationale to include value as an asset class for diversification purposes. But the traditional interpretation of the "value effect" as being a sure-fire winning proposition in the long run is not a valid proposition. Financial markets are complex, and complex systems produce emergent properties that only become apparent after they emerge. Change happens. No doubt there will be a few emergent surprises for us in the weeks and months ahead.

Masood Vojdani
President & CEO

Katrina Lamb, CFA
Head of Investment Strategy & Research

advice. A copy of the MV Capital Management, Inc.'s current written disclosure statement discussing our advisory services and fees is available for review upon request.