



Don't Give Up on the Value Factor

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As the director of research for Buckingham Strategic Wealth and The BAM Alliance, I've been getting lots of questions about whether the value premium still exists. Today I'll share my thoughts on that issue. I'll begin by explaining why I have been receiving such inquiries.

Recency bias – the tendency to give too much weight to recent experience and ignore long-term historical evidence – underlies many common investor mistakes. It's particularly dangerous because it causes investors to buy after periods of strong performance (when valuations are high and expected returns low) and sell after periods of poor performance (when valuations are low and expected returns high).

Is the value premium fading?

A great example of the recency problem involves the performance of value stocks (another good example would be the performance of emerging market stocks). Using factor data from Dimensional Fund Advisors (DFA), for the 10 years from 2007 through 2017, the value premium (the annual average difference in returns between value stocks and growth stocks) was -2.3%. Value stocks' cumulative underperformance for the period was 23%. Results of this sort often lead to selling.

Investors who know their financial history understand that this type of what we might call "regime change" is to be expected. In fact, even though the value premium has been quite large and persistent over the long term, it's been highly volatile. According to DFA data, the annual standard deviation of the premium, at 12.9%, is 2.6-times the size of the 4.8% annual premium itself (for the period 1927 through 2017).

As further evidence, the value premium has been negative in 37% of years since 1926. Even over five- and 10-year periods, it has been negative 22% and 14% of the time, respectively. Thus, periods of underperformance, such as the one we've seen recently, should not come as any surprise. Rather, they should be anticipated, because periods of underperformance occur in every risky asset class and factor. The only thing we don't know is when they will pop up.

However, a long period of underperformance should not cause investors to abandon a well-developed plan. Nor should it cause them to question the existence of the value premium any more than it should

have caused them to question the existence of the market beta premium when DFA data shows it turned negative for 3% of the 20-year periods from 1927 through 2017. That's not all too different than the 6% of 20-year periods that the value premium was negative during that time.

Don't give up on value

As I've discussed before, there are several reasons investors should continue to expect an *ex-ante* value premium. The first is that risk cannot be arbitrated away, and the research offers many simple and intuitive risk-based explanations for the persistence of the value premium.

Second, if – as many people believe – the publication of findings on the value premium has led to cash flows that have caused it to disappear, we should have seen massive outperformance in value stocks as investors purchased those equities and sold growth stocks. Yet the last 11 years have witnessed the reverse in terms of performance.

Third, academic research has found that valuation metrics, such as the earnings yield (E/P) or the CAPE 10 earnings yield, and valuation spreads have predictive value in terms of future returns. In other words, the higher the earnings yield, the higher the expected return, and the larger the spread in valuations between growth and value stocks, the larger the future value premium is likely to be. What's more, this relationship holds across asset classes, not just for stocks.

For example, the 2007 study “Does Predicting the Value Premium Earn Abnormal Returns?” by Jim Davis of DFA found that, despite book-to-market ratio spreads containing information regarding future returns, style-timing rules did not generate high average returns because the signals are “too noisy.” They don't provide enough information to offer a profitable timing signal.

The October 2017 study “Value Timing: Risk and Return Across Asset Classes” by Fahiz Baba Yara, Martijn Boons and Andrea Tamoni (which the authors last updated in March 2018) offers further support that valuation spreads provide information.

The authors found that “returns to value strategies in individual equities, commodities, currencies, global government bonds and stock indexes are predictable by the value spread In all asset classes, a standard deviation increase in the value spread predicts an increase in expected value return in the same order of magnitude (or more) as the unconditional value premium.”

More evidence

Given that valuation spreads have been shown to possess predictive value, we can examine current valuation spreads to see if they have shrunk in a way that would be expected to eliminate the value premium.

I happen to have kept a table from a seminar DFA gave in 2000. It shows that, at the end of 1994, the price-to-book (P/B) ratio of large growth stocks was 2.1 times as big as the P/B ratio of large value stocks. Using Morningstar data, as of March 23, 2018, the iShares S&P 500 Growth ETF (IVW) had a P/B ratio of 4.9, and the iShares S&P 500 Value ETF (IVE) had a P/B ratio of just 2.0 – the spread has

actually widened from 2.1 to 2.5.

We can also look at the price-to-earnings (P/E) metric. In 1994, the ratio of the P/E in large growth stocks relative to the P/E in large value stocks was 1.5. Using the same ETFs as I did before, that ratio is now 1.4, virtually unchanged.

We see similar results when we look at small stocks. The DFA data show that, at the end of 1994, the P/B of the CRSP 9-10 (microcaps) was 1.5 times as large as the P/B of small value stocks. Using data from Morningstar, and DFA's microcap fund (DFSCX) for microcaps and its small value fund (DFSVX) for small value stocks, as of Jan. 31, 2018, the ratio of the funds' respective P/B metrics was the same 1.5.

When we look at P/E, again the results are similar. At the end of 1994, the ratio of those funds' respective P/E metrics was 1.2; it is now the same 1.2. (Full disclosure: My firm, Buckingham Strategic Wealth, recommends DFA funds in constructing client portfolios.)

Discipline required

The premiums for the market overall, for small stocks and for value stocks, have been earned only by investors disciplined enough to stay the course through periods when the asset classes (and factors) in which they have invested underperform.

As we have seen, those periods can be quite long, long enough to test even the most disciplined of investors. That is perhaps why Warren Buffett has said that his favorite holding period is forever. He has also said that successful investing has far more to do with temperament than intellect.

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