After a Lost Decade, Will Value Get its Groove Back in 2019?
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Borne in academia and raised by fund managers seeking to outperform, value style mutual funds and ETFs today hold close to $2 trillion.[1] But with poor returns over the past decade, the question of whether value as an investing style and factor is dead has become a popular topic of conversation. The search term “is value investing dead” generates over 23 million results in less than 0.38 seconds! For comparison, searching for “FAANG Stocks” generates just 570,000 results.[2] Perhaps it’s because FAANG is a funny acronym for financial news shows to utter rather than a well-documented investing style with academic rigor associated with its outperformance dating back to 1926,[3] launching many careers both within the classroom and on Wall Street.

Fueling the debate, value[4] is underperforming the market again this year. If nothing changes, 2018 would mark the sixth year of underperformance in the last decade. This is notably different than value’s excess return to the market historically, which has essentially been a coin flip with value underperforming only 49% of the time over the last 39 calendar years.[5] But let’s look beyond calendar-based returns to examine some trends and cyclical shifts to gain some insight into how value might perform, and possibly come back to life in 2019.
Ten years later, where has value gone?

In spite of its recent track record, value is not dead. It’s just been wounded a few times since the financial crisis, as investors favored growth-oriented segments of the market amidst easy monetary policy. In the early years of value’s lost decade, low long-term interest rates helped lift growth stocks as their future cashflows became more valuable due to the lower discount rate. Bank stocks, the highest weighted value sector in the past 10 years (24%), also didn’t perform well as a result of the low rate era. At the same time, oil prices became erratic, falling 78% from peak to trough over the last ten years, hampering one of the larger sector weights in value (13%).[6]

Sector biases can play a role in broad-based value strategies over short-term horizons. For example, one of value’s four positive performing years in the past ten was 2016 when oil prices rallied by 85% and the market began to fully price in the Federal Reserve’s expected interest rate hikes.

Over the more recent three-year period, the flattening yield curve has weighed on value’s performance relative to the broader market—exuding an 88% correlation to the spread between the 10- and 2-year yield,[7] an uptick over the average for the last 10 years. Lastly, being underweight high growth large-
cap tech and consumer discretionary stocks was the straw that broke value’s back.


**Determining the right “value”**

It’s constructive to explore different segments of value to understand the trends leading to value’s lost decade. The below chart displays the heritage meaning of value, the Fama & French High-minus-Low (“HML”) factor,[8] and its rolling 5- and 10-year annualized return over the better part of the last century. The most recent 5- and 10-year rolling return trends show that it’s been quite a tough time with just minor peaks above zero in 2014 and 2016 on the rolling 5-year time series. On a 10-year basis, HML hasn’t been positive since 2014.
But that is an academic, highly concentrated long-short value factor exposure. What about broad based investable gauges of value? Unfortunately, we find the same result, as shown below using data back to the 1970s as represented by Russell 1000 indices. The rolling 10-year performance of Russell 1000 Value relative to the Russell 1000 Index has been below zero since the fall of 2013, now sitting in the bottom 10th percentile.
The cuts have been deep and the shifts here show that there have been many protracted periods of underperformance, but the recent occurrence has been the deepest. Underperformance persists across many forms of value, as shown below, with large and small cap US as well as global value falling. The most concentrated factor exposure (top decile book-to-market portfolio from Fama & French[9]) fell the most versus the market (MKT) factor from Fama & French.[10] The only value exposure modeled below with positive returns over any of the last one-, three-, five-, and ten-year period is the highly concentrated S&P 500 Pure Value exposure that weights based on stocks’ value characteristics, which had a positive 10-year outperformance versus the S&P 500. Given the period analyzed started in an idiosyncratic event (the Great Financial Crisis), this outlier is just that—an outlier. Even with that one up bar, it’s clear that value has had a rough 10 years.
Regardless of market shifts, as other styles (e.g. momentum, size) can underperform based on market trends as well, the long-term evidence of the value premium is hard to argue with, given top decile book-to-market stocks 2% annualized excess return relative to the markets return since 1926. This is probably why even though value has had a lost decade; it has won out in flows versus growth, amassing $70 billion in fund flows versus growth style’s loss of $350 billion over the last 10 years.[11]
Certain value strategies hold promise for 2019

These trends we’ve explored are why everyone, with good reason, is very interested in whether the demise of value investing has been exaggerated or rightly called. Can we just agree that the value factor is the Schrödinger’s cat[12] of investing styles, depending on what period you look at? It’s both alive and dead at the same time based on the lookback period. We base our “alive” view on comparing long-term versus short-term returns. In the past 10 years we have seen a cyclical shift requiring patience from investors. And patience may soon be rewarded, as the most recent performance trends may offer some hope that certain value strategies may beat the market in 2019.

With 2019 on the horizon theses four trends should favoring certain value strategies:

Valuations: Valuations on broad value relative to growth have shifted, as shown below in a quantitative z-scoring model of blended valuation characteristics for value (Russell 1000 Value) relative to growth (Russell 1000 Growth). The characteristics used are Price-to-Book, Price-to-Earnings, Price-to-Sales, Price-to-Free-Cash Flow, Price-to-Next-Twelve-Months-Earnings, and Enterprise value-to-EBITDA. As shown, the metric has spiked significantly and reached levels not seen since the dot-com bubble era, albeit still sitting well below those bubbly peaks. Valuations indicate value may offer some “value” in 2019, a view supported by the State Street Global Advisors Investment Solutions Group when assessing factor returns for global equities. Specifically, the team focuses on book/price spreads for each factor and relates that to the factor’s subsequent returns. Using these relationships, they forecast a 1-year return premium of 1.4% for the value-tilted portfolio, 1.3% for the quality-tilted portfolio, 1.1% for the minimum-variance portfolio and 1.8% for the equal-weighted portfolio over the
broader global equity market[13].


**Growth**  Growth trends are also encouraging for value oriented strategies and styles. As shown below, growth stocks have experienced a larger recent decline in 2019 consensus earnings-per-share (EPS) growth than value stocks. The spread between these two style’s expected 2019 growth rates has narrowed to just 1.7%, the lowest point on the year and a 61% decline from peak to trough. And this trend is consistent with our view that we have gone past the peak of earnings growth and companies are revising their expectations lower as the boost from fiscal stimulus wanes, monetary policy continues tightening, and ongoing geopolitical tensions impact sentiment. Combine this with the lofty valuations for growth stocks and it’s no surprise that value has started to turn things around a bit.
Momentum/Trend: As the fourth quarter kicked off, value only had four months of outperformance, and 92 days of market-beating returns, less than half of all trading days (223). The trend, lately, however, has been more positive with value outperforming the market on 61% and 67% of the days in October and November (thru November 19th). There is still more room to maneuver as well, as the ratio of value to the market and value to growth had recently fallen below the 10th decile in its history, as shown below. The dotted lines show the trends in value compared to growth, while the solid lines depict value relative to the market (Russell 1000). Both are still below the 10th percentile but due to the positive days in October and November have recently reversed course. Combined with encouraging valuations and earnings expectations, this indicates some further mean reversion is likely ahead.

**Quality**: With the market selling off there has been a desire to seek out companies with healthy balance sheets, a phenomenon that powered value’s performance and may be a driver ahead. Decomposing factor spread returns on the Russell 1000 Value Index shows that value stocks with low earnings volatility (i.e., a quality growth characteristic) drove October’s returns significantly. As shown below, the earnings variability of quintile one minus quintile five—a factor spread which goes long companies with the highest earnings variability and short companies with lowest earnings variability—posted a return of -8.38% in October. This is a sign of the market favoring quality-centric firms, as a negative return means the short side (low variability) of the spread had higher returns than the long side (higher variability). There is further evidence of this when we see decomposing value returns by companies with high return on equity (ROE), another sign of quality. Value stocks with high ROE have outperformed low ROE stocks in 2018, and more so since August of this year when the market took on a more decidedly defensive tone. The same trend has occurred with free-cash-flow, another quality trait.[15]
Putting this all together in portfolios

The goal here was to show how the value factor has performed over different periods and how recent history may inform what specific market environments mean for value investing.

Value is not dead. Cyclical shifts happen and the premia has almost 100 years of quantifiable data to support its thesis. Based upon trends in valuations, earnings growth and momentum, value may outperform the market and growth stocks in 2019. However, due to the current length of the cycle and the pervasive headline risk present in the market from ongoing political schadenfreude and the Federal Reserve’s rate hikes likely making the yield curve flatter or inverted in 2019, it may be more beneficial to look beyond value to focus on quality growth at a reasonable price.

Favoring more quality-defensive type exposures with a defined value bias may be beneficial in 2019, as it has been over the past two months. Given concerns over growth’s lofty valuations, it may be wise not to pay high multiples for next year’s earnings if we are at peak earnings growth. And now value stocks are expected to grow their bottom line at a closer rate in 2019, but at more reasonable valuations.
Warren Buffett, one of the legendary value investors once proclaimed “Long ago, Ben Graham taught me that ‘Price is what you pay; value is what you get.’ Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down.” With all the trends mentioned above, it’s shaping up to be a Buffet type of market in 2019.

Stay tuned to SPDR® Blog as we continue to explore this and other investment themes in our 2019 Market Outlook series.

Definitions

**Earnings Per Share (EPS)**

A profitability measure calculated by dividing a company’s net income by the number of shares outstanding.

**Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)**

An approximate measure of a corporation’s operating cash flow that is used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

**NTM Price to Earnings Ratio (NTM P/E)**

The ratio of the price of a stock and the firm’s earnings per share over the next twelve months. A lower NTM P/E indicates cheaper valuation.

**Price to Book Ratio (P/B)**

A financial ratio used to compare a company’s current market price to its book value which is the carrying value of an asset according to its balance sheet account balance. A lower P/B indicates cheaper valuation.

**Price to Earnings Ratio (P/E)**

The ratio of the price of a stock and the firm's earnings per share. A lower P/E indicates cheaper valuation.

**Price to Sales Ratio (P/S)**

The ratio of the price of a stock and the firm's sales per share. A lower P/S indicates cheaper valuation.

**Russell 1000® Index**

A benchmark that measures the performance of the large-cap segment of the US equity universe.
Russell 1000 Growth Index

A benchmark measuring performance of the portion of the large-cap segment of the US equity universe that exhibits strong growth characteristics.

Russell 1000 Value Index

A benchmark measuring performance of the portion of the large-cap segment of the US equity universe that exhibits strong value characteristics.

S&P 500 Index

A popular benchmark for US large-cap equities that includes 500 companies from leading industries and captures approximately 80% coverage of available market capitalization.

S&P 500 Pure Value Index

A style-concentrated index designed to track the performance of stocks that exhibit the strongest value characteristics by using a style-attractiveness-weighting scheme.

[1] Morningstar


[4] As referenced by the Russell 1000 Value Index unless specifically referenced otherwise.


[6] Expect we'll need a footnote for this information.


[8] HML (High Minus Low) is the average return on the two value portfolios minus the average return on the two growth portfolios. HML = 1/2 (Small Value + Big Value) - 1/2 (Small Growth + Big Growth).


[10] Return on the market, value-weight return of all CRSP firms incorporated in the US and listed on the NYSE, AMEX, or NASDAQ that have a CRSP share code of 10 or 11 at the beginning of month t, good shares and price data at the beginning of t.

[12] Schrödinger’s cat: a cat, a flask of poison, and a radioactive source are placed in a sealed box. If an internal monitor (e.g. Geiger counter) detects radioactivity (i.e. a single atom decaying), the flask is shattered, releasing the poison, which kills the cat. The Copenhagen interpretation of quantum mechanics implies that after a while, the cat is simultaneously alive and dead.

[13] As of 09/30/2018. The forecasted returns are annual arithmetic averages based on SSGA’s Investment Solutions Group September 30, 2018 forecasted returns and long-term standard deviations. The forecasted performance data is reported on a gross of fees basis. Additional fees, such as the advisory fee, would reduce the return. For example, if an annualized gross return of 10% was achieved over a 5-year period and a management fee of 1% per year was charged and deducted annually, then the resulting return would be reduced from 61% to 53%. The performance includes the reinvestment of dividends and other corporate earnings and is calculated in the local (or regional) currency presented. It does not take into consideration currency effects. The forecasted performance is not necessarily indicative of future performance, which could differ substantially.
