Tough Times for Classic Value Investors

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While the U.S. equity market has performed exceptionally well since its bottom in March 2009, Warren Buffett's Berkshire Hathaway has trailed the index by nearly 6%. Buffett is among a number of prominent classic-value investors who have fared poorly over this period. Over long time horizons, value investing has consistently outperformed growth strategies and the broad market index.[1] So what is causing this recent phenomenon?

Like skirt lengths and tie widths, investment styles come in and out of fashion in long waves. The period since the crash of 2008 has been difficult for value managers, who try to buy stocks at prices below their fundamental value and wait for the market to realize that value. Growth stocks, whose earnings are expected to grow faster than the market, have fared better during this volatile time.

While the recovery in the real economy has been disappointing, the U.S. stock market has performed strongly (but the rest of the world's equity markets have lagged behind). Since the bottom in March 2009, the S&P 500 has popped from its low of 677 to a high of over 1,520 recently.This return of 124%, spread over a little less than four years, represents an annual price-only return of approximately 23% and is typical of recoveries from very severe declines. Dividends were in addition to this amount.

The Russell 1000 value benchmark had performance similar to that of the S&P 500 from March 2009 to November 2012. But classic value managers, those who follow principles articulated by Benjamin Graham and David Dodd in their 1934 book, *Security Analysis,* have underperformed both value benchmarks and the broad market.

The managers profiled in this article try to identify stocks selling below their fundamental values by a "margin of safety" (Graham's words). The margin ensures that if fundamental value is incorrectly estimated or deteriorates slightly, the strategy still succeeds. As the market "realizes" the value, the stock price rises, and its price-to-earnings ratio, or P/E, reverts upward to a more typical P/E. The classic value manager sells the stock when it no longer offers a margin of safety between price and value.

Value managers have often complained – since the middle 1990s, at least – that the stock market is so expensive that few stocks offer a margin of safety that would make them appealing in a Graham and Dodd value strategy. These complaints receded at the 2002-

[1] Over the very long run, that is, the longest period for which value and growth benchmark returns are available – 1927 to 2011 – value has beaten growth by an annual average of 4.73%.

2003 and 2008-2009 market bottoms, but they're back. Some managers, nonetheless, believe they've identified a number of such stocks and hold concentrated portfolios of them. These are the strategies on which I focus here.

Both value and growth investing require avoiding "traps." The growth trap is when a company that has grown tremendously looks good but may have nowhere to go but down.

The value trap is subtler: A stock could appear cheap but actually be expensive because shareholders are aware of long-term difficulties with the company's strategy or competitive position. A classic example is airline stocks, which periodically fall to prices so low that they appear to offer a sure profit. As often as not, however, such airlines have gone bankrupt, with existing shareholders getting nothing. A similar situation exists with bank stocks, which are much more likely to go to zero than industrial stocks, because of leverage. In fact, analyst and consultant Ronald Surz attributes most recent weakness in value stocks to the banking sector, which has performed poorly in the recovery from the 2008 crash.[2]

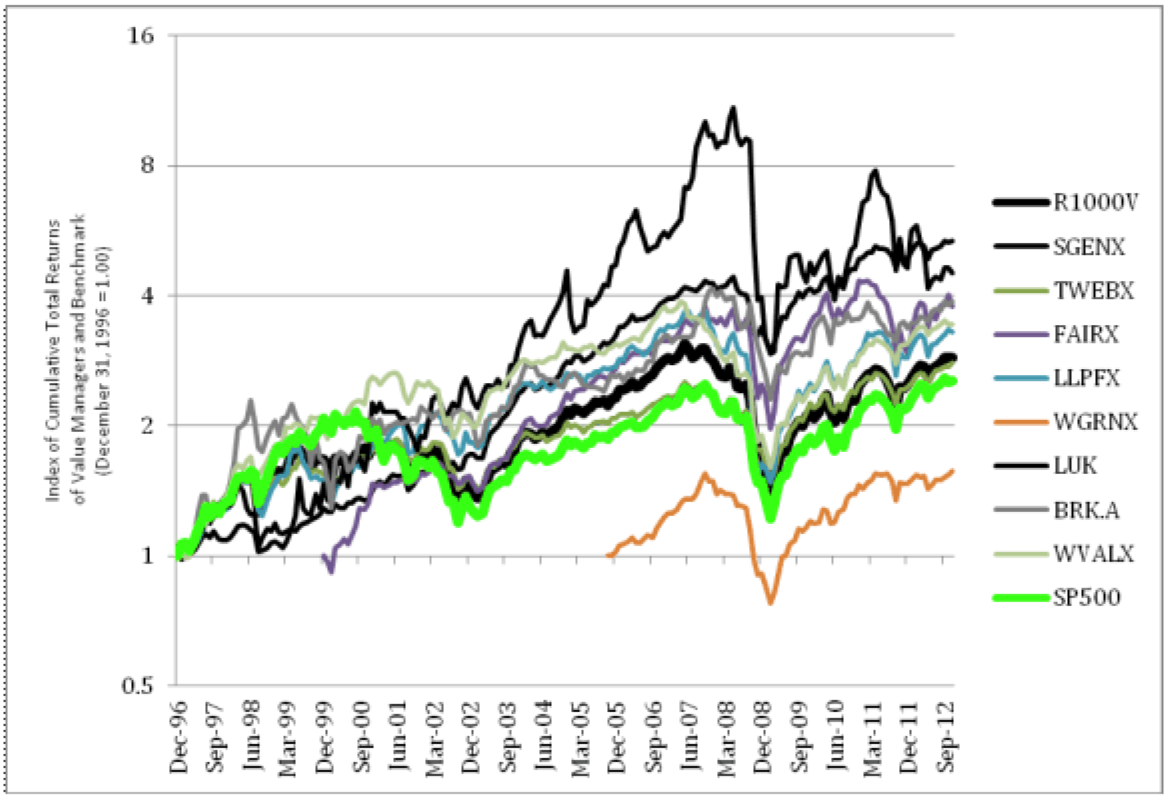
I'll look first at the outperformance of value managers over a long period, encompassing multiple market cycles. Then, I'll look at the performance since the most recent market bottom, during which value strategies have underperformed. I'll then explore the possible explanations for this underperformance – including those offered in interviews with two of the managers I studied – and posit the underlying message for investors.

Value wins over long periods

Figure 1 shows the performance of a selection of classic value managers from January 1997 to October 2012. I selected these managers to represent a broad cross-section of value-oriented approaches in the tradition of Graham and Dodd, but this is by no means a complete sample. The S&P 500 is shown using a thick, bright green line, and the Russell 1000 Value benchmark is a thick black line. I chose such a long period because I want to capture a full value-growth cycle and because of my general attitude that a longer view is a clearer one.

[2] Surz argues that bank stocks should not be in value benchmarks. Their franchise has been severely damaged, he says, so they are not really value stocks. The benchmarks he constructs have three style categories – value, core and growth. Bank stocks tend to be in Surz's core category.

Figure 1
Cumulative Total Returns of Value Managers and Benchmarks,
January 1997-November 2012

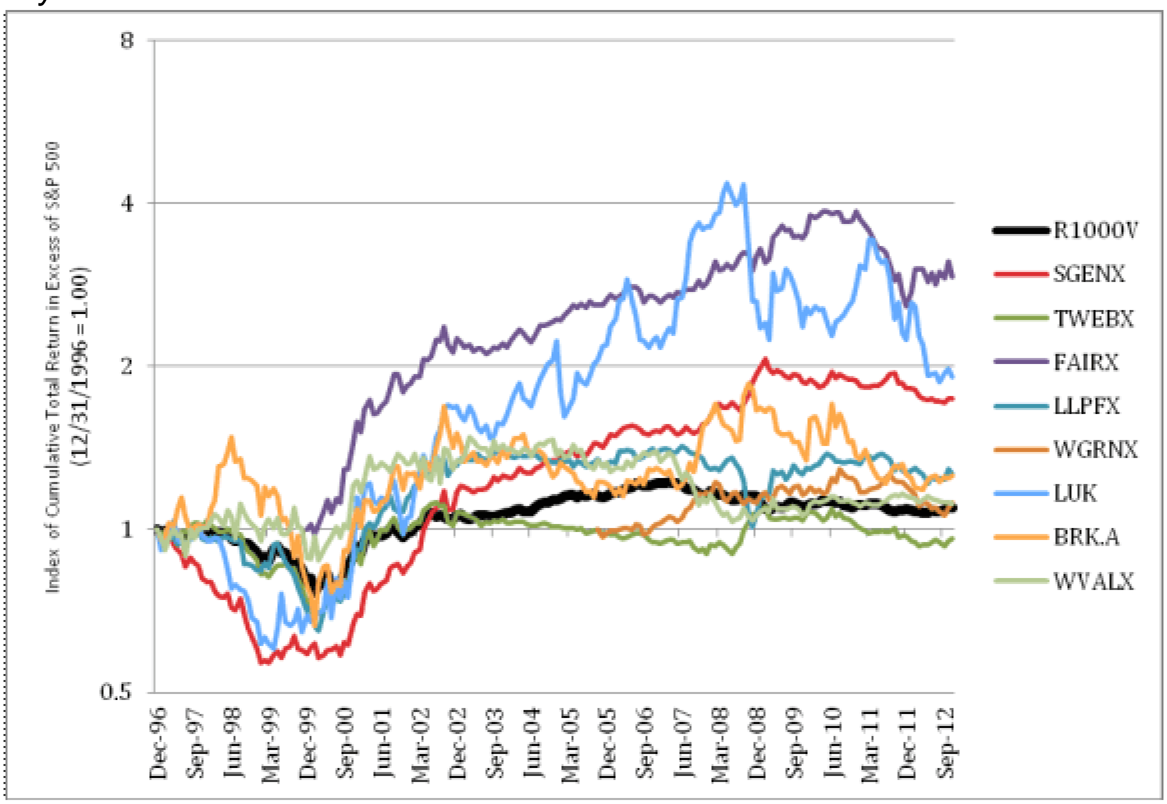


Legend: R1000V – Russell 1000 Value index; SGENX – SoGen First Eagle Global, class A; TWEBX – Tweedy, Browne Value; FAIRX – Fairholme; LLPFX – Longleaf Partners; WGRNX – Wintergreen Investors; LUK, Leucadia National Corporation; BRK.A – Berkshire Hathaway class A; WVALX – Weitz Value Fund; SP500 – Standard and Poor's 500-Stock Index.

Since 1997, the market has been in a weak uptrend, despite the two crashes. The S&P 500 earned most of its return for the period between 1997 and 1999, but the value benchmark and value managers had their best years from 2003 to 2006. SoGen's First Eagle Global fund had the best return, although the volatile Leucadia National was in the top spot for most of the period. (Leucadia National [LUK] and Berkshire Hathaway A [BRK.A] operate companies that function much like value-oriented investment management firms.) The other managers generally did well over this long period.

Figure 2 shows performance relative to the S&P 500, which is indicated by the value 1 on the y-axis. From the performance of the Russell 1000 Value benchmark, we see that growth beat value during the run-up of the Internet bubble from 1997 to 1999, value beat growth from 2000 to 2007 and growth has beaten value since. The managers in our study generally did well. Tweedy Browne trailed the Russell value benchmark slightly, and the others beat the value benchmark, in some cases handsomely. But since the crash of 2008-2009, and especially during 2011 and 2012, several of the value managers underperformed.

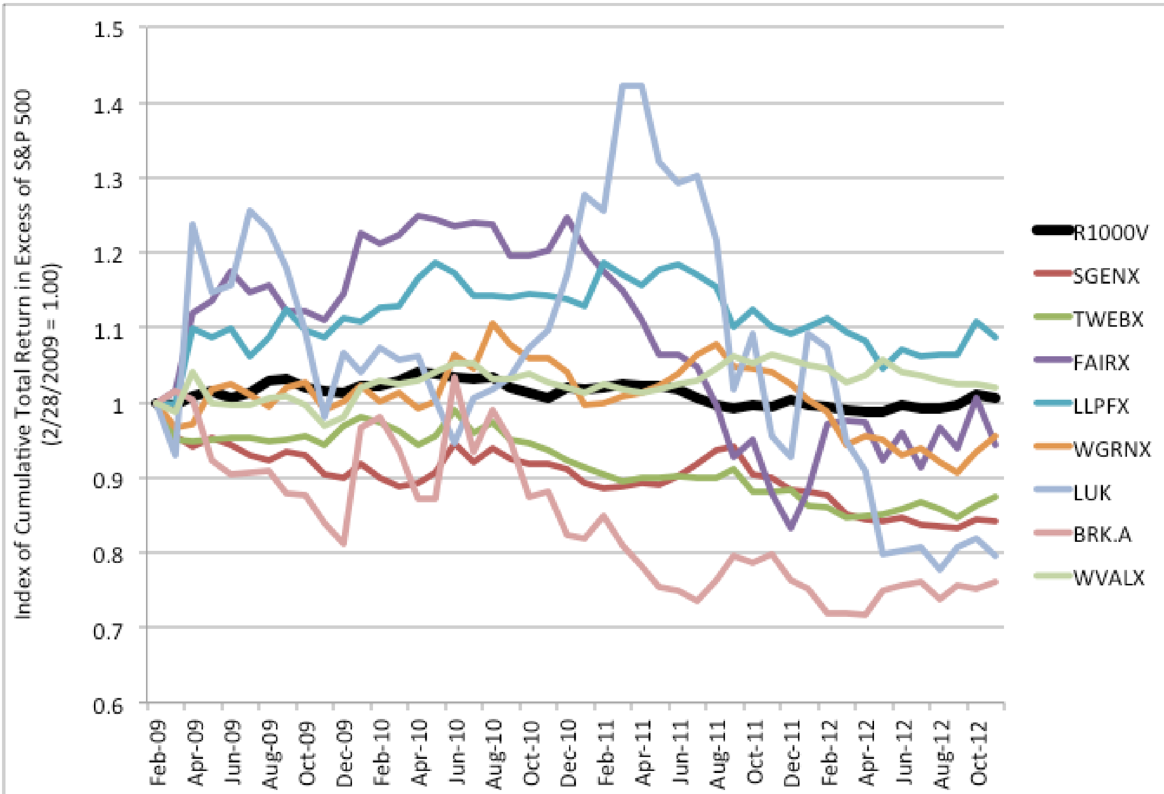
Figure 2
Cumulative Total Returns of Value Managers and Benchmark in Excess of S&P 500
January 1997-November 2012



Documenting the value underperformance since March 2009

Let's home in visually on the crash and post-crash periods when value has underperformed growth. Figure 3 shows the benchmarks and managers from Figure 2 but with a starting date of February 28, 2009, when the market hit its lowest point (on a month-end basis) of the 21st century.

Figure 3
Cumulative Total Returns of Value Managers and Benchmark in Excess of S&P 500
March 2009-November 2012



In Figure 3, as well as in Figure 2, the S&P 500 return has been subtracted from all returns shown, so we are looking at relative, not absolute, performance. Starting in late 2010 or early 2011, just about all of the selected value managers had weak performance, relative to the Russell 1000 Value benchmark and to the S&P 500. Of the managers shown, Berkshire Hathaway had the worst performance, and the formerly high-flying Longleaf Partners had the best, but none of them were particularly impressive. Summary statistics of the returns in Figures 3 are shown in Table 1 below.

Table 1

Performance of Selected Value Managers from March 2009 (market bottom) to November 2012

Ticker	SGENX	TWEBX	FAIRX	LLPFX	WGRNX	LUK	BRK.A	WVALX	SP500
Full fund names:	First Eagle Global A	Tweedy Browne Value	Fairholme	Longleaf Partners	Winter-green Investors	Leucadia National Corp	Berkshire Hathaway A	Weitz Value	S&P 500 Index
Compound annual return	17.0%	18.0%	19.0%	23.8%	20.8%	12.3%	14.8%	22.5%	21.6%
Annual return in excess of S&P 500	-3.8%	-3.0%	-2.1%	1.8%	-0.7%	-7.7%	-5.6%	0.8%	

Reasons for the difficulty

Let's now examine the reasons why so many value managers fared poorly over the last several years.

Interviews with executives at two of the funds profiled in this study provided insights into that question. A recent (January 22) *Advisor Perspectives* issue featured an interview with Wally Weitz, the founder and manager of the highly respected Weitz Value Fund. It is ranked in the top 1% of its peer group by Morningstar and managed according to traditional value-oriented principles. Second, Southeastern Asset Management runs the legendary Longleaf Partners Fund, which nearly quadrupled its investors' money between January 1997 and May 2007. Lee Harper, its head of client portfolio management, spoke on behalf of the firm.

With those interviews as background, here are four explanations for the value underperformance:

Mean reversion has been impeded

The Federal Reserve has kept both short- and long-term interest rates at historic lows for an extremely long period. This has a dual effect: the fixed-income markets have been artificially manipulated and investors have been given an incentive to move to riskier asset classes such as equities.

Consequently, one might argue that capital markets have not functioned in the traditional manner. Marginal companies, for example, have been able to avoid bankruptcy by securing inexpensive debt that would otherwise be unavailable. Corporate profit margins have been at historically high levels for much of the last couple of years. This impedes the reversion-to-the-mean process on which value investors rely.

On a broader scale, value investors are notorious for being agnostic about the effect of macroeconomic factors on their stock-specific analyses, as James Montier of GMO noted in a recent commentary. Indifference to the effects of non-traditional monetary policy may have blindsided value investors over the last several years.

Value traps are more prevalent

Seth Klarman, the highly regarded manager of the value-oriented Baupost hedge fund, has warned of an especially dangerous value trap that occurs during times of distress: the low prices of value stocks, rather than being bargains, could be market forecasts of deteriorating business conditions.

Southeastern's outperformance of the market since March 2009 may, in part, be due to its wariness of increased value traps. Harper said that following the financial crisis, the fund's managers did not normalize revenues or margins in their appraisals. They assumed that businesses had stabilized at their then-depressed levels.

"This helped us avoid the value traps from deteriorating conditions that Klarman described in the post-2009 period," she said. "Perhaps this is a part of the explanation for our outperformance versus peers."

Security selection has become more difficult

By pushing investors into riskier assets, the Fed has increased the demand for – but not the supply of – equities. Some might contend that imbalance between supply and demand has inflated prices, reduced the margin of safety that value investors demand and made stock-picking more difficult. The success of value investing over long timeframes has attracted more and better-funded practitioners, and that competition has intensified as a result of monetary policy.

The difficulty in selecting securities is illustrated in the valuation of Berkshire Hathaway, which is a top-10 holding in Weitz' fund. To determine Berkshire's fair value, Weitz said it is necessary to understand the value of the insurance float and the wholly owned subsidiaries. But he said he relies on the market to correctly price the subsidiaries and for those prices to be reflected in Berkshire's stock. Those valuations did not increase over the time period we studied.

Harper echoed the sentiment that security selection has become increasingly difficult. Active equity managers have tended to favor stocks such as healthcare and consumer staples that are seen as more stable and “tend to fall into the growth camp,” she said.

Insufficient patience

Successful value investors must be patient, and one explanation for the underperformance is that the time period we studied was not long enough to allow the values of the holdings in the funds to realize their full potential. Perhaps three years is too short a time for evaluating such a long-term strategy, and the expected rewards could appear in the future.

Indeed, since trading at $126,900 in November 2012, Berkshire Hathaway’s price has increased to nearly $150,000 today. In Harper’s case, she noted that some of those stocks hit hardest in 2008 were among those that have more than doubled since March 2009, including Liberty Interactive, Pioneer Natural Resources, Cemex, FedEx and Disney. And several names that Southeastern bought in the depths of 2008 or in subsequent downturns, particularly Marriott and Intercontinental, did very well.

Summary

There is overlap among the four factors described above. The slowing of reversion to the mean, for example, has made security selection more difficult. This analysis is more art than science, and nobody can offer a definitive explanation for value’s underperformance.

The managers we spoke with are undeterred. “Since the 2009 low, we have continued to follow the Graham and Dodd principles that have been in place at Southeastern for 38 years,” Harper said. “The severe deterioration in business conditions in 2008-2009 led to our writing down our appraisals on average by 15%, which partially explains our weak returns. Our assumptions were wrong.“

The market crash of 2008 had a disproportionate impact on classic Graham and Dodd value managers who rely on the availability of 60- and 80-cent dollars and on the market’s willingness to run those prices up to fair value.

Value is a strategy that requires patience and risk tolerance. Underpriced stocks can become more underpriced, rather than reverting to fair value. This is even truer now, in a time of large index-driven funds flows, than it was when stock selection was a more visible part of the institutional investment setting. Investors who want to profit from Graham and Dodd’s insights — and they can lead to substantial profits — need to adopt a long-term horizon and stick with it, despite temporary setbacks.

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