Where Does Value Investing Go From Here?

Three key principles for investors in a postcrisis world.

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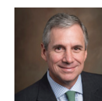

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KEY INSIGHTS

- Value investing has had a tough decade, but we believe current low valuations have created a target-rich opportunity set.
- Making the most of these opportunities requires a long-term perspective and an intensive focus on industry and company fundamentals.
- It also requires close observation of the macro environment as massive fiscal and monetary stimulus shapes the post-coronavirus investment landscape.

The past few months have delivered a near-perfect storm for value investing. Collapsing oil prices and falling interest rates have put tremendous pressure on the energy and financials sectors—two of the largest sectors for value investors—while valuations have failed to provide support as investors have favored expensive, lower-beta[1] companies. Virtually everything that could negatively impact style performance has occurred, and March was the worst month in 30 years for companies that were cheap according to traditional valuation metrics.

What's more, value has underperformed for the past decade. Since the 2007–2008 global financial crisis, value stocks have delivered lower returns than the S&P 500 Index while growth stocks have comfortably outperformed the index over the same period.

The good news is that the low valuations brought about by the current crisis mean that, for value investors, there are a number of attractive investment opportunities in the market today. In our view, making the most of these opportunities—and successfully navigating the significant risks also present in this market—requires an approach that incorporates three key principles: first, adopting a long-term perspective that looks beyond the current uncertainty; second, focusing more intensively than ever on fundamentals in order to identify those companies that are well positioned; and third, keeping a close eye on the macroeconomic environment as massive fiscal and monetary stimulus shapes the post-coronavirus investment landscape in the years ahead.

Let's consider each of these three principles in more depth.

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[1] Beta measures the volatility, or risk, of a stock relative to the risk of the broad market.

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Adopting a Long-Term Perspective

How can we properly frame a company's reward and risk potential in the context of the coronavirus? Both will be heavily influenced by the severity and the length of the economic contraction, but as yet these remain unknown—there is no coronavirus playbook for us to consult. Another problem is that when near-term visibility is poor, the near-term earnings- and cash flow-based valuation tools we typically use become very blunt instruments because we can only guess what a firm's earnings and cash flow will be in the short term.

The absence of near-term visibility means we must focus on the longer term and try to create a context for how a company might perform once conditions return to normal. To this end, valuation metrics such as price/normalized earnings and either price/book value or price/tangible book value can be very useful when combined with a qualitative assessment of a company's longer-term prospects.

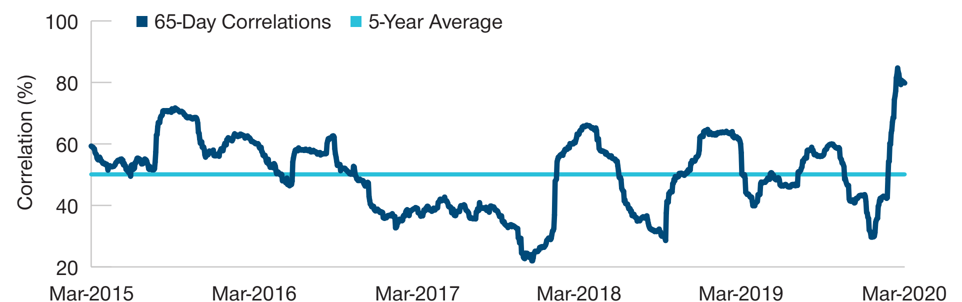
Another reason to maintain a longer-term time horizon is the current high correlation between stocks (Figure 1). The market has been indiscriminate in its sell-off, largely because of the forced buying and selling by risk-parity strategies and asset allocation rebalances, as well as the more prevalent use of exchange-traded funds. Trading pressures such as these can sometimes last longer than expected, and some industries—even those with very stable cash flows—have been driven to irrationally low valuations. Economist Benjamin Graham famously observed that, in the short run, the market is a voting machine, but in the long run it is a weighing machine. Now, more than ever, it is important to give our investments the opportunity to be weighed by the market.

Focusing on Fundamentals

First, though, we must do our own weighing. Our objective, as always with value investing, is to find stocks that are trading at a significant discount to their intrinsic value. The current cheapness of so many industries means that companies with low valuations are plentiful; the challenge is to identify those that are likely to make it through to the other side intact. This requires in-depth analysis of companies' balance sheets, liquidity, and access to credit markets. It demands a clear understanding of the amount of debt a firm has, its upcoming maturities, its mandatory capex obligations, and the breakdown of its fixed versus variable costs.

The Sell-Off Has Driven Correlations to New Highs

(Fig. 1) 65-day correlations, ending March 2020



As of March 31, 2020.
The correlation is based on all stocks within the S&P 500 Index. Correlations are a measurement of how one asset class, style or individual group are related to each other. A perfect positive correlation means that the correlation coefficient is exactly 1 (or 100%). This implies that as one security moves, either up or down, the other security moves in lockstep, in the same direction. A perfect negative correlation (-100%) means that two assets move in opposite directions, while a zero correlation (0%) implies no relationship at all.
Source: Strategas Research Partners.

> Bear markets often result in changes in market leadership.

Long conversations with company management teams are essential. However, management teams may not always have full visibility of their firm's ability to navigate a severe downturn, so these conversations cannot be relied upon in isolation. Respectfully challenging management on certain issues may sometimes be necessary. It is also helpful to stress-test a company's financial situation in different scenarios to understand the near-term risks should the coronavirus-induced lockdown last longer than expected. By working through these scenarios, a clearer picture can be obtained of the potential downside of an investment as well as its potential upside in a more "normalized" environment.

In addition to scrutinizing a firm's financial strength, it is also important to consider its likely industry position when markets return to normal. Companies that operate in industries most impacted may find themselves in a stronger position in the long term as many of their competitors might not survive a collapse in demand. Other firms whose revenues have increased over the past few months may find it difficult to sustain that performance once the lockdown is lifted. Some consumer goods companies, for example, have enjoyed high sales growth due to consumer stockpiling but may struggle to maintain that growth when the crisis abates. This crisis will also bring about changes in consumer behavior, and we need to think carefully about what those changes will be and which industries and firms are likely to benefit from them.

Monitoring the Macro Environment

Governments and central banks will also play a huge role in shaping the post-coronavirus investment landscape. When the figures are finally added up, the policy response to the pandemic is likely to be unprecedented in scale, vastly exceeding the response to the 2007–2008 global financial crisis, and the mass deployment of government resources would inevitably create industry winners and losers. It could also fuel inflationary pressures, eventually leading to interest rate hikes.

Higher interest rates and inflation would likely be good for value stocks and potentially less beneficial for growth stocks, which often feature long-dated cash flows and rely heavily on assessments of terminal value. Bear markets often result in changes in market leadership—the bursting of the dot-com bubble in 2001 led to a switch from growth to value investment strategies, and the global financial crisis caused a shift back to growth. Given how significantly value stocks have trailed growth stocks during the downturn and the preponderance of cyclicality in the value investing universe, the setup for value stocks is attractive.

In the meantime, volatility and dislocation look set to remain for a while yet. With volatility and dislocation comes opportunity, and we believe we are currently in the most target-rich opportunity zone for investing in decades. As we do not know how long or how deep the downturn will be, we are stretching the time horizon for our investments as we believe this is the best way of identifying the true potential of companies that have been overly discounted due to forced selling or a short-term focus. We believe that a long-term investment approach that is fundamentally driven and rooted in valuation discipline stands the best chance of delivering strong results over the market cycle.

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