A 12-year losing streak has tested investors' faith in systematic value investing, but giving up on the strategy now would be a huge error, according to Rob Arnott, founder and chairman of Research Affiliates.

Arnott dismissed claims that value investing is broken. Research Affiliates, which specialises in factor investing, has analysed those arguments and found them wanting, he said. The firm believes value stocks in the US are now so cheap that investors should expect a return of at least 16% over three years if valuations return to normal levels. That's on top of the alpha the strategy typically delivers in normal conditions.

"None of the narratives that value is permanently impaired stands up to empirical testing," Arnott said, speaking by video link to delegates at the firm's annual symposium in London on October 10. "Within equities, the value effect looks poised to be the best place [to invest] today. Value is cheap all over the world, and notably cheap in the bottom decile of relative valuations in the US and emerging markets."
Value factor investing – where investors buy cheap stocks and short expensive ones to profit from the tendency of prices to revert to the mean over time – has been on its longest drawdown ever in the US, with cumulative losses of more than 36%.

Critics say the slump reflects a structural problem with the strategy, as tech disrupters such as Amazon and Facebook upend the business model of old-economy companies, creating a so-called value trap where stocks are cheap for good reason.

Those in this camp argue the elevated valuations of growth companies are justified because they have become more profitable relative to value companies, while mean reversion in prices has slowed as a consensus forms on who will be new-world winners and losers.

A team at Research Affiliates together with Duke University professor Campbell Harvey, an economist and expert in factor investing, set out to test that thesis.

The researchers found that the gap in profitability – measured as return on equity – between US growth companies and value companies widened by only 1 percentage point after 2007 compared with the forty-five year period before – not enough to justify the much-higher valuations.

“It doesn’t look like profitability is all that different,” said Vitali Kalesnik, head of research for Europe at Research Affiliates, and one of the collaborators on the study.

The study compared the percentages of stocks moving between quintiles of rankings for growth and value each year and found the rate of migration had stayed “almost exactly” the same (see table A).
If mean reversion is the “engine” of the value effect, “there was not much evidence that the migration part of the value engine had slowed down,” Kalesnik said. “The rate of migration and the difference in profitability on average were on a par with history. That tells us the engine for value performance is not broken.”

Low stock valuations, conversely, explain four-fifths of the variation in the strategy’s performance in a simple model, the researchers found.

That arguably sets up a big opportunity for investors. Valuations for value stocks today are lower than at any time since the dotcom bubble, Kalesnik said, likening value today to an “alpha store”.

Normal levels of mean reversion in markets would generate outperformance over the market of 35% for value stocks, he said. Even halving the assumptions about a reversion in valuations would lead to 16% outperformance. At the same time, “it would take just a trivial amount of mean reversion for value to stop bleeding,” he argued.

When might that happen? Speaking later at the conference, Harvey said value had beaten the market after the US treasury yield curve had inverted on each of the past seven occasions. An inverted yield curve is an oft-cited signal of impending recession that Harvey himself originated in the 1980s.

The US treasury yield curve inverted in May. Value stocks, meanwhile, saw a sharp rebound in early September, gaining nearly 14% against growth.

Still, Research Affiliates is not suggesting a punt on value will be easy.
Buying value stocks requires investors to go against the crowd. “There is always a narrative for why valuations are entirely reasonable,” Arnott said. “If you buy what's newly inexpensive, you may have a little while to wait until markets turn. And during that period of time, you will look and feel like an idiot.”