Research Affiliates: What is driving value’s underperformance?

By George Geddes
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Value investing has been underperforming relative to its growth counterpart ever since the Global Financial Crisis in 2007, but have these performances been overplayed?

Many argue value is structurally impaired due to a number of factors such as the new-normal interest rate environment, growth of private markets, crowding and vast technological change, among others.

However, a recent study by Research Affiliates, entitled Reports of Value’s Death May be Greatly Exaggerated (https://www.researchaffiliates.com/en_us/publications/articles/reports-of-values-death-may-be-greatly-exaggerated.html), highlighted several points as to why value investing’s performance has been downplayed while growth has been rallying.
The report’s authors, Rob Arnott (pictured), Campbell Harvey, Vitali Kalesnik and Juhani Linnainmaa, selected five events and factors that have played a role in value’s underperformance:

- The value factor could be a product of data mining
- Structural changes in the market could have caused the value factor to become irrelevant
- The value trade could have become crowded
- The value factor is becoming cheaper
- A left-tail outlier or simply bad luck

Between 1963 and 2019, the value factor has produced the most attractive market-adjusted returns compared to its factor peers, even with significant drawdowns over the 56-year period.

A value investor is still six times wealthier than a growth investor, even having experienced the Global Financial Crisis, the tech bubble and Iran oil crisis.

Value’s performance rebounded in Q4 2019 (https://www.etfstream.com/feature/9472_rebounding-value-factor-in-play-in-the-us/) in tandem with momentum stocks crashing which was determined to be the result of the unwinding of overcrowded growth stocks.

The report found 70% of value’s volatility over the last 12 years is explained by revaluation – the valuation difference of growth versus value.

Furthermore, value’s underperformance relative to growth appeared to be due to falling relative valuation. This suggests revaluation is important in understanding why growth stocks have outperformed value stocks in recent times.

However, a regression test suggests value’s underperformance since 2007 if a result of an “oversampling of bad luck” in addition to rising valuations of growth stocks. But what has been causing the higher valuations for growth stocks and undervaluation of value stocks?
Research Affiliates: Not so happy days for backtests
(https://www.etfstream.com/feature/10043_research-affiliates-not-so-happy-days-for-backtests/)

Research Affiliates found non-physical investments play an important role in evaluating a company, but today’s accounting standards in the US ignore these internally created intangible investments.

In fact, a measure of value calculated with capitalised intangibles outperforms the traditional P/B measures for the period of the internet revolution (since 1990s).

Going into a new decade, value stocks’ expected returns are elevated in comparison with growth. Furthermore, a positive net return in the near future for value could be expected as a result of migration and profitability positively impacting performance.

However, given its historical bad luck, which is significantly influential, it is not a guarantee that value will outperform growth over the short run.

The report concluded: “While value strategies seem (almost) as attractive as they have ever been, an elevated expected return is not a guarantee that value must outperform growth in the short run.”

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