Value Investing Isn't Dead Yet, Research Associates Argues

Value's underperformance in comparison to growth may simply have resulted from bad luck, according to a new paper from the firm.

By Alicia McElhaney  January 17, 2020

The eulogy for value investing may have been written too soon, according to new research from investment strategy provider Research Affiliates.
This month the firm released a paper, “Reports of Value’s Death May Be Greatly Exaggerated,” which analyzed the 12-year slump in value investing relative to growth investing.

According to the paper, value investments have contracted 39 percent between the beginning of 2007 and August 2019. This drawdown has been widely covered by researchers and news publications alike.

“These narratives include the new-normal interest rate environment, growth of private markets, crowding, and technological change, among others,” according to the paper. But its authors have a different idea for why value has been struggling.

The paper, written by Rob Arnott, Campbell Harvey, Vitali Kalesnik, and Juhani Linnainmaa, posits that the value factor’s underperformance could instead be the result of bad luck.

“Is the current episode of value underperformance an unlucky outcome, in line with previous periods of disappointment, or is this time truly different?” the researchers asked. “Specifically, if we use the pre-2007 characteristics of value for guidance, how likely are we to see a drawdown of -39.1% within a span of 12 years and nine months?”

To answer these questions, the researchers used a simulation of possible value factor returns for the period between 2007 and 2019 to determine how unusual the drawdown would be. That simulation found that only 4.9 percent, or one out of twenty of the simulated samples, exceeded a 39.1 percent drawdown. In other words, a drawdown of that magnitude is rare but possible, rather than being a statistical red flag.

According to the researchers, this demonstrates that value isn’t dead. Instead, its underperformance can be tied to one thing: “bad luck,” according to the paper.

The paper uses a framework to compare value investing’s relationship to growth investing. This framework attributes value’s performance relative to growth to three components: migration, profitability, and change in relative valuation (or, as the researchers call it, revaluation).
Revaluation is the relative valuation of growth versus value, the paper said. When value is cheaper than growth, it will underperform growth. This, according to the research, accounted for approximately 70 percent of the performance differential between growth and value over the past 12 years.

This has been observed by others, particularly Dimensional Fund Advisors, which told *Institutional Investor* in October that growth stocks were priced abnormally high compared with value stocks.

Migration, meanwhile, occurs when a value stock trades at a higher price-to-book ratio, moving from the value portfolio to a neutral or growth portfolio, according to the research. It can also occur when a neutral or growth stock becomes cheaper and drops into the value portfolio. This, according to the research, hasn’t changed much over the past twelve years.

Profitability, which is exhibited at higher rates in growth stocks, was also determined by the researchers to not be a factor in value’s underperformance.

“In the most recent 12-year period, the revaluation component appears to be the key to understanding why growth stocks outperformed value stocks,” the paper said.

[II Deep Dive: Why Value Investing Sucks]

Research Affiliates likely isn’t alone in arguing that the death of value has been overplayed. JPMorgan Chase & Co.’s alternatives outlook report showed that the firm’s asset management unit believes that investing in value is one of the best bets for hedge funds in the next 12 to 18 months.

And in December, while BlackRock managing director Andrew Ang told *Institutional Investor* that value investors should be cautious, the asset management giant has tilted its value exposure from underweight to neutral.
Research Affiliates acknowledged that value strategies are “(almost) as attractive as they’ve ever been.” But, according to the paper, investors may have to wait a while for value’s alpha to show its face. “An elevated expected return is not a guarantee that value must outperform growth in the short run,” the paper said.

Filed Under: Portfolio

Related Content

PORTFOLIO
Why Value Investing Sucks
Amy Whyte  November 13, 2019

PORTFOLIO
The Smart Beta Risks You’re Overlooking
Amy Whyte  October 17, 2018

SPONSORED
Special Report: The New Way to De-Risk
Sponsored by Northern Trust Asset Management  November 27, 2019