Making sense of value's disappearance

Research reveals how an inconsistency in asset accounting might have tilted the factor playing field

By LeoAlmazara
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It hasn't been easy to be a value investor, particularly given the 14-year slump it has suffered in its rivalry against growth. But new research suggests that it has been putting up a better fight than the
In a recent article published on the Wall Street Journal, columnist Mark Hulbert noted that based on traditional price-to-book measures, value stocks have lagged growth for nearly 14 years, but have far outperformed growth over the past 80 years.

But that recent history of underperformance might have been exaggerated. According to a recent study conducted by Campbell Harvey of Duke University, Juhani Linnainmaa of Dartmouth, and Robert Arnott and Vitali Kalesnik of Research Affiliates, Hulbert said, a fairer method of accounting would indicate that the value stocks’ funk started less than four years ago.

The research focused on how intangible assets – a category that includes research and development, patents, and intellectual property – are regarded on companies’ balance sheets. Under generally accepted accounting principles (GAAP), Hulbert said, such investments would be counted as expenses rather than assets, which means they’re viewed as a drag on a company’s value rather than a potential benefit.

“That makes no sense,” Harvey said.

The past half-century has brought about an economic shift from a reliance in manufacturing and agriculture to one that’s based more on information and knowledge work. That’s borne out in the increased weight of intangibles in U.S. company balance sheets, which Harvey and his colleagues said stood at just 25% of the tangible portfolio of book value in 1963, then doubled by the mid-1970s and doubled again in the early 2000s. Since then, the ratio between intangible and tangible assets has stayed at around 100%, according to the study.

Another puzzle for many is an apparent inconsistency in GAAP rules. While intangible assets are traditionally treated as expenses if they come from in-house investments, a company that acquires another firm gets to add that firm’s spending on intangible assets to its book value.

As it turns out, removing those quirks of the GAAP scoring system would have allowed for a much more interesting match-up between value and growth. By recalculating U.S. company book values for all years going back to 1963 to count intangibles as assets, Harvey and his colleagues found some companies switching teams. Dell shifted from being a growth stock with negative book value to having a low-
enough price-to-book ratio to be a value stock; another company, NetApp, saw its price-to-book ratio go from double that of the overall market to well below the market average.

The researchers then evaluated what market-wide impact the new definition would have had by segregating stocks into growth and value using both the original and new definitions. Under the traditional definition, they found that value peaked relative to growth in December 2006, while counting intangibles as assets would make its peak December 2016.

"[I]t would be going too far to argue that the exclusion of intangibles is the only cause of value’s drought in recent years," Hulbert said. Citing Harvey, he said the other major cause has been growth stocks’ extraordinary performance in recent years, which has brought the highest-flying names squarely into bubble territory – and suggests that some reallocation from growth to value may be in order.

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