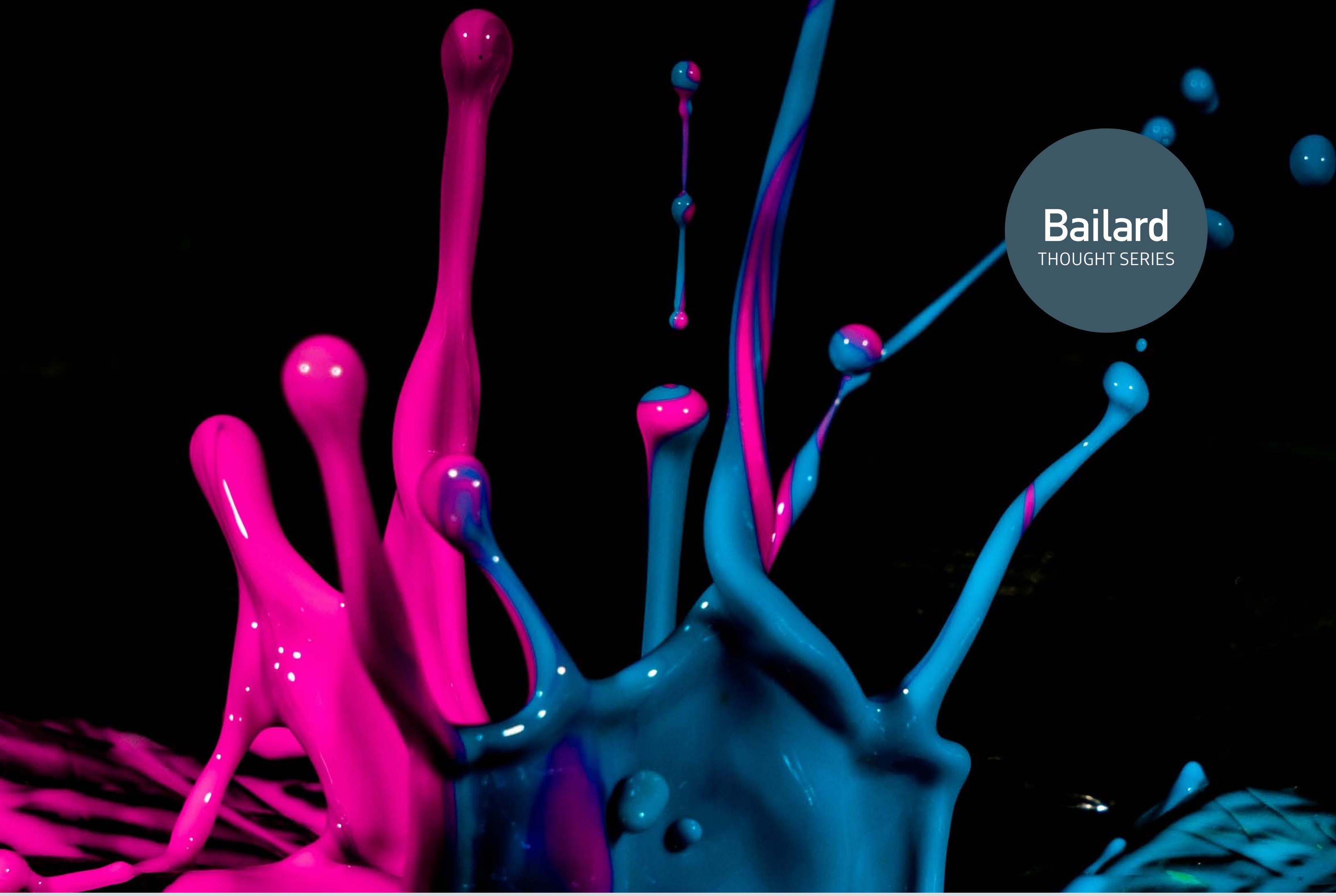

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THOUGHT SERIES

Busting Value Stock Myths

An investigation of what creates skepticism around value stocks, and six of the many myths that reappear time and again.

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MythBusters was a long-running television show on the Discovery Channel where the plausibility of commonly held wisdom or beliefs were scrutinized to determine their validity using scientific tests and experiments.

Some of the myths tested on the program were confirmed as true. Apparently, you can dip your wet hand into molten lead briefly and remove it unscathed (due to the Leidenfrost effect). Other myths were viewed as plausible. If you drive a convertible car with the top down fast enough in a rainstorm (over 90 miles per hour), you may not get wet (just imperil the safety of yourself and others). Of course, many of the myths tested turned out to be false and were busted. A goldfish's memory actually lasts for months at a minimum, not three seconds as is widely believed. The world of finance has its share of myths as well, and many center around value stocks and value stock investing.

As long-time value investors, we are regularly faced with skepticism regarding value stocks. If you Google “death of value investing,” you get over 60 million hits. If you then try “death of growth investing,” there’s only about half as many (35 million), and the headlines from the top five results give you a flavor for the rest. And, remember, these are the top links when searching for the death of ***growth*** investing:

1. The death of the growth vs value stock debate, *Financial Times*[1]
2. Arguing That 'Value Is Dead' Is Pointless, *Yahoo Finance*[2]
3. Stock Market: Don't Call the Value Rally Dead Just Yet, *Barron’s*[3]
4. Value Investing Is Dead? No, Long Live Value!, *DoubleLine*[4]
5. The death of value investing, *Family Capital*[5]

In case that’s not enough, an evaluation of the first 100 Google results yields exactly two links where growth investing’s immortality was questioned:

- ARK Innovation and The Demise Of Growth Investing, *Seeking Alpha*[6]
- The DEATH of High Growth Stocks?, *YouTube*[7]

And that more in-depth look forces you to wade through the following delightful headlines: Value Investing is a Death Cult,[8] Why Value Investing Sucks,[9] The Case Against Value Investing,[10] and one that nicely sums up the difference between growth stock and value stock investing: Why Value Investing Is Hard.[11]

Growth Stocks are Easy to Like

Growth stocks are like symmetrical faces or the golden ratio in art, people seem predisposed to like them. On average, growth companies are more profitable, less cyclical and, of course, faster growing than value companies.[12] The narratives attached to growth stocks throughout research reports, press coverage and social media chatter primarily emphasize the positive, with words and phrases like game changer, revolutionary, cutting edge, scalable, disruptive, next generation and category killer. With growth stocks, the skies tend to be persistently blue and the path toward further prosperity appears clear. For all these reasons, growth stocks are easy to like.

In contrast, value stocks typically have one or more visible—and sometimes scary—problems in addition to their generally slower growth and lower profitability. Value companies often reside in less exciting and old-fashioned industries like commercial printing, food processing, healthcare facilities, and footwear. Their road to future success is often unclear or hard to imagine, making it frequently difficult to get excited about value stocks.

Perversely, it is precisely this lack of investor excitement that has made value investing lucrative historically. More on that later. For now, let’s delve into the many myths regarding value stocks that continue to resurface, and are very much on investors’ minds currently.

Two Camps of Skeptics

The source of most value stock myths come from two different, but closely related, camps. The “never value” group is philosophically and/or temperamentally opposed to value investing. Another set of myths comes from the “maybe value, but not right now” camp. This cohort sees merit in value investing but can usually find a reason why the timing just isn’t right.

In the minds of both groups, growth stock outperformance is the natural order of things, occasionally interrupted by abnormal or extraordinary events, but destined to resume its inevitable triumph over value in short order.

To be fair, for much of the past decade—but particularly the period of 2017 through the first three quarters of 2020—growth stocks have been the place to be. Growth stocks handily outperformed value stocks during this stretch, and the initial stages of the pandemic exacerbated the relative performance gap. As students of behavioral finance, we realize the power recent experience has on investor preferences, and it is understandable growth would be particularly popular after all that success.

While the prevailing order shifted dramatically when value began massively outperforming from October of 2020 through March of 2021, since then value has given back much of those relative gains. Had value's outperformance trend continued uninterrupted, and the relative performance deficit of the last few years been fully erased, there would have been little motivation for writing this article. However, as you can see in Exhibit 1, value still has a long way to go to even the score.

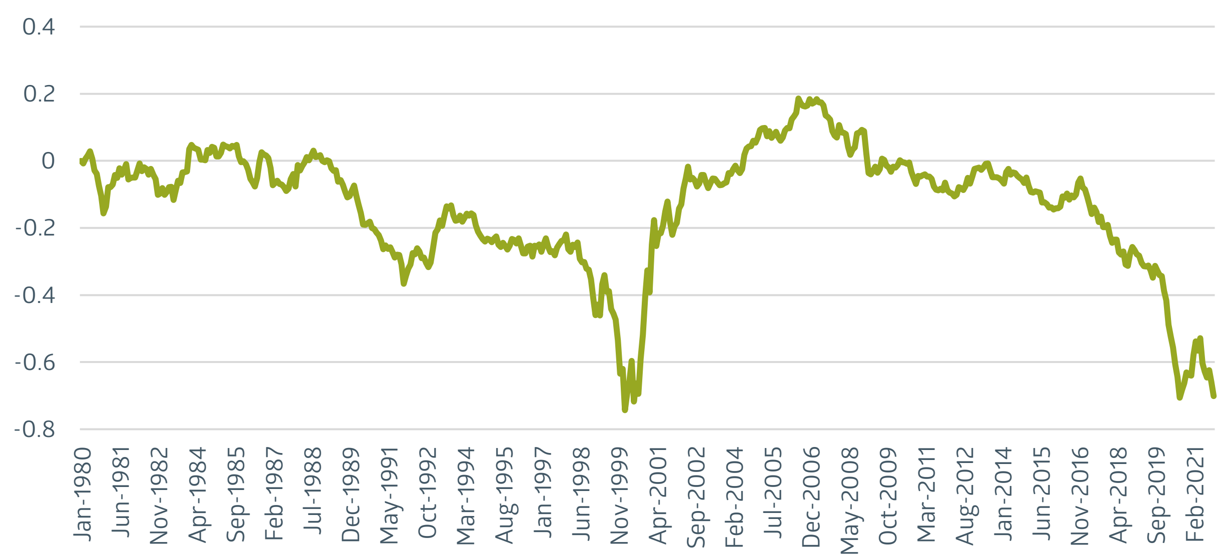
Can value stocks return to past levels of relative success?

We believe that value stocks can, and will, catch up. With that, read on as we tackle six of the many myths regarding value stocks that reappear time and again. Let's begin by addressing myths from the "maybe value, but not right now" camp.

Examining Value Stock Myths

#1	Value stocks only outperform in the early stages of an economic recovery.
#2	Value stocks only outperform when interest rates rise, so if rates fall from here, growth will do better.
#3	In a world where growth is scarce, investors will pay up for stocks that do grow.
#4	Value typically trades short periods of massive outperformance with long periods of underperformance.
#5	Value traps are a large and inherent problem for value investors.
#6	The world has changed, or "this time, it's different."

EXHIBIT 1: Cumulative Return Difference between the Russell 1000 Value and Russell 1000 Growth Indices



Source: Bailard Research, Bloomberg as of 11/30/2021.

MYTH #1: Value stocks only outperform in in the early stages of an economic recovery

Fact: While it is true that value stocks tend to outperform by the greatest extent early in an economic recovery, they have often outperformed at other stages of the economic cycle as well. Looking historically, value stocks have outperformed growth stocks on average in six calendar years out of every ten.

MYTH #2: Value stocks only outperform when interest rates rise, so if rates fall from here, growth will do better

Fact: Value stocks are shorter-duration assets than growth stocks (the time horizon for expected payouts is sooner with value) so, all else being equal, growth stocks should benefit more from falling interest rates than value stocks. However, there are typically far more influences at play than interest rates alone. The relationship between interest rates, inflation, and economic growth with the performance of growth and value stocks is complex. Exhibit 2 below illustrates that the correlation between interest rate changes and the relative returns of growth versus value stock has varied widely over time. As a result, value stocks have historically enjoyed periods of outperformance over growth stocks in just about any interest rate environment.

Recently, the correlation between interest rates with relative value and growth returns has been higher than average. This may continue into the future or not. Supposing that interest rates do remain highly correlated with growth versus value returns, the second assumption in the myth above is that rates may fall, allowing growth to outperform.

There are reasonable arguments on both sides but, as of early December 2021, interest rates remain in the uptrend that began last summer. Renewed economic strength, lingering inflation, and/or the expected tapering of the Federal Reserve's quantitative easing program could all result in further rate increases in the coming months.

EXHIBIT 2: 36-Month Correlation Between Bond Yield Changes and Value vs. Growth Returns

Source: Bailard Research, Bloomberg as of 11/30/2021.

MYTH #3: In a world where growth is scarce, investors will pay up for stocks that do grow

Since the Global Financial Crisis, U.S. GDP growth has been about half as rapid as it was in the three decades preceding it. To be fair, two of the worst recessions in a century hit during this timeframe, dragging down the recent period's average pace. We know that growth stock earnings have advanced more rapidly than value stock earnings during this time (as they almost always do). But, the question remains: has the slower, more recent overall economic growth led to a widening earnings growth rate disparity between growth and value stocks?

The aggregate earnings growth gap between growth and value stocks shown in Exhibit 3 was 1.37% from 1995 to the middle of the Global Financial Crisis, and it has been somewhat less (0.78%) since then. As growth stocks have not widened their earnings growth rate advantage over value stocks during this slower economic growth period, it is unclear why investors should be willing to pay more for them.

EXHIBIT 3: Annualized EPS Growth

	Russell 1000 Value	Russell 1000 Growth
Jan-95 to Jul-08	5.61%	6.98%
Aug-08 to Nov-21	6.52%	7.30%

Source: Bailard Research, Bloomberg as of 11/30/2021.

Now let's examine some of the less period specific myths believed by the "never value" camp.

MYTH #4: Value typically trades short periods of massive outperformance with long periods of underperformance

This myth can be addressed both retrospectively and prospectively. Let's begin by looking at history.

Fact: In the nine full, non-overlapping periods for which we have style data, large cap value stocks have beaten large cap growth stocks an average of six years out of every ten, or just under 60% of the time. The worst consistency decade for large cap value was 2008 to 2017, where it won only three out of the ten years. The best decades for large cap value were 1938 to 1947 and 1958 to 1967, where it won eight out of the ten years. If you consider rolling ten-year periods since 1938, large cap value has beaten large cap growth in 77% of those periods. Over the past 20 years, that percentage falls to a still respectable 45%. If small cap value is substituted for large cap value, the winning percentages increase. Small cap value has beaten large cap growth in 80% of those periods. Over the past 20 years, that percentage rises to 85%.[13]

Looking forward, what is likely required for growth stocks to outperform value stocks? Growth companies, as discussed earlier, are generally more successful than value companies and typically enjoy superior future prospects. It would not be surprising that these desirable characteristics of growth companies will persist into the future. However, market participants are already anticipating this, and have been pricing these stocks accordingly.

Investors do their best to adjust equity prices so that expected future rates of return of similarly risky stocks are equalized. The prices of low expectation stocks are driven down, and prices of high expectation stocks are driven up until the consensus opinion is indifferent between the two. The only way for a stock to outperform from this equilibrium is for it to produce results that exceed expectations. Therefore, for growth stocks to be in a secular outperformance trend, one would have to believe that investors will continually underestimate their future prospects, or overestimate value stock prospects.

It is accurate to argue that at least with the FANG stocks (or FAANG, or FAAMG as they have conveniently evolved), that is exactly what has happened over the past decade. These high growth companies serially exceeded investor expectations and were rewarded for it. For this to continue in the future, the positive surprises need to keep on coming.

Can it continue?

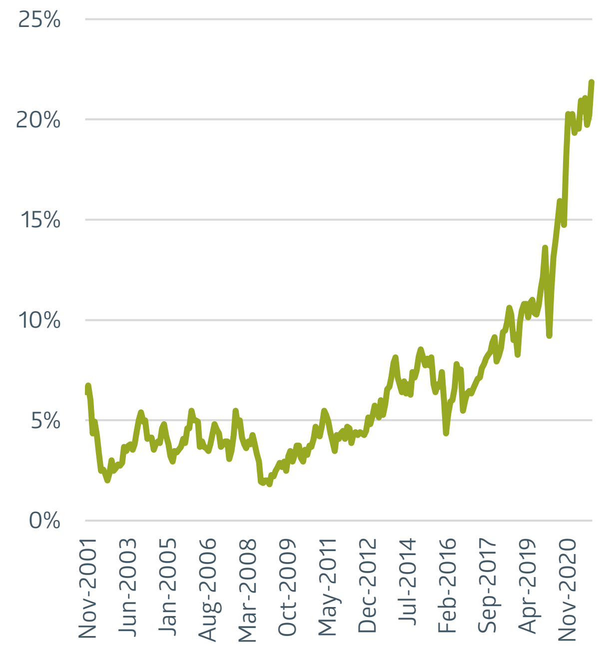
AllianceBernstein recently completed a study[14] assessing the 1,500 largest U.S. companies over the past 40 years. Out of almost 6,000 companies (the largest 1,500 changes over time), only 71 were able to grow their revenues at 10% or more for ten successive years. Growing revenues at a compounded rate of 10% or more over ten years was more easily accomplished, with 23% of the companies in the sample able to achieve this. A compounded revenue growth rate of 15% or more over ten years was only achieved by 13% of companies.

Not surprisingly, larger companies have a much greater difficulty reaching these growth rates. Of companies with revenue above $25 billion, only 6% were able to exceed 15% compound revenue growth over ten years, and only 1% of companies were able to achieve it over 15 years.

Bernstein's researchers also performed discounted cash flow valuation analysis and estimated that companies achieving a compounded revenue growth rate of 15% for the next 15 years should be trading at 10x to 20x current revenues depending upon the input assumptions. Currently, 21% of the largest 1,500 U.S. stocks are trading at 10x revenues or greater. Exhibit 4 reveals that this is both well above the average percentage of stocks valued this highly over the past 20 years, and far above the historical percentage of stocks that were actually able to grow rapidly enough to justify these valuations.

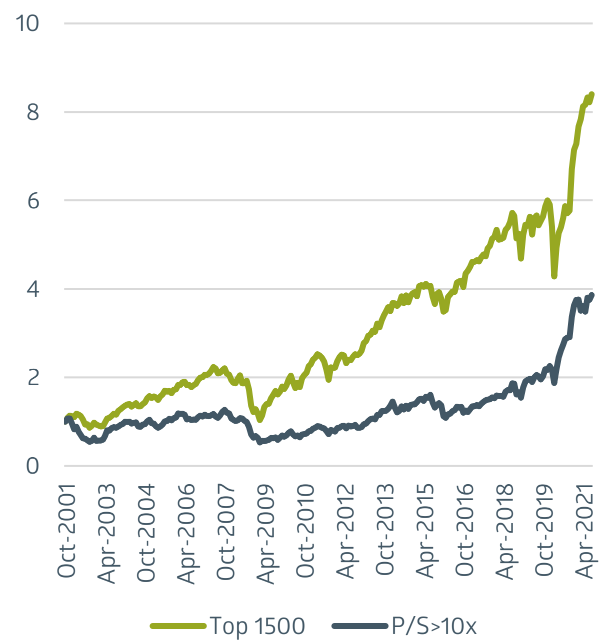
Actual historical performance of stocks trading at 10x revenues or more is not encouraging, and suggests that there are typically many more companies expected to deliver consistent rapid sales growth than are able to achieve it (Exhibit 5). While it is possible that growth stocks may continually exceed currently lofty investor expectations going forward, actually achieving it may prove elusive from this starting point.

EXHIBIT 4: Percentage of Stocks with Price-to-Sales Ratios Exceeding 10x



Source: Bailard Research, Bloomberg as of 11/30/2021.

EXHIBIT 5: Cumulative Returns



Source: Bailard Research, Bloomberg as of 11/30/2021.

MYTH #5: Value traps are a large and inherent problem for value investors

Fact: This is true in an absolute sense but relatively not the case at all. A value trap is a stock that initially looks like a bargain, only to have its fundamentals and prospects deteriorate to the point where it no longer appears underpriced. While there are sophisticated methods that can help to identify potential value traps, short of a crystal ball it is impossible to avoid them entirely. However, while value traps are a problem for value stock investors, historically growth traps have been an even larger problem for growth stock investors.

As you can see from Exhibit 6, both growth and value investors have been faced with a significant percentage of progressively disappointing stocks (traps) over time. While growth investors have enjoyed fewer traps in recent years, the advantage has been small.

More important than the percentage of traps is the performance drag incurred by owning them. Exhibit 7 digs into the relative performance of both value and growth traps. Value stocks have lower embedded investor expectations than growth stocks. This makes disappointments in value stocks typically less painful than in growth stocks.

EXHIBIT 6: Value and Growth Traps as a Percentage of Russell 1000 Style Groups

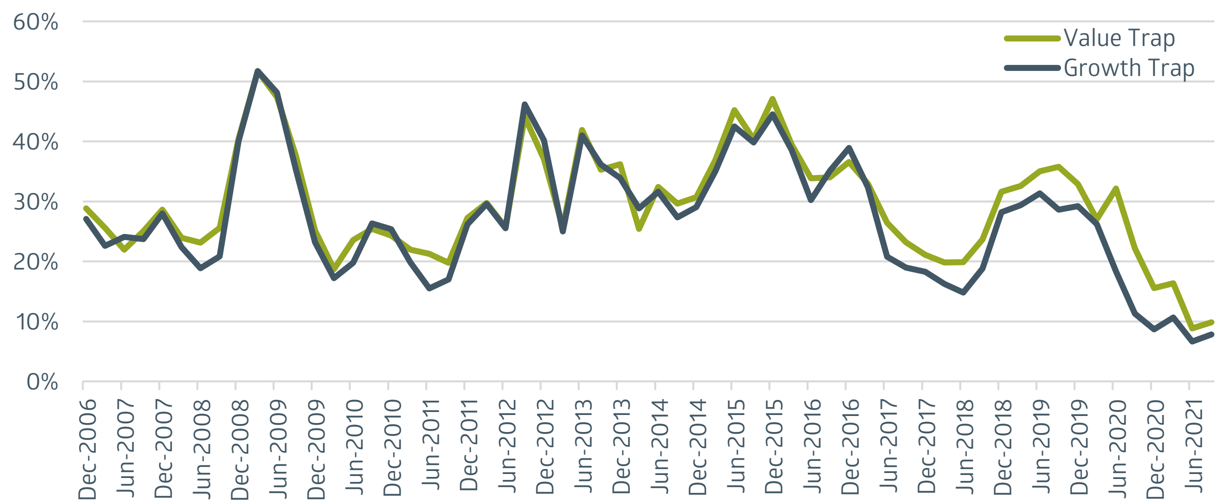
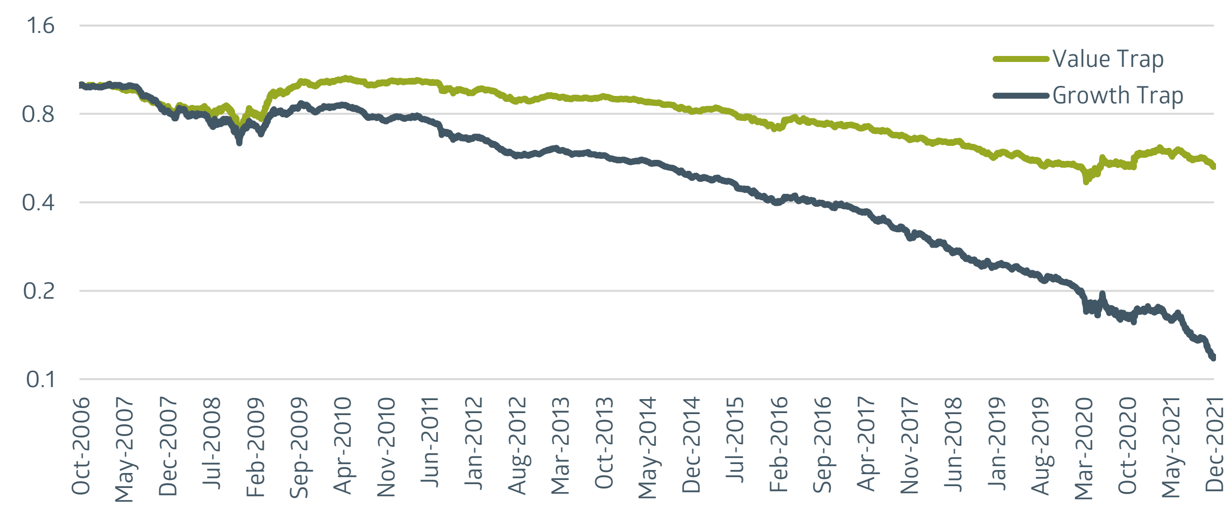


EXHIBIT 7: Value and Growth Trap Relative Performance



Source: Bailard Research, Bloomberg. Exhibit 6 as of 9/30/2021; Exhibit 7 as of 12/2/2021.

![MYTH]

Myth #6: The world has changed, or "this time it is different"

Fact: It is impossible to prove or disprove the myth that the world has changed, and that conditions are different this time. The world is always changing, though the pace of change certainly varies over time. Innovation and disruption may produce a coming golden age for growth companies, or competition, regulation, intellectual property theft, another Carrington Event (geomagnetic storm), or even plain old reversion to the mean could produce just the opposite. No one knows, but given the current relative valuation starting point between growth stocks and value stocks, "this time is different" appears to be already priced in as suggested in Exhibit 8.

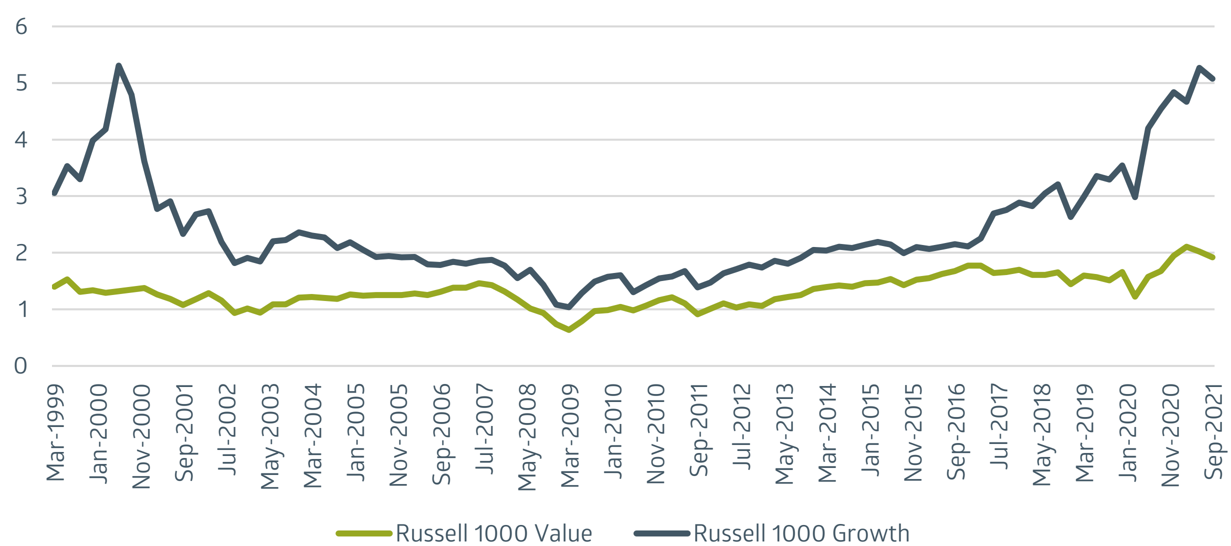
In 2016, Fortune looked back at the 30-year history of their 100 fastest growing companies list. It makes for interesting reading.[15] Amazon, Apple, and Netflix are there, but so are plenty of other companies that have since fallen off the growth stock radar. La-Z-Boy, Smith Corona, Winnebago, Chipotle, CompUSA, Hain Celestial, Enron, Biogen, Toys 'R' Us, Blockbuster, Callaway Golf, Under Armour, Gilead Sciences, Cognizant Technology Solutions, and many others had their time in the sun but the rapid growth that earned them a place on Fortune's list failed to materialize in their futures. In retrospect, identifying stocks that will outgrow expectations is easy. In real-time, it is a great deal more difficult.

"People are disturbed not by events, but by the view they take of them."

This quote from philosopher Epictetus memorializes that the power of expectations has been recognized since at least the time of the ancient Greeks. It is as true today as it was almost 2,000 years ago that people's (and investors') expectations determine how, and how strongly, they react to events. Most events in life have expectations built in, and expectations have the biggest impact when actual events deviate from them, particularly in the opposite direction.

Human nature tends to lead investors toward excessive optimism, overconfidence in their predictive abilities, and an inclination toward anchoring their predictions based upon recent past trends. Given these biases, and an uncertain future, what types of stocks are likely to be cursed with high

EXHIBIT 8: Comparing Price to Sales Ratios (P/S) for Growth and Value



Source: Bailard Research, Bloomberg. Exhibit 6 as of 9/30/2021; Exhibit 7 as of 12/2/2021.

expectations, and which are blessed by having to deliver very little in order to pleasantly surprise? Perhaps history offers some clues?

As you can see in Exhibit 9, stocks where high expectations are built in—growth stocks both large and small—have underperformed value stocks over the long run.

EXHIBIT 9: Total Returns by Equity Style, 1920-2020

Large Cap Growth	Large Cap Value	Small Cap Growth	Small Cap Value
9.7%	11.6%	9.1%	14.1%

Source: Bailard Research, Bloomberg as of 12/31/2020.

Kale, Quinoa, and Turnips

Value stocks for most people are an acquired taste. Value investing requires going against the conventional wisdom, and being wrong about 40% of the time. No matter how many myths about value investing are "busted," the value premium has not been arbitraged away even though it is widely recognized for the same reason that health foods do not dominate the shelves of most grocery stores. Even when investors know that value stocks are good for them, many would prefer to not consume any more than necessary. Value investors have historically been compensated with higher returns for exposing their portfolios to the greater discomfort and uncertainty associated with value stocks, but that is a price that not everyone is willing to pay.

While value is not the only investment style that can beat the market over time, it has proven historically to be an excellent choice that is often underrepresented in investors' portfolios.

ENDNOTES

1 https://www.ft.com/content/cb16a4d0-dfcc-4ae1-ad97-a962f24640d6
2 https://www.yahoo.com/now/arguing-value-dead-pointless-155045644.html
3 https://www.barrons.com/articles/value-growth-stocks-51624397912
4 https://doubleline.com/wp-content/uploads/Long-Live-Value_Checcone-Ear_March-2021.pdf
5 https://www.famcap.com/2020/07/the-death-of-value-investing/
6 https://seekingalpha.com/article/4412431-ark-innovation-and-demise-of-growth-investing
7 https://www.youtube.com/watch?v=Z7jzRA8BVHA
8 https://play.acast.com/s/stocks-for-beginners/enriqueabeyta-valueinvestingisadeathcult
9 https://www.institutionalinvestor.com/article/b1j0mvcy9792vt/Why-Value-Investing-Sucks
10 https://theirrelevantinvestor.com/2020/05/12/the-case-against-value-investing/
11 https://www.kiplinger.com/article/investing/t052-c017-s001-why-value-investing-is-hard.html
12 Bailard Research, Bloomberg, based on a comparison of the Russell 1000 Growth and Russell 1000 Value indices for the 20-year period ending 9/30/2021
13 Bailard Research, Kenneth French Data Library, https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html
14 https://www.bernsteinresearch.com/brweb/ViewResearchStreamer.aspx?cid=mFGh2X8e0mwqA1GVSY-q3Hh7NSpqp83vGFsXv4SA0J%2bvFjWyL7i64qf5DEpz0SQS4
15 Fortune, “A Look Back at the 30-Year History of Our Fastest-Growing Companies List,” 15 September 2016. https://fortune.com/2016/09/12/fastest-growing-companies-list-history/

DISCLOSURES

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