MORAN
WEALTH MANAGEMENT

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New Year, New Approach to Value Investing

A staple of our shared life experience is when you buy your very first car. I sure remember mine. Before we even arrived, my parents and I had spent weeks comparing different lots and cars. This was *my* first car, I wanted it to last, work well, and of course, look cool. But my parents made sure I asked all the right questions: What is the mileage? Does it come under warranty? Is there any damage or has it been in any accidents? And so on. Then we compared prices. What was the market value on average? Was the price a premium or discount and if so why? I narrowed my choices down to a sedan and sports car. Reluctantly, I decided to move forward with the sedan, despite the fact I would have much rather driven up to my high school in the sports car. But I knew that the sedan would result in less costly insurance/gas expenditures in the long-run and the ability to drive my siblings and friends around more easily. I did not know it at the time, but I was already acting on principles of value investing before I knew what a P/E ratio stood for.

The principles of value investing are understanding that securities are a stake in a business, focusing on the true worth of the business as opposed to the price the market is designating, targeting businesses that have a wide divergence in their intrinsic value and market price, and staying disciplined as to not act emotionally. Benjamin Graham and Warren Buffett are two of the most well-known “value” investors because of the success they found implementing value principles in their strategies and they amassed a huge following of loyalists as a result. But lately things have not been going the value investors way.

Value has offered pretty disappointing performance over the last decade, but 2020 was a particularly bad year. Value stocks are now trading at some of the cheaper levels relative to the market we have seen in modern times. And on the other hand, growth stocks have overheated similarly to what we saw in 2000. We do not have a crystal ball so we can not exactly say what the catalyst will be, but in our opinion eventually growth will cool down and value will recover. Mostly because we are strong believers in mean-reversion: what goes up must come down and what goes down must come up.

One chart we observed, courtesy of Neuberger & Berman, showed the cumulative relative performance of large-cap value (Russell 1000 Value Index) vs growth (Russell 1000 Growth Index) in relation to the Russell 1000 Index benchmark from 1979 through 2020 (Levine). During the Dot-com bubble, the Russell 1000 Growth and Value Indexes' spread relative to the Russell 1000 Index was around 1000%. In 2020, the spread widened to around 3500%.

The spreads between the indices just scratch the surface. When you dig into the fundamentals, the overall market is trading at some very elevated valuations compared to the historical norm. We looked at a couple charts, courtesy of GMO (Inker), showing the median Price/Sales of the growth-half of the U.S. stock market, and their median P/E. The Price/Sales show us that growth stocks are even more expensive than in 2000, though not quite as extreme in regards to P/E, but still far more expensive than any time outside 2000.

One of the most frequent questions we are getting today is in regards to what will drive mean reversion for Value. As we mentioned, it has been losing for a long time and valuation alone has not been able to arrest the underperformance. A return to more "precedented times" and economic normalcy could certainly be a catalyst. Especially with strong results from vaccine candidates. Value stocks typically rely more heavily on face-to-face activity than growth stocks and of course the pandemic made that a bit difficult.

We think another potential catalyst would be interest rates rising above today's extremely low levels. Even a small upward move would be positive for sectors like Financials, Industrials, and Materials which tend to include more value stocks. As interest rates rise, the discount rate analysts use to discount future earnings would adversely affect the valuation of growth stocks. In addition, most growth stocks today, especially in areas like technology, have been spoiled with extremely cheap and easy access to capital and rising interest rates will make future capital more expensive.

That being said, we think the likelihood of the economy opening up is close to certain, while rising inflation rates and thus interest rates are more of a medium term possibility as inflation picks up. We are far more certain that *something* is going to cause a reversal than any one thing in particular. Given how extreme the opportunity in value is today, we weigh the risk of staying on the sidelines until the turn is a bigger risk than entering into value before we are 100% sure it has bottomed.

Now while we want to make sure our investors are aware of our interest in value going forward and that growth as a whole appears to be overpriced, we are not saying that all growth should be avoided. In fact, we like to incorporate both growth and value approaches in our stock picking for a few reasons. The first is that though history has been a good guide, it is important to recognize that markets can and have changed. Many of the highest valuated companies today are capital-light and R&D heavy, a strong combo that, when using traditional accounting, can lead to big misreads of what is cheap and what is not. Value, with its emphasis on the present value, low price, and predictability and growth investing, with its focus on rapidly growing companies even at high valuations, should be used in tandem.

Just because something carries a low valuation, does not always mean it is a good buy. There are definitely value traps – companies that appear to be cheaply priced because of low valuation metrics but continue to languish and even collapse. Successful investing has to be more about making superior judgement calls over both qualitative, non-computable factors such as intangible assets and how they may affect the future as well as being able to distinguish a fairly priced stock from an expensive stock – you do not want to overpay. The natural state of a value investor is skepticism but in a world where there is such a substantial amount of innovation happening, investors should be curious and open to new ideas without a knee-jerk reaction to dismissiveness.

The idea that growth and value strategies are mutually exclusive is a dangerous fallacy. Our philosophy is that they should to be used together in both stock selection, and in the continued analysis. After an extended period of growth significantly outperforming value, we believe that we have reached a turning point but we are not anti-growth. We believe both approaches to investing add value to a portfolio and should be harmonious. While value may outperform overall versus growth, there is no reason good growth companies should not find a meaningful place in a portfolio. As long as we continue to invest in companies based on their long-term potential, than we believe the investing path in 2021 and going forward should be one of success.

"Not everything that can be counted counts and not everything that counts can be counted." - Albert Einstein

For additional information and resources, please visit us at https://www.moranwm.com/

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The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

The prices of small company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification, and competitive strengths to endure adverse economic conditions.

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