LEITH WHEELER INVESTMENT OUTLOOK

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The Rationale for "Value Investing" - Revisited

Last week, my four-year-old son was pretending to work in a restaurant and offered to cook me a burger. "Eighteen dollars, dad," he quipped, hoping to impress me that he could even think of such a big number. I tried explaining that smaller numbers worked better for me since I needed to feel I was getting a good deal. If I paid too much, I might expect more than I was actually going to get. I told him that I like good value, and could never bring myself to…ah, forget it, he was already "cooking" the thing.

Value investing does more than just embody some of the principles I was trying to convey with that anecdote. It has produced much better results for investors over the long term - a well-documented fact that was reviewed by two finance professors at the University of Illinois[1]. While this was by no means the first study of this type suggesting that value investing is superior, it did provide a thorough analysis of the topic.

The Findings

Value oriented equity portfolios (i.e. portfolios containing stocks whose prices are attractively priced relative to earnings, cash-flow, a company's assets, or other measures) were found to **significantly out-perform** growth-oriented equity portfolios (i.e. stocks with a good earnings record and outlook but not considered cheap).

The results were "stress tested" by looking at

- different periods of time;
- different markets around the world;
- different sized companies

In their report, the authors write *"the academic community has generally come to agree that value investment strategies, on average, outperform growth investment strategies"* and go on to say that *"patient investing in value stocks is likely to remain a rewarding long-term investment strategy."*

In addition, value has been shown to be **less risky**, performing better in times when markets are down, than growth strategies.

Possible Reasons Why Value Stocks Out-Perform

To an objective outsider, the valid question is "*how can* value investing beat growth investing with lower risk? This sounds like the ultimate free lunch!" It may well be.

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[1] ***Value and Growth Investing: Review and Update***, by Louis Chan and Josef Lakonishok, Financial Analysts Journal, Jan/Feb 2004

To explain the results, the professors focused on behavioral traits that influence valuations. For example, investors tend to become over-exuberant about companies that have demonstrated strong historical growth. So much so, that they bid up the prices of many growth companies to unsupportable levels, with disappointing consequences down the road. In essence, **a good company becomes a bad investment because the price moves out of sync with fair value**. Growth inevitably slows, and stock prices correct. We work hard to avoid buying companies like these.

Similarly, companies may be shunned by the investing crowd for a variety of reasons. When this happens, behavioural patterns can push the prices of these stocks to levels lower than the intrinsic value of the company. We love to own many of these companies when they fall out of favour, as long as they have a solid business and meet our quality criteria. For us to buy them, they need to be **very good investments**, but not necessarily the most exciting companies. When the market ultimately recognizes their value, they can produce exceptional returns.

Growth stocks attract more coverage from brokers and analysts as they have a more interesting "story". Often, brokers and analysts recommend more glamorous stocks in the hope of generating more trading commissions. Both of these factors can self-perpetuate a rise in the prices of these companies in the short term. In addition, many investment managers like to show their clients that they own more exciting stocks, so they gravitate towards buying growth companies and their prices get bid up higher.

The Current Markets

We lived through the technology bubble, when we were criticized for being outdated, and not in tune with a "new paradigm" of investing. Investors fell in love with "concept stocks", companies with no track record of earnings or poor management. However, as the bubble burst, our value style kicked in strongly, protecting our clients' capital.

We're going through a period now in Canada when the general market is up, but most stocks are actually down. Commodity stocks are leading the charge, and investors buying into them today are paying prices that reflect very high expectations. The belief is that China and India will keep on growing and depleting our finite resources, driving commodity prices higher and higher. If expectations are not met due to a slowing global economy, the outcome will be disappointing, as it was for the internet lovers in the 1990's.

In the business section, you read that the financial sector is broken, that banks have made too many poor loans or poor investments and have been badly run. In time though, the well capitalized and well managed financial companies, whose prices are now divorced from their underlying quality, will prosper again, since they are at the hub of our economy and they are very profitable. When that happens, investments today in those businesses should do extremely well.

It has been frustrating to see the more expensive stocks appreciating even more, and the cheapest stocks underperforming the market for the past year. Value is very beaten up versus growth, but the cycle will most assuredly turn once investors realize 'price matters'. Timing this shift from growth is impossible and the outperformance of the growth style may continue in the short term. However, in time, the benefits of value investing will re-emerge.

Lesson Learned

Next time we played the game, my son remembered the concept of good value. "How much do you want to pay, dad?" he asked, happy to oblige so that he could move onto the next stage of the game and cook the burger. I told him I wanted a free lunch.

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