U.S. Value: The Case for Defensive Quality

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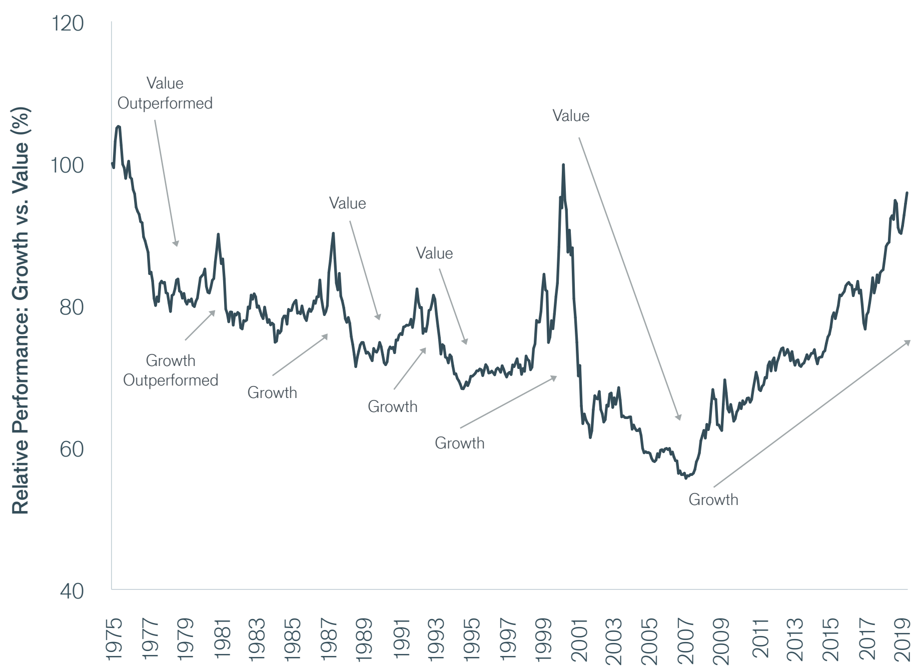
Key Takeaways

- With the current cycle particularly long in the tooth, investors should consider allocating to defensive value.
- While the long-term data makes us bullish on value strategies generally, we continue to have concern about both a market correction and overall market valuation.
- Good quality assets, sensible management, strong balance sheets and diversified sources of alpha are some of the qualities investors should look for in out-of-favor stocks.

As the equity market's rally over the past 10 years has taken valuations to lofty levels and growth has significantly outperformed value, the question arises: "Is value investing dead?" Recently, a research firm sent out a missive entitled, "The Death of Value Continues." This, of course, is music to our ears at Perkins and to anyone who believes in reversion to the mean. Despite the strength of growth equity investing today, value and growth investing tend to be cyclical – even if the current cycle is particularly long in the tooth. When death cries abound, that is the time to take a closer look at value. And for investors concerned about the market's valuation today and potential market volatility in the future, "defensive value" should, in our view, be part of a well-balanced portfolio.

As the chart below shows, despite the recent long run of superior returns by growth and momentum investing, a value-oriented strategy has still outperformed over extended periods. Value investing does not come without risks, however, which is why we believe a defensive value strategy focused on finding high-quality stocks is particularly important.

Exhibit 1: Growth Has Outperformed Value Globally Since 2008



Source: Thomson Reuters DataStream, January 1975 to May 2019. Chart shows relative performance (%) of the MSCI World Growth Index vs. the MSCI World Value Index. When the chart line goes down, value as a style outperformed growth. When the chart line rises, growth outperformed value.

An Aging Growth Cycle

Mean reversion is a powerful concept working in favor of value stocks now that growth has been on a 10-year run. From 1987 through 2016, the average growth cycle lasted six quarters, with the longest cycle topping out at 12 quarters (1988–1991). During the same timeframe, the longest value cycle lasted 15 quarters from 2002–2006. Certainly, it is normal for the market to shift between cycles. Given how long the current growth-driven market has lasted and the normalization of market volatility, we believe that we may soon revert to an environment in which value outperforms growth.

In addition, during periods of strong market upswings, investors tend to shy away from value stocks and chase momentum plays, perceiving value to be perpetually out of favor. Such times generally cause the market to expect the future to resemble the recent past. Today appears to be one such period.

Managing Market Corrections and Overvaluation

While the long-term data make us bullish on value strategies generally, we continue to be concerned about both a market correction and overall market valuation. We identify these risks first and foremost from a bottom-up perspective by looking in aggregate at our reward-to-risk statistics for each individual stock we consider. We then take a top-down approach and consider market multiples. By that measure, the Shiller cyclically adjusted price-to-earnings (CAPE) ratio has rarely looked more expensive over the last 100 years.

Our concerns about the market were only partially realized at the beginning and end of 2018, with two sudden and volatile sell-offs of 10.2% (January 26 to February 8, S&P 500® Index) and 15.7% (December 3 to December 24), respectively, which ultimately proved to be short-lived.

That said, we believe that while the economy appears strong today, corrections like these will eventually be longer in duration and more severe in magnitude. As a result, it is worth considering a defensive value strategy, which could help mitigate losses during moments of greater market cyclicality. Generally speaking, during periods of heightened risk, a defensive investment strategy affords investors the opportunity to stay invested in the market while mitigating downside risk. It also helps deter investors from the tendency to try to "time the market." Not all value investing styles are the same. Deep value investing often comes with significant risk and can lead investors into value traps. Our brand of quality value investing is a different and more risk-averse animal than many of our deep value peers.

Focusing on Quality

While we believe that value stocks are poised for relatively strong performance, investors should not be complacent in their positioning. We generally believe that risks are directly correlated to market upswings and generally get more distorted from a valuation perspective for high-growth companies during periods of market ebullience. As a result, investors should consider the risks associated with both high-quality stocks trading at peak valuations as well as lower-quality stocks that are more susceptible to adverse developments over full market cycles. There are several ways to mitigate some of these risks while still owning high-quality stocks.

Exhibit 2: Are P/Es Indicating that Stocks Are Expensive?

Source: Shiller P/E, a cyclically adjusted price-to-earnings ratio dividing price by average of 10 years of earnings, adjusted for inflation. January 1881 to May 2019.

Healthy Balance Sheets Wanted

One major risk with many companies is leverage, which has increased across the market since the early 2000s (see Exhibit 3). Many companies have taken advantage of easy monetary policy to increase leverage on their balance sheets. Specifically, companies have been able to access low-cost debt to engage in shareholder-friendly activities, such as stock buybacks and mergers and acquisitions. Some management teams have made smarter (i.e., value-enhancing) decisions than others, but corporate balance sheets are generally the worse for wear. We are concerned that some of these companies may have taken on more debt than they can comfortably service. And at this point in the business cycle – already extended by historical standards – it is especially concerning that many of these firms have not been diligent in deleveraging their balance sheets.

This debt creates a potentially dangerous dynamic. Until recently, the slow pace of economic recovery has been challenging for earnings growth, particularly in cases where a firm has significant cyclical and commodity exposure. An overly levered balanced sheet may compound an earnings miss and make it much harder for a company to recover. And if profit margins tighten from here, which seems likely as we are at record-high margins today, high debt levels will squeeze companies' free cash flow. Given these trends and where we are in the business cycle, we believe investments in well-capitalized and liquid balance sheets may serve investors better than over-encumbered alternatives.

Value Trap Avoidance

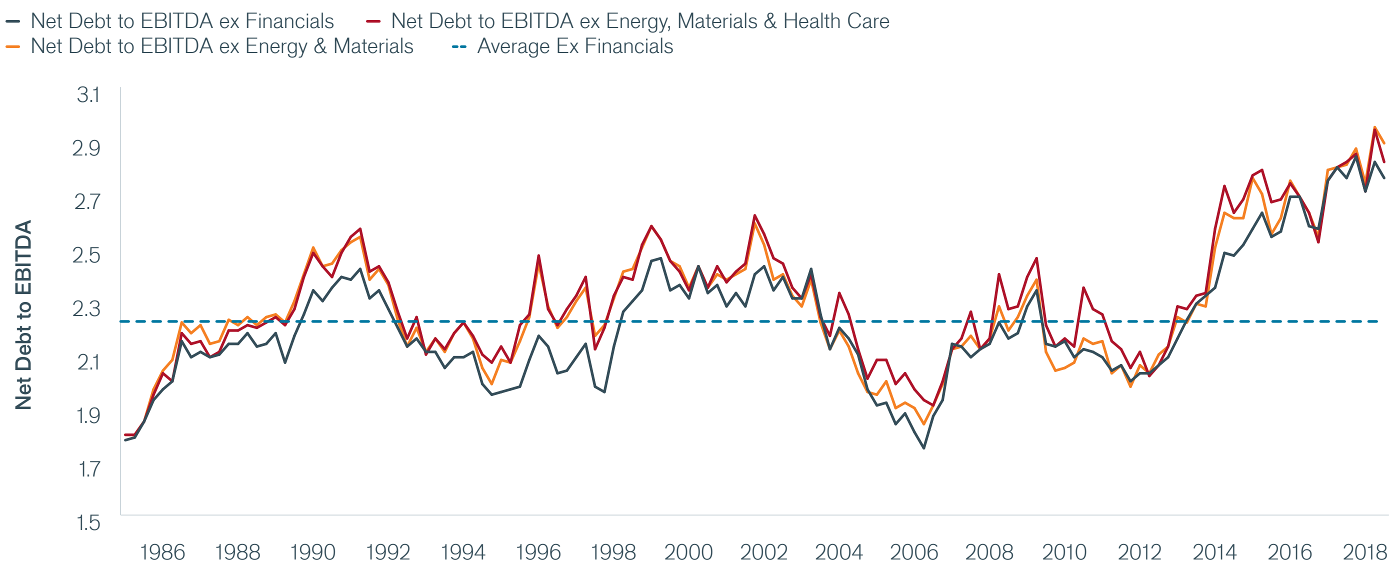
One of the biggest missteps many value managers make is mistaking a low price for a good bargain. The two are often not the same. A defensive approach to value investing puts a significant premium on competitive advantage and investing in businesses that, while potentially challenged in the near term, have strong long-term prospects. We have written extensively on value trap avoidance and believe that a variety of traps exist in today's market and should be avoided, as detailed in our September 2016 paper, Beware: Value Traps Lurking.

Diversified Drivers of Alpha

Additionally, we believe that less-mainstream holdings, which we think of as "off-the-beaten-path" stocks, limit exposure to general market bullishness. Our research efforts increasingly direct us to stocks with either less Wall Street or sell-side analyst coverage, or those that are out of favor with the Street. We like management teams that are not overly promotional and are good stewards of shareholder capital and niche businesses with secular business drivers. In navigating today's great bull market, we believe that the further a stock is from front-page headlines, the better. Investing across the market-capitalization spectrum also provides the opportunity to invest in small- and mid-cap stocks that may provide even further diversification of alpha (i.e., risk-adjusted performance).

The bottom line is that we favor an eclectic mix of holdings. In our opinion, a healthy mix of different drivers of alpha strengthens portfolios. Ultimately, as the market and many of its individual stock components become increasingly unattractive from a reward-to-risk standpoint, we want the portfolios that we manage to look less like the market.

Exhibit 3: Leverage Has Increased in the Russell 3000® Index



Source: Jefferies Group, as of August 2018. Data shown represents net debt to earnings before interest, tax, depreciation and amortization (EBITDA) for the Russell 3000 Index. Sectors are based on the Global Industry Classification Standard (GICS).

MSCI World Growth Index℠ reflects the performance of growth stocks from global developed markets.

MSCI World Value Index℠ reflects the performance of value stocks from global developed markets.

S&P 500® Index reflects U.S. large-cap equity performance and represents broad U.S. equity market performance.

Russell 3000® Index reflects the performance of U.S. large-cap equities.

Alpha compares risk-adjusted performance relative to an index. Positive alpha means outperformance on a risk-adjusted basis.

Price-to-Earnings (P/E) Ratio measures share price compared to earnings per share for a stock or stocks in a portfolio.

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