

EYE ON THE MARKET

Value Investing: Is There Any Value In It?

PETER GREENBERGER, CFA, CFP®, *Director, Mutual Fund & 529 Plan Product Management*

In late 2017, famed hedge fund manager David Einhorn wrote a letter to investors questioning whether value-oriented investing was still a viable strategy. Einhorn noted that, “The persistence of this dynamic (growth stocks outperforming value stocks) leads to questions regarding whether value investing is a viable strategy.” Eye on the Market (EotM) has examined this topic in the past, but recent tax law changes justify further evaluation into the strategy

and its ability to add value going forward.

LAST GASP

2017 ended with growth-oriented strategies continuing to generate strong returns. Furthermore, it is hard to ignore the magnitude in outperformance reflected in Table 1, as growth strategies generated total returns that were approximately two to three times higher than their value-oriented counterparts. The disparity was most evident between

small-cap growth and value stocks. The performance of growth-oriented companies was led by the healthcare and information technology sectors.

Can this trend continue? Yes, of course it can. Does it imply that investors should assume that value-oriented investing no longer has any merit? No, it does not.

EotM still firmly believes that over longer periods of time, investors seek to buy quality companies that are trading at a discount (due to nonrecurring events or market conditions) with the idea that these companies have strong enough building blocks to recover over time. Extended periods where one style consistently outperforms has occurred in the past and generally persists until the overarching market paradigm shifts. This was the case in the late 1990s, when growth portfolios outperformed by owning companies that were technology-oriented. It ended when investors realized that earnings do matter.

Table 1

2017 RUSSELL INDEX PERFORMANCE (%)				
Market Capitalization	Large	13.7	21.7	30.2
	Mid	13.3	18.5	25.3
	Small	7.8	14.6	22.2
Investment Style		Value	Blend	Growth

Source: Morningstar Direct & Raymond James

TAKE A BREATH

There are many ways to compare companies, sectors and investment styles. EotM believes that price-to-earnings ratio and dividend yield can be instructive in further discerning how growth and value strategies have performed.

It is evident from Table 2, that companies with the highest price-to-earnings ratio (Quintile 1) generated the greatest return. This should come as little surprise given the trends outlined above.

S&P 500 Attribution (Jan. '17 – Dec. '17)		
Price To Earning Ratio		Return %
Low - High	Quintile 1	26.20
	Quintile 2	21.23
	Quintile 3	25.47
	Quintile 4	20.62
	Quintile 5	22.62
Total		21.84
Dividend Yield		Return %
Low - High	Quintile 1	7.84
	Quintile 2	18.16
	Quintile 3	28.53
	Quintile 4	23.60
	Quintile 5	30.24
Total Return		21.84

What is most striking about the data is the extent of the performance disparity between the returns of the lowest dividend-yielding stocks and the highest. EotM believes that astute contrarian investors will take notice of this disparity and attempt to identify companies that are misunderstood and likely to have a catalyst. The catalyst could come in the form of successful idea generation: the development of a new product/product line, or an external change to the business environment.

RENEWED SPIRITS

The signing of the Tax Cuts and Jobs Act in late December 2017 could serve as an external catalyst that changes the landscape for value-oriented companies. Nanette Abuhoff Jacobson, Managing Director and Multi-Asset Strategist at Wellington Management Company LLP, wrote a research piece highlighting the possible benefits of the tax bill. She noted three key benefits from the bill:

- Lowering the corporate tax rate from 35% to 21%
- Allowing five years of 100% upfront expensing of capital investments
- Providing a one-time repatriation of foreign-business income at 15.5% and moving the U.S. to a territorial system that allows business revenue and

profits to be taxed in the country in which they are earned

The reduction in the corporate tax rate is more likely to benefit smaller- and medium-sized value-oriented companies as more of their business is U.S.-based. Additionally, the potential benefits to the change in the expensing of capital investments may help value-oriented sectors, such as industrials and materials, as many of the projects they undertake can be very capital intensive. EotM does not yet know how some of these themes will play out over the coming months, but the new environment could improve the returns generated by value-oriented strategies going forward.

SIDE NOTE

The 2018 Winter Olympics begins on February 9th and will include events such as figure skating, skiing, and hockey. While we all likely have our favorite events, there are many other winter sports that are not currently Olympic events. This includes dog sled racing, ski-joring, and the winter pentathlon. Each of these had been either an Olympic or exhibition event in the past, but did not have a long-term catalyst to keep them in the games.

Views expressed are not necessarily those of Raymond James & Associates and are subject to change without notice. Information provided is general in nature, and is not a complete statement of all information necessary for making an investment decision. No investment strategy can guarantee success. Prior to making an investment decision, please consult with your financial advisor about your individual situation. There is no assurance any of the trends mentioned will continue or forecasts will occur. Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The Russell 1000 Index measures the large-cap segment of the U.S. equity universe representing approximately 92% of the U.S. market. The index is constructed to provide a comprehensive and unbiased barometer for the large-cap segment and is completely reconstituted annually to ensure new and growing equities are reflected. The index includes the largest 1000 securities in the Russell 3000. The Russell 1000 Growth Index measures a segment of the Russell 1000 Index with a greater-than-average growth orientation. Companies in this index have higher price-to-book and price-earnings ratios, lower dividend yields and higher forecasted growth values. Russell Midcap Value Index is an unmanaged index that measures the performance of those Russell Midcap companies with lower price-to-book ratios and lower forecasted growth values. Russell Midcap Index is a measures the performance of the 800 smallest companies in the Russell 1000 Index. Russell Midcap Growth Index is an unmanaged index that measures the performance of those Russell Midcap companies with higher price-to-book ratios and higher forecasted growth values. The Russell 2000 Value Index measures the performance of those Russell 2000 companies with lower price to book ratios and lower forecasted growth values. The Russell 2000 index is an unmanaged index of small cap securities which generally involve greater risks. The Russell 2000 Growth Index measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. The S&P 500 is an unmanaged index of 500 widely held stocks. It is not possible to invest directly in an index. Any investor who attempts to mimic the performance of an index would incur fees and expenses which would reduce returns.

RAYMOND JAMES®

INTERNATIONAL HEADQUARTERS: THE RAYMOND JAMES FINANCIAL CENTER
880 CARILLON PARKWAY // ST. PETERSBURG, FL 33716

© 2018 Raymond James & Associates, Inc., member New York Stock Exchange/SIPC.
Raymond James® is a registered trademark of Raymond James Financial, Inc. 18-MFRM-0241 JPR 1/18