The Big Read Investments

Coronavirus crisis: does value investing still make sense?

The strategy that once worked for Keynes and Buffett has performed badly. The pandemic has compounded the pain

Robin Wigglesworth in Oslo 13 HOURS AGO

When Joel Greenblatt went to Wharton Business School in the late 1970s, the theory of "efficient markets" was in full bloom, approaching the point of becoming dogma among the financial cognoscenti. To the young student, it all felt bogus.

Mr Greenblatt had already developed a taste for calculated gambles at the dog racing tracks. Reading the wildly fluctuating stock prices listed in newspapers also made him deeply sceptical of the supposed rationality of markets. One day he stumbled over a Fortune article on stockpicking, and everything suddenly fell into place.

"A lightbulb went off. It just made sense to me that prices aren't necessarily correct," recalls Mr Greenblatt, whose hedge fund Gotham Capital clocked up one of the industry's greatest ever winning streaks until it was closed to outside investors in 1994. "Buying cheap stocks is great, but buying good companies cheaply is even better. That's a potent combination."

The article became his gateway drug into a school of money management known as "value investing", which consists of trying to identify good, solid businesses that are trading below their fair value. The piece was written by Benjamin Graham, a financier who in the 1930s first articulated the core principles of value investing and turned it into a phenomenon.

One of Graham's protégés was a young money manager called Warren Buffett, who brought the value investing gospel to the masses. But he isn't the only one to play a role in popularising the approach. Since 1996, Mr Greenblatt has taught the same value investing course started by Graham at Columbia Business School nearly a century ago, inculcating generations of aspiring stock jocks with its core principles.

Financier Benjamin Graham's theories about value investing, articulated in the 1930s, influenced generations of investors © Henry Griffin/AP

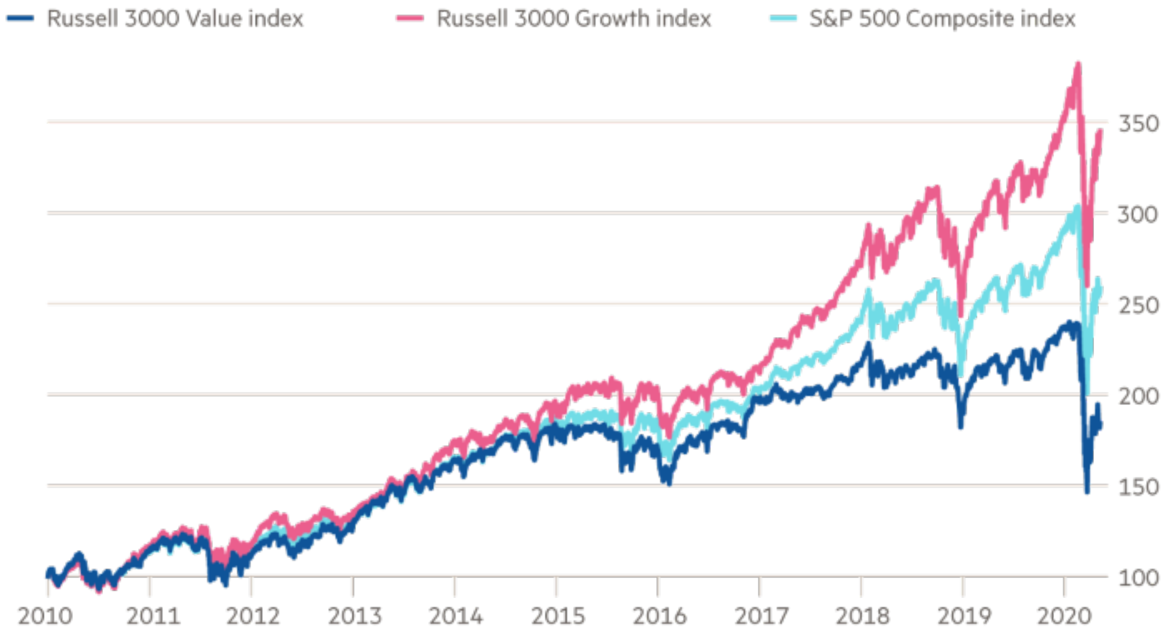
Mr Greenblatt compares value investing to carefully examining the merits of a house purchase by looking at the foundation, construction quality, rental yields, potential improvements and price comparisons on the street, neighbourhood or other cities.

"You'd look funny at people who just bought the houses that have gone up the most in price," he points out. "All investing is value investing, the rest is speculation."

However, the faith of many disciples has been sorely tested over the past decade. What constitutes a value stock can be defined in myriad ways, but by almost any measure the approach has suffered an awful stretch of performance since the 2008 financial crisis.

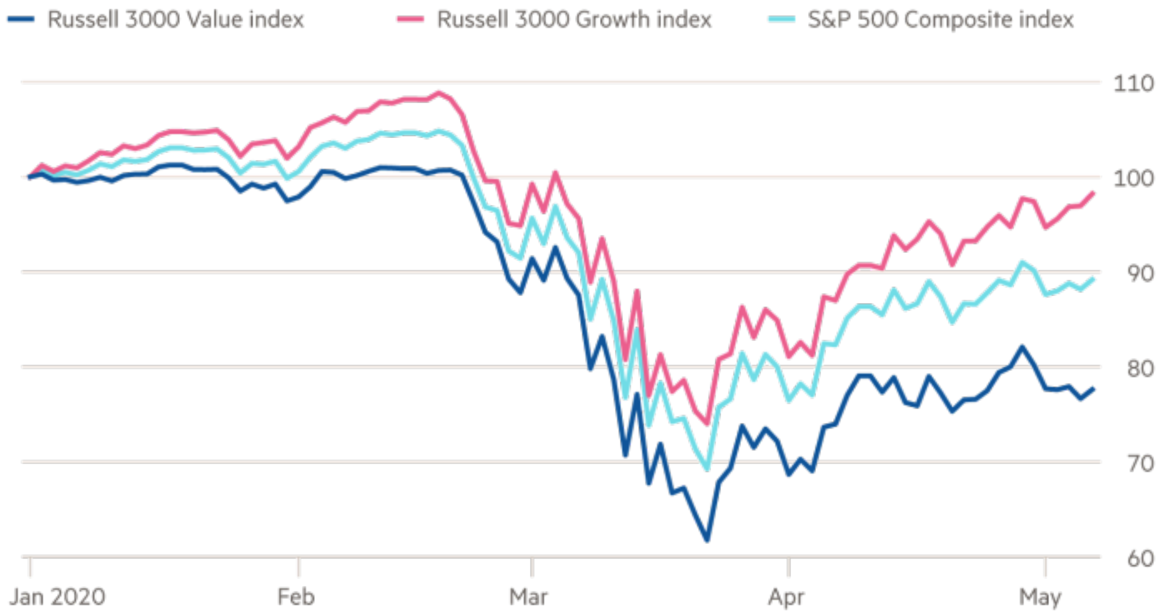
Value stocks have lagged behind broader markets for a decade ...

Indices, rebased



... and have done particularly badly in the coronavirus crash

Indices, rebased



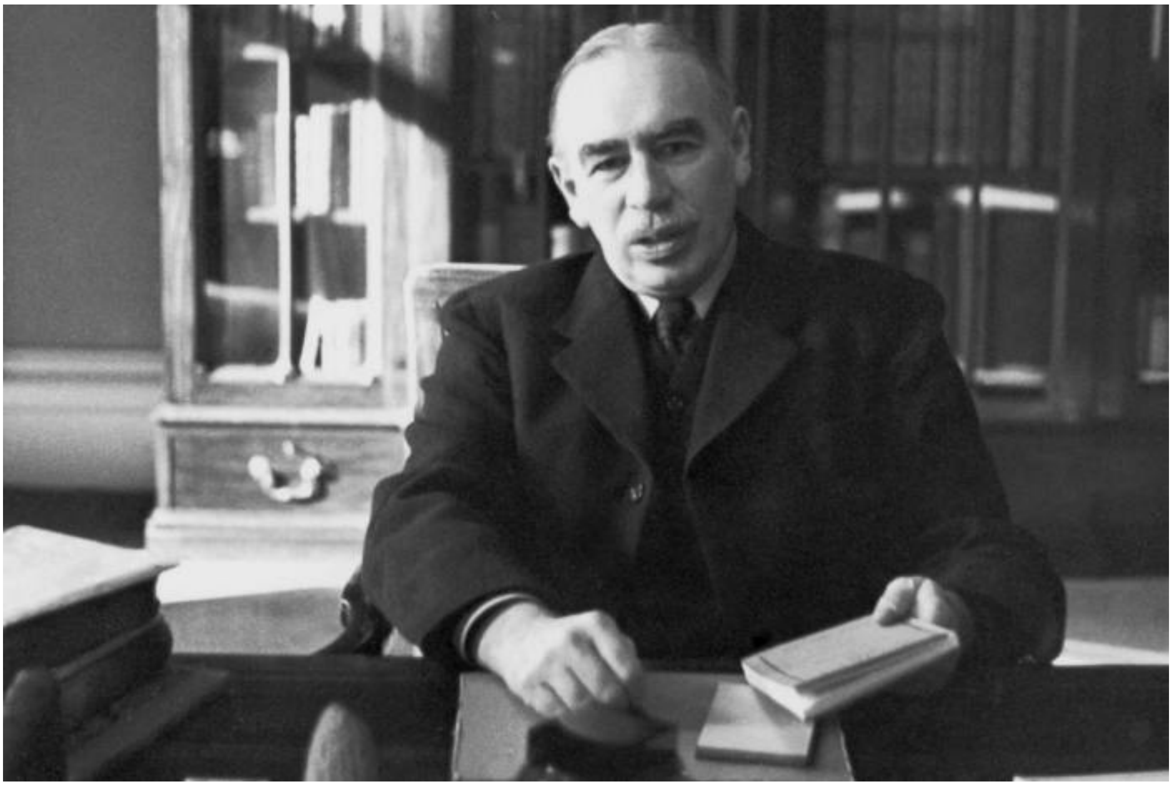
Source: Refinitiv

Many proponents had predicted value investing would regain its lustre once a new bear market beckoned and inevitably hammered the glamorous but pricey technology stocks that dominated the post-2008 bull run. This would make dowdier, cheaper companies more attractive, value investors hoped.

Instead, value stocks have been pummelled even more than the broader market in the coronavirus-triggered sell-off, agonising supporters of the investment strategy.

“One more big down leg and I’m dousing my internal organs in Lysol,” Clifford Asness, a hedge fund manager, said in April.

Value investing has gone through several bouts of existential angst over the past century, and always comes back strongly. But its poor performance during the coronavirus crisis has only added to the crisis of confidence. The strength and length of the recent woes raises some thorny questions. Why has value lost its mojo and is it gone forever?



When John Maynard Keynes managed the endowment of Cambridge university’s King’s College he beat the UK stock market by an average of 8 percentage points a year © Tim Gidal/Picture Post/Hulton Archive/Getty

Search for ‘American magic’

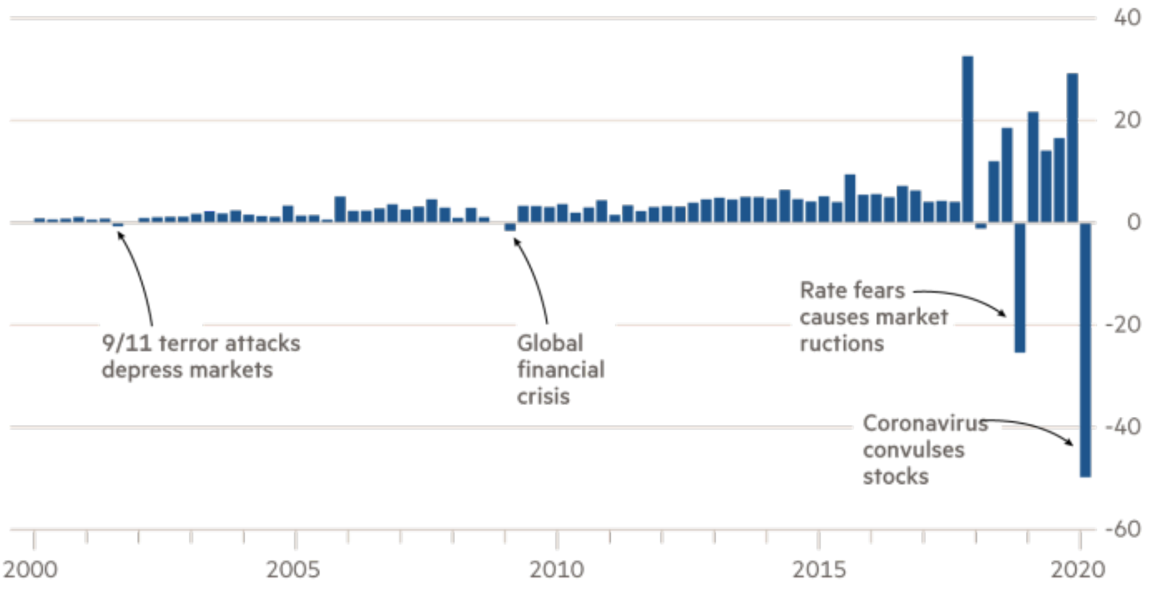
Berkshire Hathaway’s annual meeting is usually a party. Every year, thousands of fans have flocked to Omaha to lap up the wisdom of Mr Buffett and his partner Charlie Munger, the acerbic, terse sidekick to the conglomerate’s avuncular, loquacious chairman. Last weekend’s gathering was a more downbeat affair.

A shaggy-haired Mr Buffett sat alone on stage without his usual companion, who was stranded in California. Instead of Mr Munger, Greg Abel, another lieutenant, sat at a table some distance away from Berkshire's chairman. Rather than the 40,000 people that normally fill the cavernous CHI Health Center for the occasion, he faced nothing but a bunch of video cameras. It was an eerie example of just how much the coronavirus crisis has altered the world, but the "Oracle of Omaha" tried to lift spirits.

"I was convinced of this in World War II. I was convinced of it during the Cuban missile crisis, 9/11, the financial crisis, that nothing can basically stop America," he said. "The American magic has always prevailed, and it will do so again."

Berkshire Hathaway swings to $49.7bn loss in the first quarter

Quarterly profit or loss ($bn)



Source: Bloomberg
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Berkshire's results, however, underscored the scale of the US economy's woes. The conglomerate — originally a textile manufacturer before Mr Buffett turned it into a vehicle for his wide-ranging investments — slumped to a loss of nearly $50bn in the first three months of the year, as a slight increase in operating profits was swamped by massive hits on its portfolio of stocks.

A part of those losses will already have been reversed by the recent stock market rally triggered by an extraordinary bout of central bank stimulus, and Mr Buffett's approach has over the decades evolved significantly from his core roots in value investing. Nonetheless, the worst results in Berkshire's history underscore just how challenging the environment has been for this approach to picking stocks. After a long golden run that burnished Mr Buffett's reputation as the greatest investor in history, Berkshire's stock has now marginally underperformed the S&P 500 over the past year, five years and 10 years.

But the Nebraskan is not alone. The Russell 3000 Value index — the broadest measure of value stocks in the US — is down more than 20 per cent so far this year, and over the past decade it has only climbed 80 per cent. In contrast, the S&P 500 index is down 9 per cent in 2020, and has returned over 150 per cent over the past 10 years. Racier "growth" stocks of faster-expanding companies have returned over 240 per cent over the same period.

Ben Inker of value-centric investment house GMO describes the experience as like being slowly but repeatedly bashed in the head. "It's less extreme than in the late 1990s, when every day felt like being hit with a bat," he says of the dotcom bubble period when value investors suffered. "But this has been a slow drip of pain over a long time. It's less memorable, but in aggregate the pain has been fairly similar."

Joel Greenblatt of Gotham Asset Management: 'Buying cheap stocks is great, but buying good companies cheaply is even better' © Mike Segar/Reuters

Underrated stocks

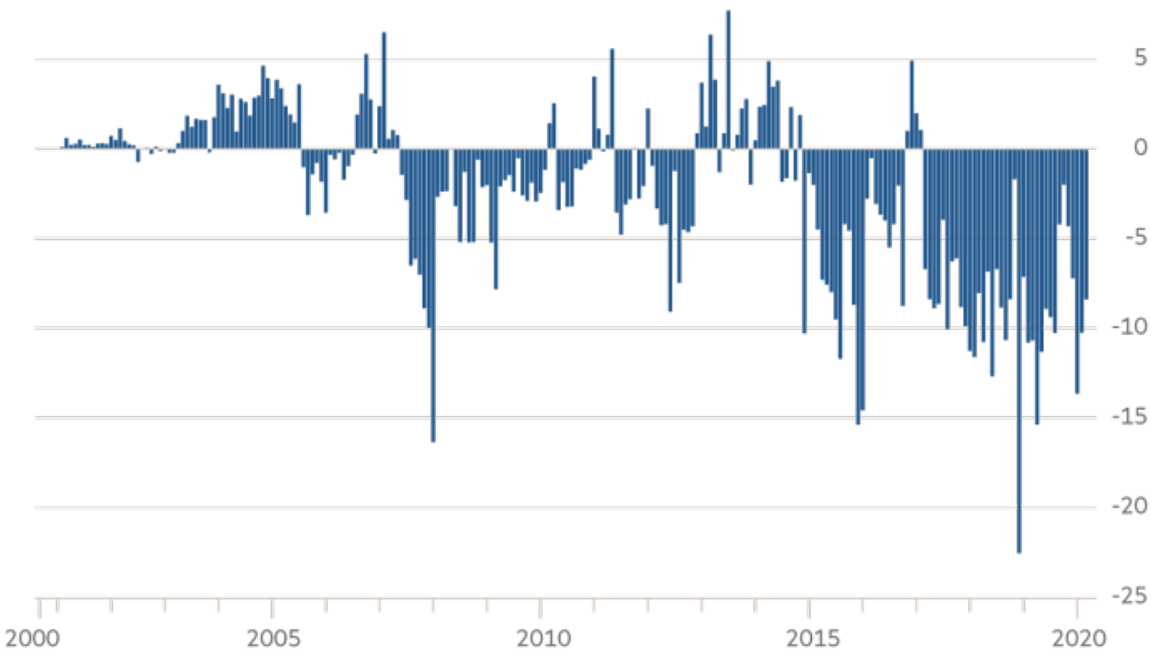
Value investing has a long and rich history, which even predates the formal concept. One of the first successful value investors was arguably the economist John Maynard Keynes. Between 1921 and 1946 he managed the endowment of Cambridge university's King's College, and beat the UK stock market by an average of 8 percentage points a year over that period.

In a 1938 internal memorandum to his investment committee, Keynes attributed his success to the "careful selection of a few investments" according to their "intrinsic value" — a nod to a seminal book on investing published a few years earlier by Graham and his partner David Dodd, called *Security Analysis*. This tome — along with the subsequent *The Intelligent Investor*, which Mr Buffett has called "the best book about investing ever written" — are the gospel for value investors to this day.

There are ways to define a value stock, but it is most simply defined as one that is trading at a low price relative to the value of a company's assets, the strength of its earnings or steadiness of its cash flows. They are often unfairly undervalued because they are in unfashionable industries and growing at a steadier clip than more glamorous stocks, which — the theory goes — irrational investors overpay for in the hope of supercharged returns.

Investors have been dumping value-focused equity funds

Net flows ($bn)



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Value stocks can go through long fallow periods, most notably in the 1960s — when investors fell in love with the fast-growing, modern companies like Xerox, IBM and Eastman Kodak, dubbed the "Nifty Fifty" — and in the late 1990s dotcom boom. But each time, they have roared back and rewarded investors that kept the faith.

"The one lesson we've learnt over the decades is that one should never give up on value investing. It's been declared dead before," says Bob Wyckoff, a managing director of money manager Tweedy Browne. "You go through some uncomfortably long periods where it is not working. But this is almost a precondition for value to work."

The belief that periodic bouts of suffering are not only unavoidable but in fact necessary for value to work is entrenched among its adherents. It is therefore a field that tends to attract more than its fair share of iconoclastic contrarians, says Chris Davis of Davis Funds, a third-generation value investor after following in the footsteps of his father Shelby MC Davis and grandfather Shelby Cullom Davis.

"If you look at the characteristics of value investors they don't have a lot in common," he says. "But they all tend to be individualistic in that they aren't generally the type who have played team sports. They weren't often president of their sororities or fraternities. And you don't succeed without a fairly high willingness to appear wrong."

Warren Buffett at Berkshire Hathaway's typically raucous annual meeting in Omaha in 2004. This year, a shaggy-haired Mr Buffett sat alone on stage © Chris Machian/ Bloomberg News

But why have they now been so wrong for so long? Most value investors attribute the length of the underperformance to a mix of the changing investment environment and shifts in the fabric of the economy.

The ascent of more systematic, “quantitative” investing over the past decade — whether a simple exchange traded fund that just buys cheap stocks, or more sophisticated, algorithmic hedge funds — has weighed on performance by warping normal market dynamics, according to Matthew McLennan of First Eagle Investment Management. This is particularly the case for the financial sector, which generally makes more money when rates are higher.

The usual price discount enjoyed by value stocks was also unusually small at the end of the financial crisis, setting them up for a poorer performance, according to Mr Inker. Some industries, especially technology, are also becoming oligopolies that ensure extraordinary profit margins and continued growth. Moreover, traditional value measures — such as price-to-book value — are becoming obsolete, he points out. The intellectual property, brands and often dominant market positioning of many of the new technology companies do not show up on a corporate balance sheet in the same way as hard, tangible assets.

The recent stock market rebound has been powered primarily by big US technology companies, such as Apple, not value stocks, which tend to be in economically sensitive industries © Drew Angerer/Getty

“Accounting has not kept up with how companies actually use their cash,” he says. “If a company spends a lot of money building factories it affects the book value. But if you spend that on intellectual property it doesn’t show up the same way.”

As a result, GMO and many value-oriented investors have had to adapt their approach, and focus more on alternative metrics and more intangible aspects of its operations. "We want to buy stocks we think are undervalued, but we no longer care whether it looks like a traditional value stock," Mr Inker says.

Mr McLennan points out that while the core principles won't change, value investing has always evolved with the times. "It's not a cult-like commitment to buying the cheapest decile [of stocks]. We invest business-by-business," he says. "I don't know what the alternative is to buying businesses you like, at prices you like."

Value investing also suffered in the dotcom boom of the late 1990s, only to roar back and reward investors who kept faith © Frederic J. Brown/AFP/Getty

Bargain hunt

Can value investing stage a comeback, as it did when the dotcom bubble burst in the early 2000s, or the "Nifty Fifty" failed to justify investor optimism and fell to earth in the 1970s?

There has clearly been a shift in the corporate landscape over the past few decades that could be neutering its historical power as an investing approach. It is telling that the recent stock market rebound has been powered primarily by big US technology companies, despite value investors having confidently predicted for a long time that their approach would shine in the next downturn. Value stocks tend to be in more economically-sensitive industries, and given the likelihood of the biggest global recession since the Depression, their outlook is exceptionally murky

Even after adjusting for all the most common theories for why value investing has struggled, value stocks are now historically cheap, according to an AQR paper published last week. “If value investing was like driving my four kids on a long car ride, we’d be very deep into the ‘are we there yet?’ stage of the ride, and value investors are justifiably in a world of pain,” Mr Asness wrote. However, the odds are now “rather dramatically” on the side of value.

Redemption could be at hand. There has in recent days been a cautious renaissance for value stocks, indicating that coronavirus may yet upend the market trends of the past decade. This stockpicking approach often does well as economies exit a recession and investors hunt for bargains.

Devotees of value investing certainly remain unshakeable in their faith that past patterns will eventually reassert themselves. Citing a common saying among adherents, Mr Wyckoff argues that “asking whether value is still relevant is like asking whether Shakespeare is still relevant. It’s all about human nature.”

Mr Greenblatt, who founded Gotham Asset Management in 2008, says that his students will occasionally quiz him on whether value investing is dead, arguing that computers can systematically take advantage of undervaluation far more efficiently than any human stockpicker can. He tells them that human irrationality remains constant, which will always lead to opportunities for those willing to go against the crowd.

"If you have a disciplined strategy to value companies, and buy companies when they're below fair value you will still do well," he says. "The market throws us pitches all the time, as there are so many behavioural biases . . . You can watch 20 pitches go by, but you only need to try to hit a few of them."