

Quarterly Market Outlook & Strategy

Value Investing: Dead or Dormant?

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Executive Summary

- During the current bull market, the performance of time-honored investment strategies – namely, tilting portfolios towards value, small cap, and high profitability stocks – has fallen flat, especially in the United States. In the US market, these style premiums have shrunk relative to historical averages, while returns to the value factor have been especially poor.
- It is, perhaps, obvious that for these premiums to “work,” small and/or inexpensive stocks need an opportunity to migrate out of their respective market categories; i.e., for those firms to experience improvements in their business prospects that justify increases in valuation. Eventually, successful value stocks become growth stocks, and successful small cap stocks become large cap stocks.
- Unfortunately, there’s been a loss of market dynamism to afford such opportunities. Value stocks are languishing, and small firms aren’t going public. Meanwhile, a handful of large cap growth stocks enjoy a significant and persistent performance advantage.
- Some of this can be attributed to classic market momentum and froth. Make no mistake, this is a humdinger of a stock market bubble! We see a more fundamental problem in the trend toward industry concentration and the corresponding reduction in antitrust enforcement, which has reduced competition and favored monopoly power. 75% of US industries have become more concentrated over the past 20 years, with the largest incumbents enjoying the highest profits, stock market returns, and valuations.
- We now see deep competitive “moats” around large businesses, especially in the tech sector. As investors seek to get a piece of the action, growth stocks have been driven to their most expensive levels (in absolute terms and vis-à-vis value stocks) since the peak of the Dotcom Bubble. All the while, there’s been a dramatic shrinkage in the public markets, as potential rivals are absorbed by large competitors, and small companies are nurtured by venture capital and private equity firms.
- The persistence of these trends has seemed inexorable and interminable. As value investors, we’ve felt our fair share of the pain. That said, we see no value in fighting the last war. Corporate earnings are stagnating because workers’ (and hence consumers’) real incomes have been curtailed by monopolistic business practices. There’s a limit to how high stocks can rise without validation from earnings. Also, the political winds are shifting with respect to antitrust regulation. We believe that we’re approaching a turning point in terms of the concentration of corporate power, and the valuations of stocks that have benefitted most from the status quo.

Introduction

Buy low, sell high is a time-honored maxim for aspiring value investors. To see why, consider the basic economics of stock ownership: in exchange for their investment, shareholders expect an eventual return of the issuing company's earnings in the form of dividends. If the market value of the company (i.e., the price paid for the stock) is greater than the *sum of future distributions to shareholders*, that's a losing proposition. *Value investors*, trained by the legendary Benjamin Graham, pursue stocks whose market value is below what they expect to receive in future payments.

Another investing basic rests on the fact that growth is usually faster off of a low base. Or, in economic parlance, that there are diminishing marginal returns to size. Consider the impossibility of a quick doubling in WalMart's revenues, as contrasted with the company's growth in its early days. Historically, large firms had to run fast just to stay in the same place, while smaller companies offered the potential for higher rates of product adoption, earnings growth, and stock appreciation – *if* they executed successfully.

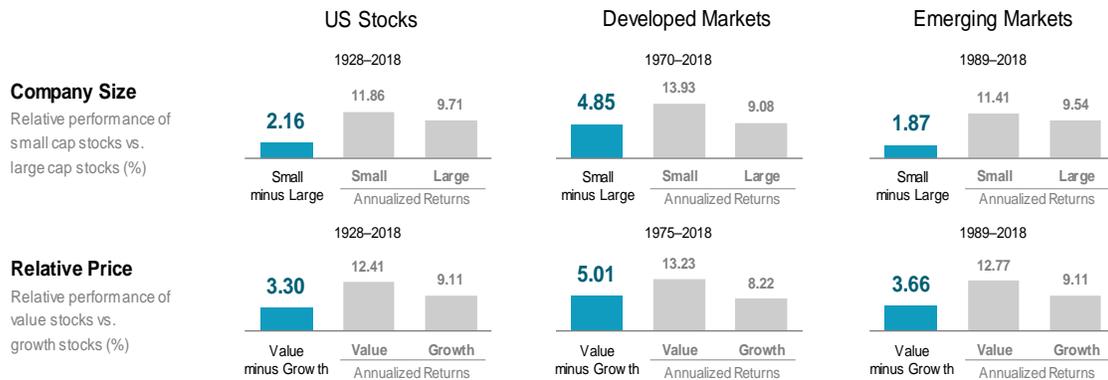
These foundational concepts have, historically, been manifested in relative share prices. Stocks with low valuations and small market capitalizations have outperformed the broader market over the long term. The rationale for these *style premiums* has evolved over time, from purely empirical to economically grounded. Lately, it's become apparent that their existence is dependent on market dynamism, which allows firms to move within and between investment categories. Unfortunately, in recent years incumbents have enjoyed increased market dominance, to the detriment of competitors whose transformation delivered the value and size premiums.

In this paper, we'll further describe the history of these style premiums, the conditions that led to their emergence, and the recent factors that have contributed to their decline. It is only in cultivating a deep understanding of these things that we can answer the question: *Is there value in value investing, or is it a trap?*

What are the Value and Size Premiums?

Research shows that the share prices of companies with low valuations (e.g., low price-to-earnings, price-to-book, or price-to-revenue ratios) and small firm size (e.g., low market capitalization) have historically outperformed the market averages. These observations were widely publicized by professors Eugene Fama and Kenneth French in a [1992 paper](#) setting out a *three-factor model* for describing individual stock returns. This research helped to establish these *value* and *size* premiums as core determinants of individual stock performance and considerations in equity portfolio construction.

The work of Fama and French provided the academic underpinnings for the investment approach of Dimensional Fund Advisors (DFA). DFA’s mutual fund strategies are designed to tilt diversified equity portfolios towards small- and low-priced stocks to produce superior returns. The following charts from DFA illustrate the excess returns generated by these style premiums, over long horizons, and across regions:



Source: DFA

The notion of excess returns to value should sound familiar to Paladin clients, and rests on the assumption that future returns are, over the long run, inversely related to purchase price. That’s been true not only at the security level, but also at the asset class level, and is a foundational principle of Paladin’s investment approach. The size premium can be similarly conceived at the macro level, as nascent sectors, strategies and countries offer higher return potential. This is reflected in Paladin’s historical tilt toward emerging markets and our search for non-traditional investments such as our low-volatility income equity and covered call strategies.

Why are there Value and Size Premiums?

Fama and French may have harbored economic intuitions about *why* the size and value premiums exist, but never ventured a guess in their research. These were empirically-observed and consistent drivers of stock performance, which was enough for them.

In addition to the three-factor model, Eugene Fama authored the *efficient market hypothesis* (EMH), which states that market prices reflect all available information. This belief limits the scope for exploitable market anomalies, and sits somewhat awkwardly alongside Fama’s observation that inexpensive and small-cap stocks generally outperform the market. The inconsistency was initially reconciled by the assumption that these premiums represent compensation for investors’ bearing additional risk—which seemed reasonable enough, since value and small cap stocks tend to be more volatile than growth and large cap stocks (perhaps due to increased business risk). At least, this is how DFA explained these style premiums to prospective investors.

That was, until a [2015 elaboration](#) of the original Fama/French research determined there are in fact *five factors* that describe stock performance: the overall market (beta), value, size, profitability, and investment. These *profitability* and *investment* factors imply that firms that generate more cash, and return more of that cash to shareholders, (rather than reinvesting in the business) tend to deliver higher market returns. The notion of “higher compensation for greater risk” no longer holds up, since firms with a surfeit of cash tend to be *less* risky, not more. DFA quietly turned to an alternative explanation (the *discounted cash flow model*) as justification for these newly-identified premiums. Now, inexpensive stocks that also deliver relatively high cash flows should outperform over time. This statement is virtually indistinguishable from the active manager’s quest to find companies that trade at a *discount to intrinsic value* based on their assessment of future earnings potential. DFA still honors EMH given Director Eugene Fama’s pioneering work...but mostly in the breach. Actions speak louder than words.

The *size premium* is a trickier case; there is no clear financial or economic rationale for the empirical observation of small cap’s historical outperformance. That said, it stands to reason that smaller companies, early in their life cycles, offer the greatest potential for business expansion (and prospective returns). Buying Apple as a small company was far more profitable than holding it as a large cap stock. The trick, of course, is to identify future “Apples” when they’re young businesses—or to be sufficiently diversified as to ensure that one’s portfolio captures these rare opportunities.

In his 2018 paper [Do Stocks Outperform Treasury Bills?](#), Hendrik Bessembinder showed that among all US stocks since 1926, the best-performing 4% of listed companies explains the *entire* excess return over Treasury bills. Yes, you read that right. Moreover, an equal-weighted blend of all US stocks outperformed a market-weighted portfolio over the same period, indicating relatively high returns from smaller companies.

Though Bessembinder never drew this conclusion explicitly, his research suggests that the value and small cap premiums reflect the benefits of owning those eventual, rare winners early in their life cycles. This speaks to the importance of diversification or—far more challenging—outstanding stock selection to harvest these extraordinary investment opportunities. DFA’s strategies embody precisely these goals – broad diversification, a value orientation, and a tilt towards smaller companies. That’s why we invest our clients’ money with them.

Unfortunately, during the current bull market, the performance of these style premiums has fallen flat across regions, and especially within the United States; the returns to the value factor have been especially poor. In other words, stocks with low valuations have significantly *underperformed* those with high prices, while small-cap and high-profitability stocks have failed to differentiate themselves from others in the market.

10-year annualized premiums (2009–2018): US, Developed ex US, and Emerging Markets

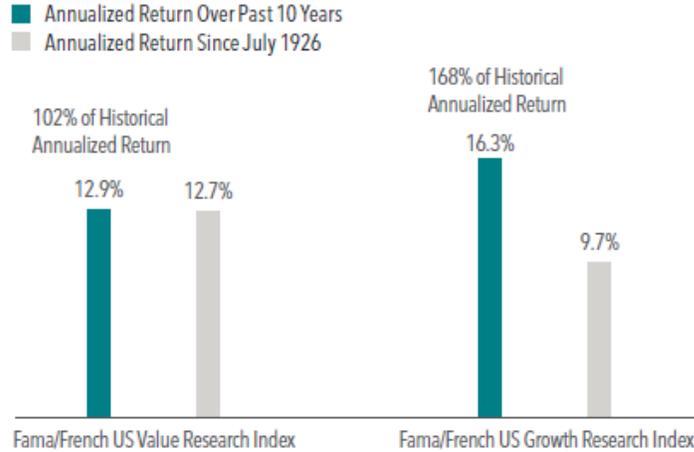


Source: DFA

The underperformance of the value factor has garnered the most attention although, in our view, value and profitability are two sides of the same *value investing* coin. Low valuations are not attractive if they aren't anchored by solid fundamentals (i.e., profits). It's important to note that DFA's profitability factor uses *current earnings* as a proxy for *future profitability*. This approach does not (nor does it claim to) predict future cash flows with great accuracy – no method does. Intrinsic value is inherently uncertain, as is the practice of distinguishing *value stocks* (the low-priced good ones) from *value traps* (the low-priced, but soon-to-be-obsolete ones). The factor approach simply argues that stocks that trade at low valuations vis-à-vis *current* cash flow metrics will outperform *on average* over time.

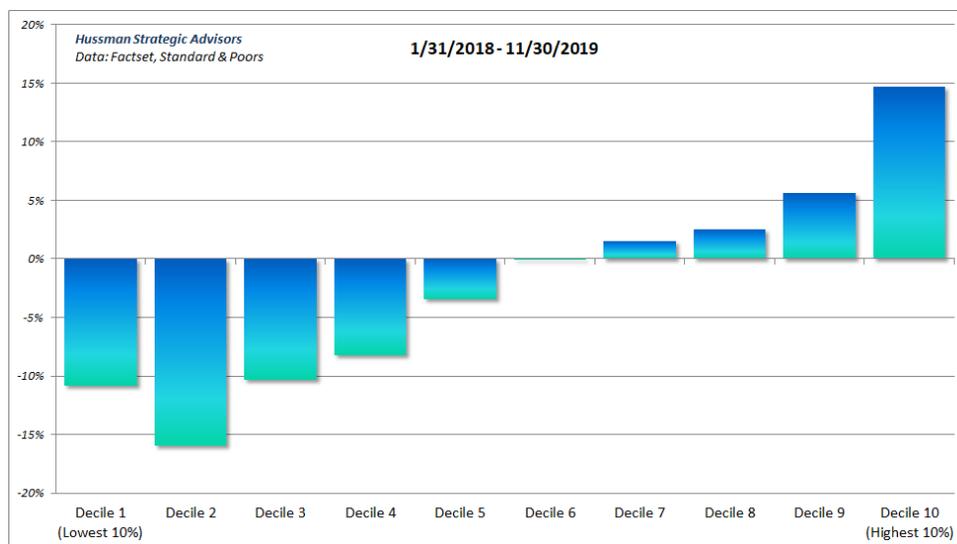
DFA has some useful context for investors in this regard. Over the past 10 years (through June 2019), value stocks have actually performed on par with their historic average. The shortfall in the value premium (which measures the performance of value *relative* to growth) has resulted from the extraordinary performance of *growth* (i.e., high-priced) stocks.

These firms may be high-priced for any number of reasons: rapid revenue growth, perceived earnings stability in recessionary environments, brand/market share dominance, or some combination thereof. Growth and value are not static labels – companies can cross these categories as their business outlooks and valuations (price/earnings, price/book, or price/revenue ratios) evolve over time.



Source: DFA

In keeping with its label, the classic growth stock experiences rapid gains in revenue or earnings. Enticed by the attractive prospects of such businesses, investors pay up for these stocks, leading to higher valuations. These firms typically offer exciting (“disruptive” is the term of our era) new products or business models that are broadly adopted – Facebook, Amazon, Netflix, Microsoft, Apple, and Google are the iconic examples. This group of stocks has delivered a 10-year average return of 720%, while the broader market rose 246%.¹ The advance of high-priced stocks has grown even more disproportionate in recent years. The following chart buckets the 2-year returns of S&P 500 constituents according to price/revenue decile. The upshot is that *the most expensive segments of the market have accounted for all of the S&P 500’s recent gains.*



Source: Hussman Strategic Advisors, [One Tier and Rubble Down Below](#), January 2020.

¹ Arnott, Rob; Ko, Amie; Treussard, Jonathan (2019). [Standing Alone Against the Crowd](#). Research Affiliates.

Growth and momentum investing, while not synonymous, are cousins. Momentum strategies presume that fundamentals are persistent (or at least uncertain), and that investors exhibit *herding behavior* driven by past performance: they buy what's going up and sell what's going down. Benjamin Graham acknowledged that while markets are *weighing machines* in the long run (i.e., driven by fundamentals) they are *voting machines* in the short run (driven by sentiment). Momentum stocks can earn outsized returns when market trends are strong and persistent, but are prone to periods of instability when there's a change in fundamentals, which (eventually) exert a gravitational pull on share prices.

While momentum investing ignores valuation as a signal, growth investing takes it with a large grain of salt. Who cares about a high price-earnings ratio when a company is increasing revenue by 30%? These stocks are expected to grow into their high valuations over time, a thesis that rests heavily on assumptions about future market conditions. Growth stocks are vulnerable to changes in sentiment, the business cycle, government policy, and/or shifting competitive dynamics that call into question the rosy assumptions that buttress high stock prices. When the growth and momentum categories overlap substantially (when stocks with positive momentum are disproportionately represented by growth companies) the divergences between prices and fundamentals become particularly pronounced—increasing the vulnerability of the whole market.

For value investors, the challenge is not knowing when (or whether) such shifts might occur. In a recent paper, Grantham, Mayo and Van Otterloo (GMO) attributed the recent underperformance of the value premium to a lack of migration between the value and growth categories for US-listed stocks:

Value stocks typically benefit when companies with clouds hanging over them improve operations or experience a cyclical recovery, strengthen their fundamentals, and see their multiples expand. As valuations rise, some value stocks graduate from the value to the growth universe. Value investors benefit by selling the more expensive stocks as they leave the group while simultaneously picking up the growth companies that have recently disappointed and thus trade at cheaper levels. That turnover, or rebalancing effect, has been a big plus for value over the years, contributing 2.2% of value's return premium. Over the past decade, this rate of shift has slowed to 1.3%. This reduction in the dynamism of these groups has been particularly striking within the expensive half of the market, which is a good proxy for growth companies, since investors tend to pay higher multiples for faster growth. Of late, expensive stocks have remained expensive for longer than usual. Typically, high growth companies are unable to sustain excessive growth rates for long periods. In the last decade, however, the growth universe has been more retentive than in the past. A handful of companies, including Facebook, Alphabet, and Amazon, have managed to grow at high rates for long periods.²

² Friedman, Rick (2019). *Value Investing – Bruised by 1000 Cuts*. Grantham, Mayo, & Van Otterloo.

To recap: stocks with low valuations, small market capitalizations, and/or high cash flows have historically outperformed their industry and sector counterparts. The rationale for the existence of these return premiums evolved slowly over time, from purely empirical to economically-grounded, and aligns with Paladin's long-held value investing philosophy. Lately, it's become apparent that the existence of these premiums depends on market dynamism that allows for healthy competition, the emergence of potential rivals, and the eventual realignment of prices and fundamentals. Instead, the recent market environment has been characterized by an unusually large and persistent advantage for a concentrated set of large-capitalization stocks, to the detriment of smaller and less-expensive companies. Momentum investing is certainly contributing to this state of affairs, but it isn't the whole story.

Easy Money Meets Unchecked Monopoly

Monopolies defeat competition and reduce industry dynamism by pricing other firms out of business and/or absorbing new technologies through buyouts. Incumbents use their advantages of scale, technology, and/or cheap funding to discourage the entry and survival of rivals, giving them control over the prices paid for inputs and/or those charged to consumers. As investors recognized these advantages, the share prices of monopolists were driven higher to reflect the potential for persistently outsized profits.

In a [2017 study](#), researchers Gustavo Grullon, Yelena Larkin and Roni Michaely found that 75% of US industries have experienced an increase in concentration over the past two decades, as measured by revenue share of the largest firms. Moreover, industries with the greatest increase in concentration enjoyed market-beating profits and stock returns. The researchers cite lax antitrust enforcement and technological barriers to entry as key drivers of this phenomenon:

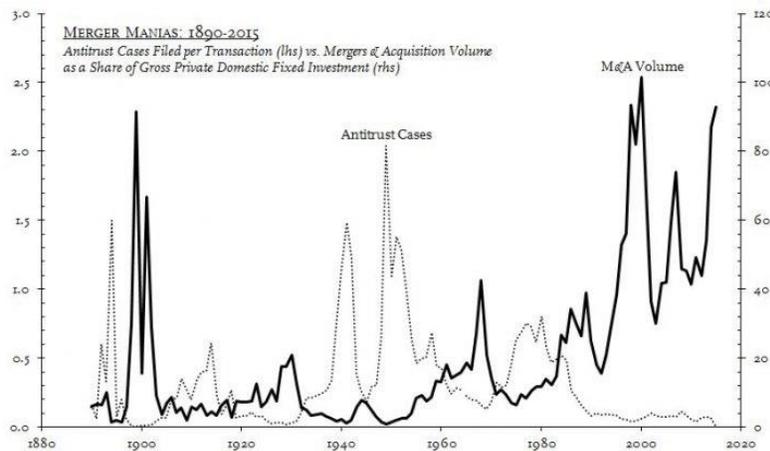
We find that the use of Section 2 of the Sherman Act, which allows antitrust agencies to prevent increase in market power of existing dominant firms, has declined from an average of 15.7 cases per year over the period 1970-1999 to less than 3 over the period 2000-2014. Surprisingly, no cases were filed in 2014 even though aggregate concentration levels reached record levels during that year.

Jonathan Tepper documents the same trends in [The Myth of Capitalism](#), and reminds us that competition has been essential to US innovation, productivity, and living standards. In his blog [BIG](#), Matt Stoller identifies pervasive abuses of monopoly power, the practical manifestations of industry concentration. We also warned about these trends in our 2017 letter [A Requiem for Growth](#) which relates industry concentration to slowing economic growth, as companies' focus shifted from growing the pie to fighting over it.

The consequences for wage earners and public market investors ring true today:

The trend toward concentration has important implications for investors as well as citizens. [Recent research](#) has shown that larger corporations pay a smaller share of their profits to their employees, and also devote less to capital investment than do small firms—which will limit productivity gains and future wage growth. Although good for investors in the short run, it’s a terrible long-term strategy, as highlighted by [BlackRock’s Larry Fink](#). At the same time, [more workers](#) are employed by large corporations than ever before. To an increasing degree, large corporations act as monopolists in product markets, and [monopsonists](#) in labor markets, putting workers and households at a double disadvantage. Finally, increasing concentration of wealth [threatens the public capital markets](#), since companies need no longer turn to individuals in order to raise money. So much for the triumph of the small investor.

Lax regulatory enforcement implies greater opportunity for M&A, which feeds the trend of industry consolidation. The following chart illustrates the spike in M&A since the 1990s, which corresponded with a virtual disappearance of antitrust filings.³ One consequence is that businesses old and new are being snapped up by incumbents. Another is that the public stock market is shrinking, as new players are absorbed by established firms and businesses that are unable to compete are forced to shutter.



Source: Taylor Mann of Pine Capital

Variant Perception details a range of US industries that are either effective monopolies or duopolies, including cable/high speed internet, computer operating systems, social networks, online search, payment systems, waste management, beer, airplane manufacturers, online advertising, soft drinks, and ratings agencies. The full industry list is longer, and longer still when you include oligopolies—markets dominated by 3-5 players.

³ This series uses a different, broader measure of antitrust filings than the study cited above.

Variant found that a diversified portfolio of concentrated industry incumbents outperformed the S&P 500 in 12 of the past 18 years, by an average of 15% in those years; they underperformed by just 2.8% in the remaining 6. Investments in monopolies have, undeniably, paid off. The current monopoly portfolio consists of 20 names with a median market capitalization of \$41 billion, and a median price/earnings ratio of 29x.⁴ By no means do these backward-looking statistics prove that monopolies will outperform in the future, but they help to contextualize the recent performance headwinds experienced by small cap and value stocks.

As the above industry list implies, the technology sector – especially the so-called *data economy* – is at the epicenter of this trend toward industry concentration. As of September 30, 2019, the so-called FANMAG⁵ stocks had a combined market capitalization of \$4.3 trillion, nearly 14% of US stock market value. These companies have a combined valuation that is greater than the entire public market of the United Kingdom, China, France, or Germany.⁶

In [*The Age of Surveillance Capitalism*](#), Shoshana Zuboff illuminates the unprecedented asymmetries of information and power that have been created through data aggregation and interpretation, behavioral prediction and modification. Google, Facebook and Microsoft are examined most critically. The scale of these data collection efforts (and resulting earnings growth) would not have been possible in the presence of a strong regulatory apparatus. The death of antitrust in the 1970s and 1980s paved the way for the success and extraordinary profitability of vertically-integrated technology firms.

These observations about industry concentration, while an important piece of the puzzle, are an incomplete explanation of the recent disappearance of the style premiums. Consider that DFA's profitability factor has produced flat performance over the past 10 years, despite the outsized profits and market returns enjoyed by the incumbents of concentrated industries. There's more going on here.

Enter easy monetary policy and the corporate behaviors it has encouraged. A new mantra was born from this cycle's easy money and enthusiasm for "disruptive" business models: It's not about how big your bottom line is, but how big your *ideas* are. Many of current market darlings went through long stretches of unprofitability while they drove competitors out of business—and were able to do so because they enjoyed easy access to funding. The assumption was that once these businesses achieved sufficient scale and ubiquity, profits would follow. In some cases (Amazon & Netflix) that assumption proved correct. In others (Uber & Tesla) the jury is still out. WeWork applied the same logic, but failed in spectacular fashion.

⁴ Variant Perception (2017). *Oligopoly USA*.

⁵ Facebook, Amazon, Netflix, Microsoft, Apple, Google

⁶ Arnott, Rob; Ko, Amie; Treussard, Jonathan (2019). *Standing Alone Against the Crowd*. Research Affiliates.

Technology-driven network effects and long runways for entrepreneurs with big ideas are two sides of the same coin. In a world of easy money and a hands-off approach to corporate power, investors want the industry leaders—or those with a primrose path to disrupt incumbents and seize that power for themselves.

Meanwhile, the proliferation of [unicorns](#) means that startups are pushing the upper end of the small-cap threshold by the time they come to market, keeping the best opportunities away from ordinary investors. That's if they come to market at all, given the record levels of private equity and M&A activity. Large companies and/or private investors are extracting the bulk of the value from these startups, posing an existential threat to the small-cap segment of the public markets.

In sum, large-cap growth companies enjoy extraordinary business advantages in the current environment. Regulation of monopoly power is minimal, allowing for unchecked expansion, acquisition, and preservation of market share. Most monopolies are high-priced "growth" stocks, since investors lavish anticompetitive behavior with high valuations.

The emergence of the information economy is leading to an extraordinary concentration of information and power for businesses that successfully harvest and interpret that data. Easy access to cheap funding (the Fed strikes again!) and enthusiasm for entrepreneurial boldness has created long runways for aspiring tech-opolists, even when profitability is a distant hope.

These facts underscore the reduction in market dynamism that is limiting competition and preventing the normalization of share prices toward long-term fundamentals. If such dynamism is a precondition for the success of small cap and value investing, where does that leave us?

Paladin Strategy

The last decade has been among the most challenging periods for the performance of these style premiums, value in particular. But is now the time to give up? As the graphic below shows, growth stocks are as expensive vis-à-vis value as they were in 2000—the height of the DotCom bubble. Warren Buffet advised fear when other investors are greedy, and greed when others are fearful. To say that greed has swamped fear in current markets is a gross understatement – measures of sentiment and momentum are *also* on par with the 2000 mania, as Lance Roberts points out in a recent market report, [This is Nuts – Part Deux](#). Both valuations and technical indicators suggest we are in the midst of one of the most irrationally exuberant periods in stock market history. In the words of John Hussman, subsequent generations will look back on this moment, shake their heads, and say, "This is where they completely lost their minds."

Undervaluation of Value exceeds extreme levels from 2000

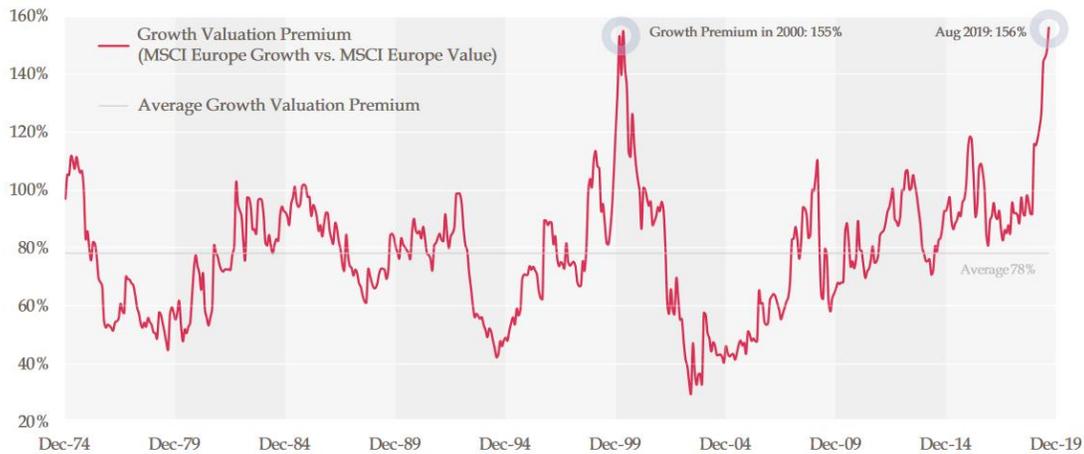


Figure 5: Average valuation premium based on PE, PC, PB and Div. Yield of MSCI Europe Value vs. MSCI Europe Growth as of 08/31/2019. Source: Thomson Reuters, StarCapital.

Source: Star Capital

The rubber band is stretched politically as well, as extremes in corporate power and resulting income inequality have made their way into popular discourse. Concerns over data privacy and personal autonomy may soon result in [firmer regulation of tech monopolies](#), which have thus far skirted reform. Inadequate antitrust regulations (which have focused primarily on *pricing* abuses) are being reconsidered. A potential catalyst for the resurgence in value could be a legislative response to corporate overreach.

That said, a political backlash isn't a necessary trigger for a major market event against a backdrop like this. In his 1954 postmortem on the [Great Crash of 1929](#), John Kenneth Galbraith noted that the popular reaction against the extreme concentration of wealth and power in the Gilded Era didn't emerge until *after* the collapse. He attributed the Great Crash and ensuing Depression to an economy that was "fundamentally unsound" noting the effects of:

- 1) "The bad distribution of income" in which the 5 percent of the population with the highest incomes received approximately a third of all income, such that "the economy was dependent on a high level of investment or a high level of luxury spending or both."
- 2) "The bad corporate structure [in which] American enterprise had opened its hospitable arms to an exceptional number of promoters, grifters, swindlers, impostors, and frauds...a flood tide of corporate larceny. The most important corporate weakness was inherent in the vast new structure of holding companies and investment trusts."
- 3) "The poor state of economic intelligence...the economists and those who offered economic counsel in the late twenties and early thirties were almost uniquely perverse." Citing the income tax reductions announced by President Hoover, Galbraith notes "these were negligible except in the higher income brackets; businessmen who promised to

maintain investment and wages, in accordance with a well-understood convention, considered the promise binding only for the period in which it was not financially disadvantageous to do so.”⁷

A key difference between then and now is our extraordinarily (and pre-emptively) accommodative monetary and fiscal policy, which has been sustaining growth—albeit at a low level, and through a rapid expansion of debt—while fostering asset bubbles and inequality. Our policymakers are now [planning more ambitious set of inflationary interventions](#) in order to diminish the real cost of debt service while sustaining asset prices—an inherent contradiction. We have chosen to abuse the US dollar’s privileged status as the world’s reserve currency and risk *stagflation* in an attempt to print our way out of a liquidity trap of our own creation.

Over the next few years, we expect slow economic growth and an increasingly frustrated voter base to produce a further escalation of the deficit spending; it’s practically a foreordained conclusion, given the impact of Boomer retirements on entitlements. The Fed will accommodate higher deficits with additional liquidity (monetization) in an effort to limit pressure on interest rates. The result is likely to be rising inflation and a weaker US dollar. Waning foreign demand for US assets will make it harder for the Fed to anchor long-term bond yields and credit spreads, with negative repercussions for stock markets. In other words, the scenario could look very much like what we saw as the 1960s gave way to the 1970s.

This scenario, *if it develops*, will play out over a multi-year horizon, with the likelihood of a recessionary episode in the interim. Therefore, we are not making wholesale changes in our portfolio strategy, but are alert to potential changes in the economic and market paradigm. We remain underweight US growth stocks, which offer exceptionally poor risk/reward. Our clients’ portfolios are instead tilted toward value, equity income, and defensive sectors. We have growing conviction that foreign assets are poised for a period of relative outperformance, thanks to a plateauing dollar and corresponding slowdown in foreign investment in the US. Therefore, we are adding to foreign currency exposure in client portfolios – first by increasing our position in the euro, and then by raising our foreign equity targets. We retain an overweight position in short- to intermediate duration bonds, with a focus on higher-quality segments.

⁷ Kenneth, John G. *The Great Crash 1929*. Boston, Houghton Mifflin Company, 1954