Learning from Value's Performance over the Past Decade

Featuring:

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Jenna:

Value performance has been trending upward recently, after a prolonged period of relatively weak performance. The long-term underperformance of Value has made investors question the validity of the strategy and the existence of a Value Premium. Joining us today is Mehdi Alighanbari Executive Director MSCI Research, and Abhishek Gupta, Executive Director MSCI Research. They'll cover reasons behind Value's underperformance, potential ways to update definitions of Value, and how Value Growth Indexes can potentially be more relevant benchmarks than Market Cap Indexes when evaluating the performance of Style Managers. Mehdi, Abhishek, great to have you both with us.

Mehdi:

Thanks for having us.

Abhishek:

Thanks for having me.

Jenna:

Yeah, great to have you here. And, Mehdi, starting with you, Value investing didn't offer much value over the last 10 to 15 years, what did you find in your search for reasons behind its underperformance?

Mehdi:

Yes, Value strategies performed poorly over the last decade or so, and this was a big contrast to their performance in the decade before that. So, what we did was to take MSCI Enhanced Value Indexes as a proxy for Value strategies, and look at its characteristics over these 2 very different decades to better understand what was the reason behind this prolonged underperformance. And we find a few contributors to the underperformance. One was the performance of the Value factor itself. Here I'm talking about the pure Value portfolios, the long-short portfolio that has exposure to the value factor only, and no residual exposure to other factors. And we find that the performance of these pure Value factors was very underwhelming over the past 10 years or so. This was intuitive, and the other reason behind the underperformance, another contributor to the underperformance was the impact of Non-

Value factors such as momentum, quality, low volatility, to the Value strategies. So, if we look back, we see that in the first decade of the 21st century, these Non-Value factors generally contributed positively to the return of the Value strategies. But this changed in the second decade of the 21st century, and they were mostly a drag on the performance of the Value strategies. So, these were the 2 main reasons behind the underperformance over the last decade or so.

Jenna:

And, building on those insights, Mehdi, does the historic definition of Value need to evolve to suit today's tech-heavy asset-light business environment?

Mehdi:

This is an important question and was part of our research. So, we investigated whether the definition of Value or how the Value is measured needed to be updated. One thing that we looked at was how R&D expenditure is treated in financial statements of companies, and whether this impacts the way that we define the valuation ratios. As you know, in accounting standards, R&D expenditure is cost. But, in reality, R&D expenditure generates IP, and IP is an asset that could generate revenue in years to come. So, that's how we took R&D expenditure, treated it as an intangible asset, and depreciated it over time. And then recreated our valuation ratios and eventually value factors, with these adjustments and looked at the performance of these adjusted value factors. And what we saw is that, especially over the last 10 years, and especially Book-To-Price, we saw some improvement in the performance of the value factor. We also looked at how valuation ratios are normalized, or how we decide what is cheap or expensive. This is often done cross-sectionally, meaning that at any point in time we take one stock and compare it with its peers to decide whether it's cheap or expensive. That's one way, but there's an alternative way to do that, which is, at any point in time, take the stock valuation ratio and compare it to its own history, so a time-series approach essentially, and recreate the Value factor this way. So, this is what we did, and recreated Value factor, and looked at the performance of the factor created this way, and we saw some improvement in the performance of the Value factor, especially over the last 10 years. We also observed some other interesting characteristics. One was that, although the time-series and cross-sectional value came from the same data, they were very lowly correlated. Which suggests that they might have some complementary characteristics. So, we created the Value factor by combining the two, and we saw further improvement in the performance of the Value factor.

Jenna:

So, Abhishek, turning to you, we discussed how investors may enhance their approach to construction of Value factor portfolios, evaluation of manager performance, however, continues to be an important topic as well. Over the past decade, value managers have, in general, underperformed, and Growth Managers have outperformed, is that reflective of their skillets?

Abhishek:

Yeah, so, managers are oftentimes evaluated against Market Cap benchmarks. And while that may lead to the conclusion that Growth Managers have had better skills compared to Value Managers, it may not be entirely accurate. Benchmarking of funds is an important issue, and misspecification of benchmarks can lead to incorrect influences. Managers should instead be evaluated against benchmarks that are reflective of their investment styles so that we are really able to isolate the impact of their active investment decisions. In this particular case, you know, Value includes styles of investing. They come naturally along with exposure to the Value and the Growth factors. They also come with some other natural and inherent exposures to certain countries, industries, and stocks. Now, we don't want to be penalizing or rewarding managers for their inherent exposures. For instance, we don't want to penalize the Value Managers for the underperformance of the value factor, nor do we want to reward the Growth Managers for the Growth Factor outperformance. Instead, what we want to really do is, that we want to isolate the impact of their active investment decisions over and above these inherent exposures. Benchmarking of Value and Growth Managers to Value and Growth style indexes can remove the effect of these inherent exposures and isolate the impact of their active decisions. In fact, we did that exercise, and we arrived at a different conclusion, that Value Managers did not necessarily have poor skills compared to Growth Managers.

Jenna:

Now, based on what you just said, if we switched the benchmark from Market Cap to style indexes, what does it say about Value and Growth Manager performances?

Abhishek:

Yeah, so, notably in our research, we found that Value Growth Managers, they had lower tracking error compared to the Value Growth Style Indexes, compared to the Market Cap indexes. Firstly, this implies that the style indexes were indeed more appropriate benchmarks, but what it also means is that the active managers were making fewer bets than was previously thought. As we switch the benchmark from the Market Cap to the Style Indexes, in general, active return increased for value managers, and it decreased for Growth Managers. We found that there were industry bets on negative exposure to momentum, which appeared to have dragged down the performance of the Value Managers, but those contributions were significantly neutralized when we compared them to the Value Style Index. In contrast, the exposures that were actually profiting the Growth Managers, they were significantly scaled-down when we used to more appropriate benchmark that is the Growth Style Index. The benchmarks which was also pretty crucial, and it allowed for a more truer accounting of the manager's stock-picking skills. Which we saw increase or improve for the Value Managers and deteriorate for the Growth Managers.

Jenna:

Well, Mehdi, Abhishek, thank you both so much for joining us, and sharing your insight on Value Investing.

Mehdi: Thank you.

Abhishek: Thank you.

Jenna:

And thank you for watching. Once again, that was Mehdi Alighanbari Executive Director MSCI Research, and Abhishek Gupta, Executive Director MSCI Research. I'm Jenna Dagenhart with Asset TV. For more information, you can visit MSCI's factor investing webpage to access the latest research and thought leadership.

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