Factor focus: Value

In the realm of investing, a factor is any characteristic that helps explain the long-term risk and return performance of an asset. MSCI Factor Indexes are designed to capture the return of factors which have historically demonstrated excess market returns over the long run.

MSCI Factor Indexes are rules-based, transparent indexes targeting stocks with favorable factor characteristics – as backed by robust academic findings and empirical results – and are designed for simple implementation, replicability, and use for both traditional indexed and active mandates.

Defining Value

The foundation of value investing is the notion that cheaply priced stocks outperform pricier stocks in the long term. Value is categorized as a “pro-cyclical” factor, meaning it has tended to benefit during periods of economic expansion (see “Performance and Implementation”).

Value has several dimensions: the stock price as a multiple of company earnings, price as a multiple of dividends paid, price as a multiple of book value, and other such “ratio descriptors.” Academics and investors differ on which best represents a value company, creating opportunity in the marketplace for a variety of investment products.

The MSCI Enhanced Value Index applies three valuation ratio descriptors on a sector relative basis:

- Forward price to earnings (Fwd P/E);
- Enterprise value/operating cash flows (EV/CFO); and
- Price to book value (P/B).[^1]

The index aims to address the pitfalls of value investing, among them “value traps” – stocks that appear cheap but which in fact do not appreciate. Our analysis shows that using forward earnings has helped provide protection against value traps, and that whole-firm valuation measures, such as enterprise value, have reduced concentration in highly leveraged companies, meaning those that have borrowed heavily.

Why investors have used value strategies

Many investors use this approach in identifying assets that they expect the market to revalue.

The concept of value was first popularized in the 1930s by economists Benjamin Graham and David Dodd, who advocated owning companies that provide a “margin of safety” – meaning the current stock price is less than it is expected to be under conservative projections of the firm’s future earnings.[^2]

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MSCI World Factor Indexes

Over time, individual factors have delivered outperformance relative to the market.

The MSCI World Enhanced Value Index has historically generated excess returns over the long run with a 2.0% annual return over the MSCI World Index since 1999 as represented above.
Although factor strategies have exhibited long-term outperformance, in the short-term, factor performance has been cyclical and has generated periods of underperformance.

At the core of value investing is the belief that “cheaply” valued assets tend to outperform “richly” valued assets over a long horizon.
How factors have performed relative to each other:

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<td>World Quality</td>
<td>1.2%</td>
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<td>-3.6%</td>
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<td>World Minimum Volatility (USD)</td>
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<td>World High Dividend Yield</td>
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The analysis and observations in this report are limited solely to the period of the relevant historical data, backtest or simulation. Past performance — whether actual, back tested or simulated — is no indication or guarantee of future performance. None of the information or analysis herein is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision or asset allocation and should not be relied on as such. The time periods covered in the charts in this paper were dictated by the data available when we conducted the simulations which produced them. There are frequently material differences between backtested or simulated performance results and actual results subsequently achieved by any investment strategy.
In general, factor performance has been cyclical in nature. Individual factors have been shown to outperform during different macroeconomic environments.
Conclusion

Value investing is premised on identifying stocks whose prices seem to understate their intrinsic value. While many institutional investors may agree with that premise, implementation of value-index strategies differs widely. MSCI Enhanced Value Indexes are based on research that has found that combining value ratio descriptors has captured the value factor better than using any individual ratio descriptor alone.

Footnotes

1. Exceptions are Financials: Forward P/E and P/B, Real Estate: EV/CFO

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 45 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process.

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