

Value For the Long Run – Video Transcriptions

Estimated time to read all clips – 12m 08s

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Introduction [Estimated time to read - 4m 15s]

It is a very long period that value has had difficulties. We are starting from the financial crisis, because the financial crisis wasn't amazing for a lot of value companies, so mid-2007. In essence we are into this mess for 13 years. But until 2017, Cliff mentioned 2018 so we might be off a year, it wasn't really a disaster for value stocks. Value underperformed growth by roughly 2.5% and you could easily overcome this 2.5%. And the 2.5% of underperformance, most of it came from financials. If you look at Citigroup today, at what it trades, it trades at 30% of what it traded at the end of 2016. If you look at some of the regional banks, it might be 50%. And without any doubt the emergence of FANG companies that were tiny in the benchmark, in 2006 I think were around 3%. Of course Alphabet and Facebook made it difficult on us.

But definitely, the last couple years were more than crazy. Cliff studied at the University of Chicago. There is a lot of respect for Gene Fama who said 'I don't want to call it a bubble, but if it's not a bubble, I don't know what to call it'.

If you look at relative valuations, they are as big today as we saw during the tech bubble. One simple number to look at is the P/E ratio of growth companies to core. Growth to core, the normal level is about 1.2. Growth companies are 20% more expensive typically than the core benchmark. And the reason is very simple; growth companies, at least in the near future, do grow faster than companies in the core benchmark and definitely than companies in the value benchmark, and the value companies are trading at a discount. But focusing on the growth companies, the ratio now is 1.5. So if growth companies would revert to the norm of 1.2, it suggests that growth companies are overpriced by 20%. Of course it's possible that growth companies are not overpriced. And if we're trying to justify this high valuation, the most possible candidate are growth rates. So, if somehow growth companies are going to grow at much higher rates in the future, than they grew in the past; you can explain the 1.5 ratio vis-à-vis an average of 1.2.

As an academic, we started the company in 1994, but during the tech bubble in 1998/1999 I was still spending a lot of time in Illinois playing tennis, trying to bring some business, still trying to publish some papers. I was sitting with Jason Karceski and Louis Chan, and we saw all those companies (Qualcom, EMC, Sun Microsystems, etc..) trade at P/E's of 100. And we were sitting and thinking, how can we justify such a multiple? And we decided probably in 98 that we should write a paper that we called "The level and Persistence of Growth Rates". Academia doesn't work very fast. Although we started the paper in 98, it was published in the Journal of Finance in 2003, but we did a lot of work on growth rates. We found that there is more persistence in growth rates when it comes to growth rates in sales, but by the time you get to the bottom line earnings, it's very difficult to count on persistence that will last beyond 5 years.

And basically, we're at the same point today. We continue to do research on growth rates. The typical company is growing by not more than by 5% per year, roughly GDP + 2-3% real growth rates. It's extremely difficult to grow at 10% a year over a longer period of time. So it's very difficult for us to see how the current valuations, companies trading at P/E of 50 and more, can be justified. It's also very difficult to assume that the economy became much less competitive today than it was in the past.

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I know there is a question about the tech bubble later, but I want to touch on one thing related to the tech bubble which is very similar to what is going on today. If you put yourself in March of 2000 and you look at the biggest tech companies, the biggest companies were Microsoft, Intel, etc..., IBM was very high on that list. They traded at crazy multiples, suggesting that the market thinks that those companies will be able to generate huge growth rates going forward. But what really happened? In the past 5 years, those companies grew at rates which were on average 25%. 25% covers a lot of valuation, but they couldn't sustain those growth rates, and in the next 10 years those companies grew at 5-6%. Most of you know, although it's probably a very young audience and the tech bubble was a prehistorical ages for many of you, but the typical company declined by something like 60%. So at the end, valuations matter. What is driving everything are growth rates. It is very difficult to count on high growth rates to continue to be very persistent for a long time.

Growth Relative to Value [Estimated time to read - 1m 35s]

I kind of agree to what you said Jeremy that in terms of performance, growth did extremely well relative to value. If you look at the last year, value underperformed growth by 43%. This is a bigger number than we had during the tech bubble period, so performance is awful. I agree with Cliff that the growth companies may not be as expensive, but the ratio of growth to value is as high as during the tech bubble. Definitely the case. I somewhat disagree, but I didn't calculate it, that the quality of the bigger growth companies was lesser during the tech bubble because the biggest names were names like Microsoft, like Intel, like EMC, Oracle and so on. And those were high quality companies but I just don't know, but it also depends on what is your measure of quality.

The only difference is really that the tech bubble lasted 7 quarters. It started in the second half of 98 and it ended in the first quarter of 2000. I think that if it had ended in the second quarter of 2000, I probably would not be around because we had a lot of new clients that got started with us just before the tech bubble and all of them had double digit underperformance. We were hanging on to those clients telling them we were doing exactly what we promised to do, which probably wasn't good enough for them, but they kept us.

This period is longer. Even if we take Cliffs 2018, we have 2018, 2019, 2020... it's longer. However, I think that if not for COVID, which was a second knock-out for value companies, maybe we would have seen a recovery of value companies before. So COVID, actually prolonged this whole thing for value companies, because it was awful for our stocks.

Bargain Companies [Estimated time to read - 0m 23s]

Value money managers are kind of bargain hunters. We try to find cheap companies, high quality cheap companies; each of us are maybe doing something a little different. But there are periods where people hate bargains! But eventually, greed will take-over and they will go to TJ Max, because they will come back to those bargains. Because those bargains are generating cash flows, the bargains are paying dividends, and the bargains are buying back shares.

Indexation [Estimated time to read - 1m 26s]

If you look at the index, the index is market weighted so it is heavily weighted towards the largest companies. Right now, the large companies are a bigger proportion of the index than they have been before. So for example, take the largest 10 companies. And we compare the largest 10 to the remaining 490, and everything is value weighted. So typically the largest 10 were 21% of the weight among the largest 500 companies.

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Right now, the weight of those 10 companies is much, much bigger, it is 29%. All sorts of studies show that the large companies never did well. If you compare the largest to the rest, there was typically an underperformance of 1 - 1.5%. But now, the potential pain is even bigger because the large companies are just so large. But there is another point that is very important. If you compare the valuations of the top 10 to the remaining 490, the ratio historically was 1. Which means that the same multiples that the market gave to the largest companies it gave to the remaining 490. The ratio today is 1.57, it is how expensive those companies became. One point fifty seven. They started to become expensive, as Cliff pointed out around 2018 because their ratio was really not very far from 1 before. And this number of 1.57 is exactly the same number that we saw at the peak of the tech bubble. What is interesting is that after the tech bubble, it took only 2 years for this ratio to go down to 1.1. So you are now buying the index, which is so top-heavy, and in addition the biggest companies are damn expensive. It is not a good combination.

Persistence of Growth Rates [Estimated time to read - 0m 32s]

If you look at the history of the largest companies, like the top 25, and you look at their growth rates. And if you look at companies that survived for 10 years, you have to be in the 90th percentile to get growth rates of 10-12% a year over the next 10 years. How the hell can you predict sitting today, who is going to be in the 90th percentile? If you have a good forecasting model maybe you hit the 70th percentile. This will not buy you a lot of growth. It really boils down to growth rates, competitive economy, regulators, anti-trust, all of those issues.

Interest Rates [Estimated time to read - 0m 56s]

I encountered a paper in Journal of Portfolio Management, I think by Cliff. Where he went and partitioned month to month with low interest rates, months with high interest rates and tried to see what happens in terms of real returns in the next 10 years. We did something similar because we're getting a lot of questions from clients. 'Unless interest rates are going to go up, then value is not going to do well'. So we looked at months with low real interest rates, and definitely we have a very low interest rate right now. And we compared performance of value and growth over the next 5 years. And we really did not find that value is underperforming growth. Then we did something else, we also looked at the spread because some people are coming to us and asking "what about the spread, 10 years minus 3 month"? So we did the same exercise for the spread. And we also didn't find that when the spreads are very low, that our types of guys are taking a beating relative to growth companies.

Momentum [Estimated time to read - 1m 19s]

Momentum, I think Cliff is probably using momentum. We are using momentum. Probably to a lesser extent than Cliff, but I don't know exactly what Cliff is doing. I did some work on momentum, and also Cliff published actually a nice paper in Financial Analyst Journal, many years ago, right Cliff? Where you looked at momentum for value companies and for growth companies. And it was somewhat difficult to get excited about momentum if you are really a value money manager. (Cliff: "Within value, yes").

So let me just tell you one thing that we did, actually yesterday. Just got results yesterday. Probably Cliff, some other people, did it before. But we tried to see if valuations also matter within momentum. So actually what we did, we looked at companies with high momentum, low momentum, deciles, quintiles, whichever you want to do, and then we looked at the valuations. Let's call it momentum factor. So when the momentum factor is cheap, it kind of tends to do well.

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But when the momentum factor is crazy expensive, the high momentum guys are very expensive relative to low momentum guys, subsequently the return on this momentum factor is nothing to write home about. And I actually find it to be a very interesting finding because valuations always matter. We know that valuations matter when you compare value to growth. Valuations matter when you compare high momentum to low momentum. I'm sure that it matters when you compare large companies to small companies. So for me it is just another indication that you cannot run away from valuation.

International Value [Estimated time to read - 0m 31s]

We see the same trends outside the United States, if you look at EAFE. I quoted some numbers and you even asked me about this number of 1.5. So the current premium of EAFE (growth divided by core) is 46%. In the United States it is 50%. The norm for EAFE was 20% and in the United States it was 19%. If you look at the destruction of indicators like EBITDA and forecasted earnings and so on, you almost cannot distinguish between United States and those other countries. Maybe, and Cliff is adjusting for industries and so on, maybe Europe is a touch cheaper.

Time to Consider Being Contrarian [Estimated time to read - 0m 52s]

I agree with a lot of what Cliff said and basically I have roughly the same summary. It is a time to be contrarian. It is definitely not a time to reduce allocation to value. I think that you should at least be neutral on value. If you can stomach, you should probably be somewhat more aggressive on value. If you look at science, people talk about science now. If you look at science, science for us is empirical evidence. A good time to invest in value is when value has had difficult times and when value is very cheap. We have those two conditions now. I was giving that same advice to my handful of clients, I even don't know if we had a handful of clients in 1997 and 1998. I don't think that a lot of them listened to me, but most of them, all of them stayed with us. So maybe the people that are listening now will take it a little more seriously. Don't run away from value!