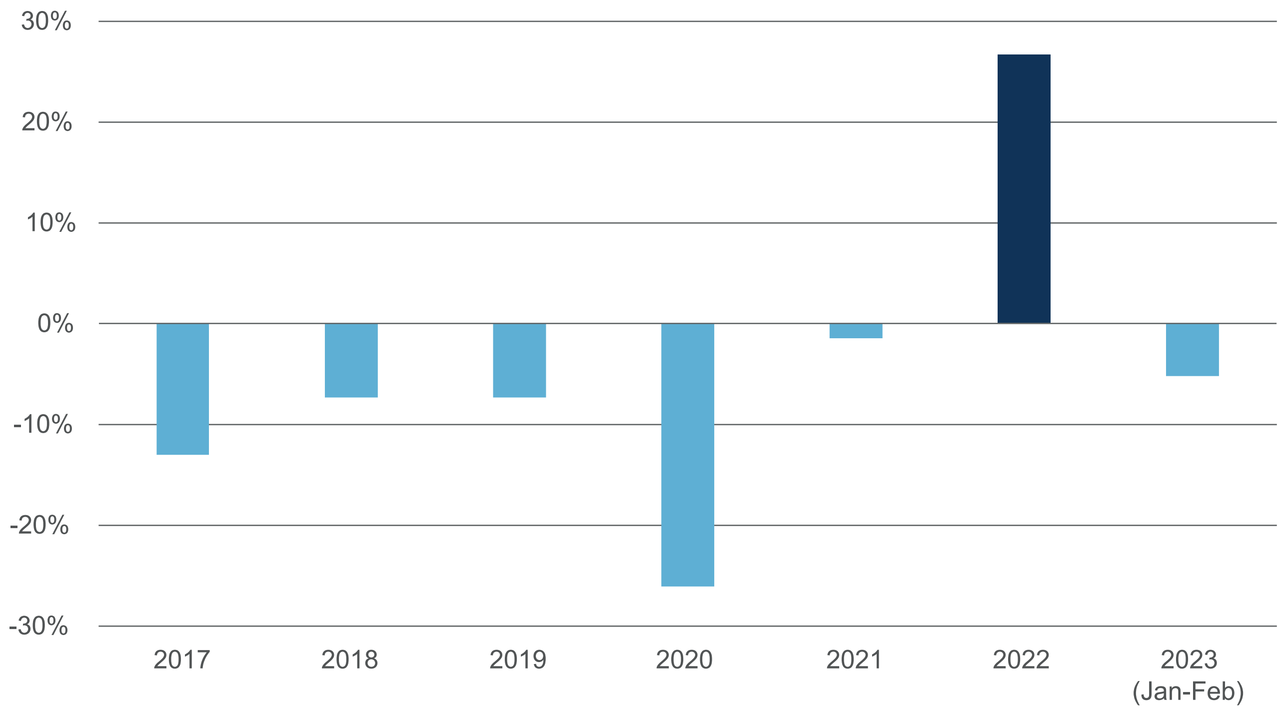
Is Value Back?

While many look at 2022 as a bad year for markets, value investors had something to celebrate due to the strong return of the value premium. After being out of favor for 5 consecutive calendar years, value stocks outperformed their growth counterparts by 25%. However, some argue that the value rebound has run its course, citing the recent outperformance of growth stocks of +5% through the first two months of 2023 as evidence.

Exhibit 1. Annual Value Premium Performance, 2017 to Present



Value premium is defined as the performance of Russell 3000 Value Total Return Index minus the performance of Russell 3000 Growth Total Return Index. Source: Innealta Capital, using monthly data from 1/2017 to 2/2022.

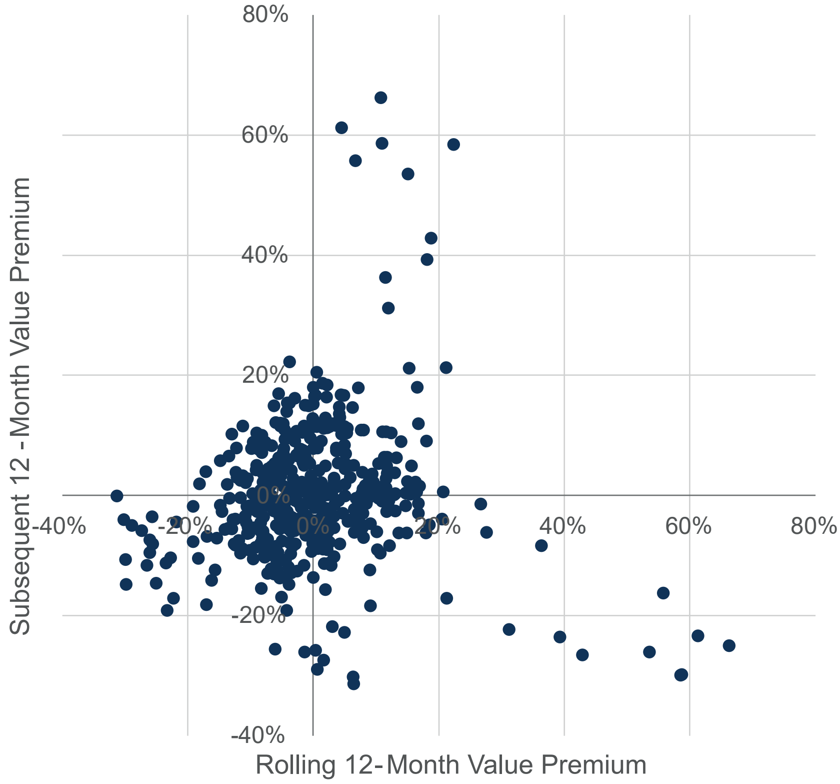
Is value now back out of favor? To provide an answer to this question, we can look at the ability for value's recent performance to predict future value performance, as well as current valuation spreads against the back-drop of historical observations.

Does recent value performance predict future value performance?

Cognitive biases often interrupt our ability to make objective judgments about future events. One such bias, the gambler's fallacy, refers to the mistaken belief that recent events occurring more frequently, or in larger magnitudes, have a lower probability of occurring in the future. Have you ever been to a roulette table that has spun red five times in a row? If you have, you probably will have noticed other gamblers making statements suggesting that black is 'due' to occur. Investors make similar mistakes, often pointing to recent events as evidence for why something recently occurring will not continue to occur into the future.

In the value premium's case, investors should expect a positive value premium every day, week, month, year, etc. However, this is not the case in practice. There are plenty of periods when value will outperform, but also periods when value underperforms. It is important to recognize that the recent performance of value has no power in predicting the future performance of value.

Exhibit 2. 12-month Value Premium and Subsequent 12-Month Value Premium



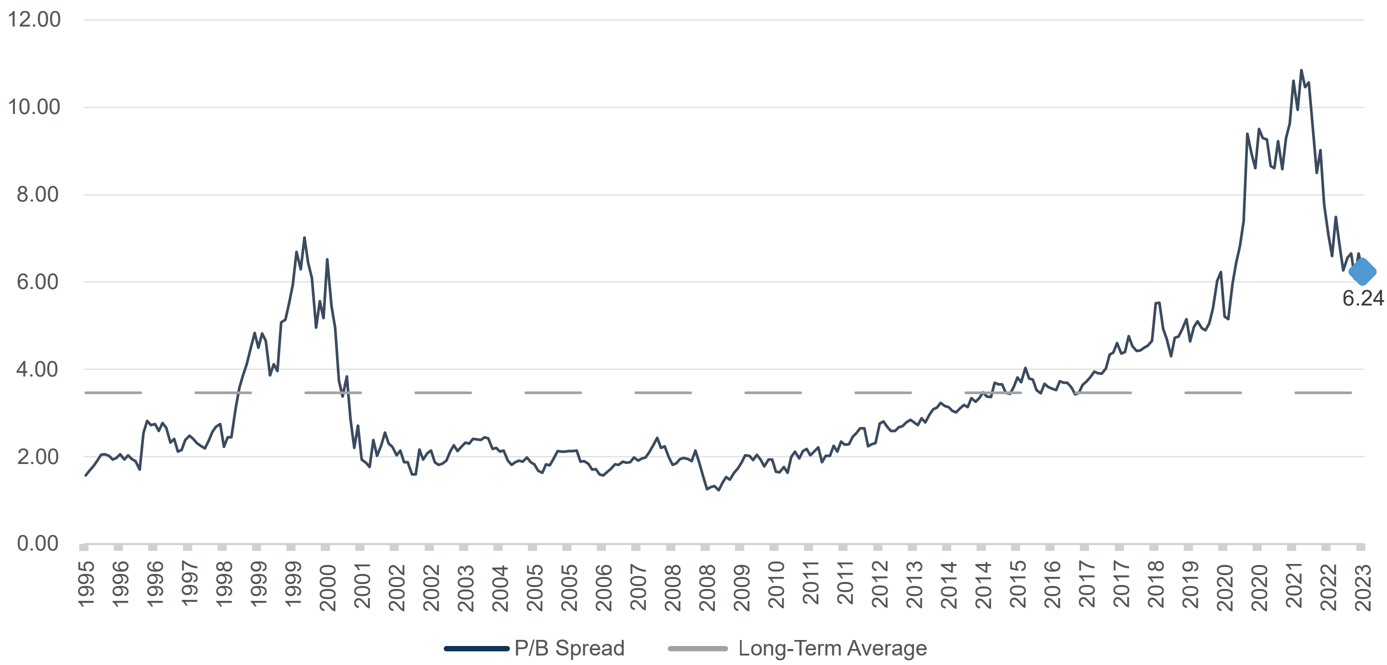
Value premium is defined as the performance of Russell 3000 Value Total Return Index minus the performance of Russell 3000 Growth Total Return Index. Source: Innealta Capital, using monthly data from 1/1979 to 2/2023.

As you can see, there is no discernable relationship between rolling 12-month value premiums and the subsequent 12-month premium. There are many periods of strong positive value premiums followed by a subsequent period of continued strength. Instead of falling into the same trap as gamblers at the roulette table, value investors should remain steadfast in their value conviction, even after a run of success.

What can current valuation spreads tell us about what to expect going forward?

Valuation ratios, like the price-to-book ratio, provide useful insights into the relative prices investors are willing to pay for companies. By comparing the valuation ratios between two sets of securities, creating a valuation spread, we can understand the relative price difference between them. In observing the valuation spread between value and growth stocks, we are directly comparing the relative 'expensiveness' of the two. Buoyed by record low interest rates, growth companies have consistently become more and more expensive relative to value stocks over the last decade, with this bubble beginning to pop in 2021.

Exhibit 3. Valuation (P/B) Spread Between Growth and Value S tocks, 5/1995 to 2/2023



P/B Spread is defined as the difference in P/B ratio between Russell Value 3000 Total Return Index and Russell Growth Total Return 3000 Index. Source: Innealta Capital, using monthly data from 5/1995 to 2/2023.

While we have observed a contraction in the valuation spread between growth and value stocks, the current reading remains in the 89th percentile of historical observations. Further contraction in this ratio, as it reverts towards its historical mean, would mean continued outperformance for value stocks. In other words, this value rally still seemingly has a lot of room to run. Furthermore, there is evidence indicating higher valuation spreads predict higher future returns, albeit with considerable uncertainty[1]. This suggests it's best to maintain consistent focus on the value premium moving forward.

[1] Cohen, R. B., Polk, C., & Vuolteenaho, T. (2003). The Value Spread. The Journal of Finance, 58(2), 609–641. htp:/www.jstor.org/stable/3094552

Conclusion

For value investors, the trailing decade has not been an easy one. Despite the value premiums strong return in 2022, we feel it is important for investors to recognize that a swift, strong premium is not a reason to expect a reversion back to the growth regime. Instead, investors should expect a value premium continuously and should position their portfolios to capture premiums when they do appear, as it can happen quickly and in large magnitudes. Systematic strategies rooted in empirical evidence are the best tools investors can deploy to do this. Furthermore, two months of strong relative growth performance in 2023, doesn't overcome the fact that the valuation spreads between value and growth stocks suggest that the value premium still has considerable room for outperformance before spreads revert to historical averages. For investors willing to continue to be patient, value seems to still have a lot to give.

ACCLIVITY
INVESTMENT RESEARCH

Acclivity noun
ac·cliv·i·ty | \ ə-ˈkli-və-tē
plural acclivities
Definition: an ascending slope
Synonyms: ascent, elevate, rise, upgrade

Index Descriptions

The **Russell 3000 Growth TR Index** is a market-capitalization weighted equity index and measures the performance of the Russell 3000 companies with higher price-to-book ratios and forecasted growth values. Total return indexes reinvest dividends. The **Russell 3000 Value TR Index** is a market-capitalization weighted equity index and measures the performance of the Russell 3000 companies with lower price-to-book ratios and forecasted growth values. Total return indexes reinvest dividends.

Disclosures

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