

A Triumph of Hope over Experience

By almost any measure, the current underperformance of value stocks appears to be one of the longest and deepest over the last century. By itself, this is a sterile fact, but we can progress to insight by asking *why* this has happened.

While the intuitively simple notion of buying a dollar at a discount has been a successful investment strategy throughout history, the performance of value stocks has now lagged that of growth stocks for more than a decade. This underperformance has deepened in the last two years as the late cycle momentum rally has gathered pace.

As one might expect, many commentators have proclaimed the death of value, offering varied explanations for their views. This letter addresses the two most common—and perhaps at first glance the most plausible—of these theories, as well as our view on what is really driving the extreme divergence.

Argument One – Are value investors using the wrong metrics?

Over the course of the current down cycle for value stocks, various market commentators have criticized the relevance of the price-to-book (P/B) ratio. Indeed, a recent academic paper by business school professors Baruch Lev and Anup Srivastava¹ concluded that the “likelihood of a resurgence of value investing is low” based on the shortcomings of this metric.

Four points are relevant here, we believe:

1. There is a long history of new metrics and valuation approaches being used to explain a boom in a particular type of asset. Today, people talk about ratios to total addressable market (TAM), but recall the purported game-changing importance of “eyeballs” in the 1999 tech boom or undeveloped oil reserves in the oil boom. In prior cycles, the “old” ratios eventually had the last say.
2. The portrait of a P/B-obsessed fundamental value investor is a caricature, and the P/B ratio itself a convenient straw man. We analyse the P/B ratio performance data because of its long record, but our approach does not depend on this factor. In the overwhelming proportion of cases, our thesis makes no reference to book or NTA multiples at all, and we currently own stocks with P/B ratios varying from 0.6x to 14x. Value, as described by Benjamin Graham, is an investment philosophy informed by principles such as competitive mean reversion, the inability to forecast the future, and the importance of taking the category view, to name just a few. That’s why various value firms have beaten their benchmarks over the last 10 years while mechanical valuation ratios have performed poorly. Not that valuation ratios aren’t useful. They are good proxies for the relative environment across the cycle, but they tell us very little about the performance of individual fundamental value investors.
3. Academics and investors are right to criticise the shortcomings of simple P/B ratios, and the argument that the usefulness of this metric is declining has merit. Intangibles account for a rising proportion of book values, and some capex is capitalised, while some is expensed. We have witnessed a dramatic 38% drawdown against Kenneth French’s P/B ratio factor, which is a 99th percentile event in the context of the last 93 years. Even if we accept the premise that the P/B ratio is becoming a less useful guide, this huge degree of underperformance cannot be rationally explained unless one posits that a high price to book ratio has actually become an indicator of future outperformance. Some commentators have done just that, implying that any stock becomes a better investment if its price (and thus P/B ratio) rises, a proposition which is clearly absurd.
4. The P/B ratio isn’t the only valuation ratio to have underperformed. All accounting factors, including cash flow, dividend yield and price to earnings, are at or near extreme drawdown percentiles. This makes it unlikely, in our view, that book value accounting is the cause of the fundamental value underperformance (Exhibit 1). For the P/CF ratio, for example, this episode appears to be the worst drawdown in the entire 68 year US history available, even exceeding that of the dot.com boom peak in early 2000. Long-term historical series for FCF ratios are unfortunately not available.

Exhibit 1
Book values are imperfect but do not appear to be the main cause

Value less Growth	P/B	DY	P/E	P/CF
Period	1926-2019	1926-2019	1951-2019	1951-2019
Relative Return (pa)	+3.7%	+1.7%	+4.9%	+3.8%
Cumulative Relative Return	+2703%	+369%	+2,555%	+1126%
Aug 2019 Drawdown	-38%	-24%	-26%	-37%
Percentile of 8/19 Drawdown	99%	84%	98%	100%

As of 31 August 2019

Source: Kenneth French US dataset, periods ending Aug 2019

Argument Two – Are Growth Stocks Simply Better Companies?

A second line of argument is that value companies have inherently inferior earnings potential compared to their growth counterparts due to new technology, the market-changing effects of disruption, and network effects in which the winner takes all.

It is a good story and would certainly explain the extreme divergence of the simple valuation ratios shown above. But is it true?

It is worth noting at the outset that those advancing this narrative do not usually provide any data to buttress their claims, but rather seem to assume that growth stocks *must* have inherently higher earnings potential, given the performance differential between the two styles. We break from this practice by examining the relevant data.

In Exhibit 2, we disaggregate the relative performance of the MSCI World Index through September 2019 into two categories: fundamentals, including growth in earnings per share (EPS) and dividends paid, and sentiment, as measured by relative multiples.

Forward EPS for the value index grew 2.5% faster per annum (pa) than the growth index over the last three years, and paid a 1.9% higher yield. This adds up to fundamental outperformance by value stocks of ca. 4.5% pa. However, the relative forward price-to-earnings (P/E) ratio of the value index declined 8.1% pa over the same period relative to growth, leading to an 11% cumulative performance lag. Thus, contrary to the widely accepted view, the data suggests that multiple expansion, rather than any earnings differential, drove the global disparity in performance between growth and value stocks. Over the last three years, 215% of the underperformance was due to relative multiple inflation by growth stocks.²

The trend holds for Australian stocks as well as shown in Exhibit 3 which disaggregates the relative performance of the MSCI

Australia Value Index over periods from one to nine years ending October 2019. We note that forward EPS for the value and growth indices was the same over the last six years, so the excess earnings growth for value was (conveniently) zero. However, the stocks in the value index paid out a 1.8% pa higher dividend. On fundamentals - then, assuming no relative multiple changes, the value accumulation index should have outperformed by 1.8% pa over the period. But the relative multiple of the stocks in the value index fell by an average rate of 6.8% pa (34% cumulatively), and value underperformed by over 5% pa on average. This is worth emphasizing: Outperformance of 1.8% pa in the fundamentals turned into underperformance of 5% pa for six year (or 27% cumulatively) due to relative multiple inflation in growth stocks. Thus over the last six years, it appears that 126% of the relative underperformance of value stocks were due to relative multiple inflation by growth stocks.

Two key takeaways from the Australian data are that: (1) due to multiple inflation, growth stocks have positive price momentum and are generally well liked; and (2) the annual dividend yield advantage of the value index is now 2.5% pa. Going forward, the challenge for relative growth index returns will be even greater. That is, from the starting point of today's higher dividend yield gap, stocks in the growth index need to grow even more rapidly in a relative sense in order to compensate for their lower yield.

Over the long run, growth stocks *do* exhibit slightly faster EPS growth than value stocks on average – in that sense, they *are* better stocks. Historically, the data indicates that they have been worse investments, however. Value stocks can outperform because growth stocks fail to meet the higher earnings expectations priced into their shares. Value stocks can do well despite slower earnings growth, because the earnings often turn out to be better than priced. Add in the higher running yield on value stocks, and you have the basis for value's long-term historical outperformance.

Exhibit 2
Fundamentals Vs Multiples

MSCI World: Value relative to Growth	1 Year	3 Year	5 Years
Relative Forward EPS (pa)	2.9%	2.5%	-1.3%
Relative Dividend (pa)	2.2%	1.9%	1.8%
Fundamental Difference (pa)	5.2%	4.5%	0.5%
Relative Multiple (pa)	-6.5%	-8.1%	-4.3%
Cumulative Relative Multiple	-6.5%	-22.3%	-19.5%
Total Relative Return (pa)	-1.7%	-3.9%	-3.8%
Total Relative Cumulative Return	-1.7%	-11.4%	-17.7%

As of 30 September 2019

Source: FactSet, periods ending Sep 2019

Exhibit 3
Performance Disaggregation of MSCI Australia Relative to MSCI Australia Growth Indices

MSCI Australia Value rel Growth To Oct 18	Relative EPS(pa)	Relative Yield (pa)	Relative Fundamental (pa)	Relative Fundamental Cumulative	Relative Multiple (pa)	Relative Multiple Cumulative	Relative Performance (pa)	Relative Performance Cumulative
Last 9 Years (2010)	3.4%	2.0%	5.4%	60%	-4.6%	-35%	0.5%	5%
Last 8 Years (2011)	2.7%	2.0%	4.7%	44%	-4.9%	-33%	-0.4%	-3%
Last 7 Years (2012)	-0.1%	1.8%	1.7%	12%	-4.5%	-28%	-3.0%	-19%
Last 6 Years (2013)	0.0%	1.8%	1.8%	11%	-6.8%	-34%	-5.1%	-27%
Last 5 Years (2014)	-2.4%	1.9%	-0.5%	-3%	-5.9%	-26%	-6.5%	-28%
Last 4 Years (2015)	-0.7%	2.0%	1.3%	5%	-7.7%	-27%	-6.6%	-24%
Last 3 Years (2016)	-0.9%	2.3%	1.5%	4%	-9.7%	-26%	-8.4%	-23%
Last 2 Years (2017)	-7.6%	2.6%	-5.0%	-10%	-7.0%	-14%	-11.9%	-22%
Last Year (2018)	1.1%	2.5%	3.6%	3%	-8.9%	-9%	-5.7%	-6%

As of 31 October 2019
Source: FactSet, MSCI

A Third Reason - The Power of Narrative

What then is the real reason for this dramatic period of underperformance for value? Mechanically, it's simply multiple inflation, but why is this occurring?

It is our view that the rise of two data monopolies, Google and Facebook, have played an outsized role, not so much because of their actual financials, but because of the profound ways in which they have shaped the narrative of the current tech-led boom. There is some evidence for that in the fact that growth has performed better than value worldwide, even in countries like Australia, where the local technology sector is not as robust.

Most booms are inspired by spectacular and visible success that make investors who were in the right place at the right time feel like lottery winners. Examples include Western Mining in Australia's late 1960s Japan boom, Microsoft in the dot-com boom, Fortescue Metals in Australia's China boom, and today the data monopolies.

Historically, the companies at the heart of these booms turned out to be unique stories, rather than the leading edge of a trend. Nevertheless, for some time the life-changing gains made drive the development of a narrative and this becomes the leitmotif and inspiration for a boom. Thus, investors in 1969 bought Poseidon Nickel because it looked like another Western Mining. Today, investors look for stocks that look like Facebook and Google. Initially, as investors back the narrative and prices continue to rise, this "confirms" the dominant narrative of the boom and it becomes accepted wisdom. Today's question is: What are the chances we will see another new global-ex-China data monopoly? The market has placed large multiples on many technology stocks, particularly in Australia, but the reality is that none of them has the privileged position of a Google or Facebook. After

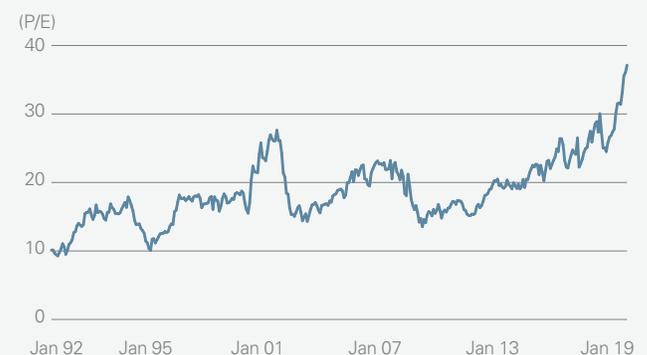
all, monopolistic profits are rare and once established difficult to maintain in a democracy, and especially in foreign jurisdictions.

The Power of Multiple Inflation

We have made reference to growth stock multiple inflation above. As this is the main mechanism behind the underperformance of value over the last decade, we thought it worthwhile to provide a concrete example. Exhibit 4 shows the forward consensus P/E of the Australian healthcare sector. This GICS sector has a current market capitalization of a bit over \$200bn and thus accounts for close to 11% of the value of the ASX200 Index.

As shown in Exhibit 4, the forward multiple of the healthcare index has risen from 14x to 37x in the bull market to end December 2019. This means that the multiple alone has delivered capital gains of 9.3%pa for close to 11 years or 160% cumulatively! This is without appeal to any growth in EPS at all.

Exhibit 4
Multiple Inflation



As of 21 January 2020
Based on the ASX/S&P 200 Index, Health Care Sector.
Source: UBS

Exhibit 5 places the current forward EPS multiple into a historical and international context. The sector traded at a 97% premium to its own 30-year average at Dec 2019. As of 22 January 2020, it traded on a 128% premium to the MSCI World, a 148% premium to the S&P Healthcare sector and a 131% premium to healthcare in developed markets. It is not clear why the Australian healthcare sector should trade at two and half times the multiple of the equivalent US sector.

Some readers may, at this point, object with the statement “Yes, but a large part of the index is CSL!” This does not change the multiples, of course, but appeals to the fact that CSL is now one of the most successful, admired and loved stocks on the exchange (similar to, for example, QBE in 2007, Lend Lease in 1999, BHP in 2007 or Westfield Holdings and Cochlear in 2001). CSL has been one of Australia’s greatest corporate successes, but it is worth noting that if CSL traded today at the average multiple between 2003 to 2015, its share price would be less than half of its current \$320ps – that’s the power of multiple inflation.

Those with longer memories will also remember 2001-2003. As shown above in Exhibit 4, in the 2001 healthcare/biotech boom this sector traded on demanding forward multiples (reaching 27x at the peak), with CSL itself on about 55x – when CSL experienced some currency-related operational issues in 2002, the share price fell 75%, while the sector overall halved in price from that peak. Even good companies can deliver poor outcomes when expectations are too high.

Exhibit 5 Multiple Inflation

Australian Healthcare Sector Forward P/E (NTM)		Premium
Average 1990-2019	18.8	+97%
Mar 2009	14.2	+160%
Dec 2019	37.1	
GICS Healthcare Sector Forward P/E (FY1) 22nd Jan, 2020		
ASX	41.1	
MSCI All World	18.0	+128%
S&P 500	16.6	+148%
MSCI Developed World	17.8	+131%

As of 22 January 2020
Source: Lazard, FactSet

The Best Companies in the World

Viktor Shvets at Macquarie noted recently that there is now an entire generation³ in the market that has never seen value stock perform and in whose experience growth stocks always do, no matter the multiple you pay (after all, it kept on rising). This has led to more and more market commentary that implies that good companies are by definition good investments. The author has heard the pitch of one fund manager, whose approach and philosophy was simply this: “I buy you the best companies in the world!”

An immediate question is whether the manager in question can identify these companies in a forward looking sense, as opposed to just identifying the best stocks in the past. What seems to be often forgotten over recent years, however, is the implied assumption that good companies necessarily make good investments. It is not correct, but our associative brains are sorely tempted to make this connection.⁴

Any asset has a fair value at some appropriate discount rate – if an investor pays more than that price, he or she will make less than that required rate of return and vice versa. In order to make this abstract mathematical fact real, we note that this is not the first time that the “quality/growth at any price” (QAAP) thematic has dominated markets.

It did so famously in the “Nifty Fifty” market of the late 1960s and early 1970s, when a broad set of leaders were seen as “one decision” stocks – even the top 18 leaders of this large-cap growth boom lost a large average proportion of their value in the 1973/74 downturn. It did so in the dot.com boom for the internet leaders and associated hardware makers, when multiples were forgotten in the rush to make riches on the NASDAQ and even in the GFC crash, many quality/growth blue chip leaders fared rather poorly (most dramatically the global banking giants, such as JPMorgan Chase and CitiGroup, of course).

Exhibit 6 reminds the reader of some of these outcomes. You can still lose money from an investment in the best companies in the world. *Caveat emptor.*

Exhibit 6
Blue Chip Performance at Turning Points

Blue Chip Performance: 1973-1974		Maximum decline in share price from peak to trough over 5 year period 1/1/1999 to 31/12/2003		Maximum decline in share price from peak to trough over three year period 1/1/2007 to 31/12/2009	
Company	(%)	Company	(%)	Company	(%)
Du Pont	-58.4	Cisco Systems Inc	-89.3	Alphabet	-65.3
Eastman Kodak	-62.1	Microsoft Corp	-65.2	Bank Of America	-94.2
General Electric	-60.5	JPMorgan Chase & Co	-76.5	Microsoft Corp	-59.1
Goodyear	-63.0	Intel Corp	-82.3	Merck & Co Inc	-65.5
IBM	-58.8	McDonald's Corp	-74.4	Coca Cola Co	-42.3
McDonalds	-72.4	Walt Disney Co	-68.2	JPMorgan Chase	-70.1
Motorola	-54.3	Oracle Corp	-84.2	Intel Corp	-56.8
PepsiCo	-67.0	Merck & Co Inc	-58.8	At&T Inc	-49.3
Philip Morris	-50.3	Boeing Co	-64.2	Cisco Systems Inc	-60.0
Polaroid	-90.2	IBM	-60.1	Boeing Co	-72.6
Sony	-80.9	Apple Inc	-81.8	Apple Inc	-60.9
Westinghouse	-83.1	Amazon Inc	-94.4	Amazon Inc	-65.3
Average	-66.75	Average	-74.95	Average	-63.45

Source: FactSet

The Value Opportunity

In summary, we do not believe that either the well-known shortcomings of the P/B ratio, nor poor relative earnings growth adequately explain the underperformance of value stocks over the last decade. We believe investors are buying a story about technology rather than looking at actual earnings growth, chasing the next Google, despite the fact that successes on a Google-sized scale are incredibly rare and almost impossible to predict. It all goes back to human psychology: People tend to think they know more about the future than they actually do. That's why those who have tried to predict the next explosive growth stock or industry in the past haven't had much luck and those paying high prices late in the boom have often experienced large losses.

Unless market analysts suddenly become much better at predicting the future, we doubt that the ultimate source of the value premium has disappeared. We believe betting against the strong, consistent, and well-documented track record of humans' inability to forecast the future represents the ultimate triumph of hope over experience.

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Notes

- 1 "Explaining the Recent Failure of Value Investing", Baruch Lev and Anup Srivastava, October 2019. Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3442539
- 2 In a January 2020 review of the US data by Robert Arnott et al, "Reports of Value's Death may be grossly exaggerated", the authors conclude that over 100% of the cumulative underperformance of value since 2007 was due to relative multiple changes. Value stocks became relatively cheaper by 4% pa (-39% cumulatively), resulting in 3% pa (-31% cumulatively) underperformance. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3488748
- 3 Perhaps it seems an overstatement to label a period of 11 years a generation, but given the short memory usually exhibited by stock markets, this may not be way off the mark.
- 4 For completeness, we note here that over the last 20 years, the average quality score of stocks held within our portfolio has been statistically indistinguishable from that of the index. This holds for the UBS quality scores and the quality factor used by various risk models, such as Axioma. We also do not like being associated with "low quality".

Important Information

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