50 shades of value

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The idea behind value investing is simple—less-expensive companies tend to outperform more-expensive companies in the long term. Investors have two main arguments why this investment style works: behavioral biases and risk premiums. Most investors focus on stocks with a narrative about future growth, thus making already undervalued stocks less expensive than they should be. Value stocks should also compensate investors for higher levels of risk given their attractive valuations. Despite these arguments, value as a factor has lagged the market over the last 10 years, but recent market activity is starting to point to a potential comeback in this investment style.

In our research, we recognize that there are many ways to define "value" in terms of fundamentals. Low price to earnings (P/E) ratios, high book to market values and high dividend yields would represent a few such examples of taking a metric and then tilting toward lower share prices as compared to that metric. Within US equities, we believe a dividend focus family represents a deeper cut of value because it removes zero-dividend-paying (growthier) stocks from the investment universe.

Dividend payers trailing, but is the trend reversing?

Dividend payers have been under pressure since late 2016. As of the end of December 2018, the MSCI USA Information Technology Index, generally constituted of non-dividend payers, had outperformed the dividend-heavy MSCI USA Utilities Index by more than 10% annually since 30 December 20161. In fact, the spread in trailing 12-month returns between non-dividend payers and the highest dividend-yielding quintile within the S&P 500 reached its 10-year maximum at the end of September. As can be seen in the chart below, the reversion to the mean has been quick, such as the last two times this difference in returns hit those levels, in 2003 and 2009.

Figure 1: S&P 500: Highest dividend yielders vs. non-dividend payers (Comparison of trailing 12-month rolling returns, measured quarterly)

Source: FactSet, for the period 31 December 2002 to 31 December 2018. You cannot invest directly in an index.

Historical performance is not an indication of future performance and any investments may go down in value

During the second half of 2018 and more magnified in the recent market sell-off, we've seen defensive sectors commonly associated with the value factor begin to outperform the growth sectors in the market. In the chart below, we show the log of re-based index levels for the MSCI USA Utilities and MSCI USA

Information Technology Indexes. This log chart allows us to visually compare the performance of both indexes over a given period by comparing the steepness in the lines. Comparing this chart to the one above, we can see that periods where non-dividend payers outperform the highest dividend-yielding quintile coincide with periods where the MSCI USA Information Technology Index outperforms the MSCI USA Utilities Index, having a steeper line. During October 2018, the MSCI USA Utilities Index outperformed the MSCI USA Information Technology Index by almost 15%2, and we can see that this outperformance began a few months ago as the blue line has been getting steeper while the gray line inverted.

Figure 2: MSCI USA Utilities Index vs. MSCI Information Technology Index

Sources: WisdomTree, FactSet, for the period 31 December 2001 to 31 December 2018. You cannot invest directly in an index.

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Conclusion: Momentum or value?

The concept of “mean reversion” has most likely not ceased to exist—even if we can all recognize that the “value” style is long overdue for some outperformance. There is little question that, as we approach the tenth full year of economic expansion since the last recession in the US, the US market is “late in the economic cycle.” Momentum - capitalizing on the continuance of an existing market trend - as an equity style may still have further to rally, but the reality of what we’re questioning if whether investors are beginning to believe that the next incremental dollar placed in US equities has a better chance of stronger performance being put toward “momentum” or towards “value.” We think that the balance of chances may be starting to favor value over momentum.

1 Bloomberg, as of 12/31/18.

2 Bloomberg, as of 31 October 2018.

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