Pzena Investment Management

Second Quarter 2013 Commentary

Despite a strong run, deep value stocks are still behind the market this cycle. An abundance of deeply undervalued companies gives us optimism that we are still in the early phases of recovery.

A Protracted Value Cycle

The history of deep value investing is one of long cycles which last on average approximately ten years. The initial periods are defined by underperformance versus the broad market, followed by even longer periods where deep value wins, resulting in meaningful deep value outperformance over the complete cycle. This margin has averaged 390 basis points per annum in the U.S. (Figure 1).

This cycle, however, has tested the patience of even the most committed value investor. Now six years and three months since the peak of the last value cycle in February 2007, deep value has yet to match the performance of the market. Using U.S. data for illustration, deep value has returned 3.0% per annum cycle-to-date, versus 4.6% for the S&P 500. By this time in all four previous cycles, deep value had made up all the underperformance of the cycle's early phase, and was outperforming the broad market cumulatively. This leads to the inevitable question: *Is it different this time?*

Figure 1: The Cycles of Value Investing in the U.S.

	Low Price-to-Book Stocks	S&P 500	Low Price-to-Book vs. S&P 500	# Months
Feb '69 - Jun '73	-8.3%	19.3%	-27.6%	53
July '73 - July '79	206.9%	30.4%	176.4%	73
Full Cycle Annualized	10.4%	4.3%	6.1%	126
Aug '79 - Nov '80	17.4%	45.6%	-28.3%	16
Dec '80 - Aug '88	414.7%	160.7%	254.1%	93
Full Cycle Annualized	21.9%	15.8%	6.1%	109
Sep '88 - Oct '90	-16.2%	25.1%	-41.3%	26
Nov '90 - Aug '95	247.9%	113.2%	134.6%	58
Full Cycle Annualized	16.5%	15.1%	1.5%	84
Sep '95 - Feb '00	71.8%	163.0%	-91.2%	54
Mar '00 - Feb '07	187.5%	15.5%	171.9%	84
Full Cycle Annualized	14.9%	10.1%	4.8%	138
Mar '07 - Nov '08	-56.3%	-33.4%	-22.8%	21
Dec '08 - June '13	176.3%	99.5%	76.7%	54
Full Cycle Annualized	3.0%	4.6%	-1.5%	75
Feb '69 - Current	**13.7%**	**9.8%**	**3.9%**	**532**

Source: Pzena Analysis

What's Different This Cycle

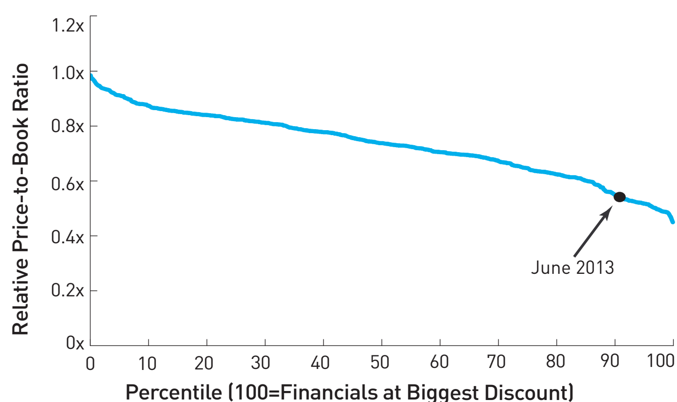
We would point to four major factors that have contributed to the prolonged nature of the current cycle:

- severity of the early part of the cycle (March 2007 - November 2008);
- permanent impairments suffered by value stocks during that period, particularly in financials;
- interruptions of the recovery in 2011 and 2012 by Europe's financial and sovereign debt crisis; and
- the normal dose of investor "disaster myopia."

This cycle's early days were defined by a severe financial crisis, with a wholesale sell-off of equities, and particularly deep stress in the cheapest quintile of stocks which was dominated by financials. Although the S&P 500 fell 33.4% over the 21 month period, deep value stocks declined by a shocking 56.3%. These losses included not only panic selling, but also reflected permanent capital impairments, mainly in the financial sector, due to bankruptcies and massively dilutive capital raises. Though the cycle hit bottom in November of 2008, it wasn't until the Fed stress tests of early 2009 when a tenuous confidence was restored to the markets, and the value recovery began.

Value stocks started recapturing their lost performance through early 2011, when the European sovereign debt crisis triggered another downturn in the markets. Deep value stocks were inordinately affected, as financials once again made up a large part of the cheapest quintile of stocks, still deeply depressed from the financial crisis. This time, however, financials generally fared better on a fundamental basis, having built up

Figure 2: Financials Valuations Remain at Historically Low Levels



Source: Empirical Research Partners

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capital and liquidity. The interruption in value's recovery, however, lasted until mid-2012 when the European Central Bank provided the markets confidence that they would use "all necessary means" to backstop the European financial system. Since August, 2012, the deep value index has outperformed the broad market, gaining 29.9% versus 19.2% for the S&P 500. During this time, however, investors fled to safety and quality, pushing up dividend yielding stocks to historically high relative valuations, leaving many economically sensitive stocks behind.

These returns are only part of the story of the value recovery. Although deep value has staged an impressive comeback, there is continued evidence of severe disaster myopia depressing the valuation of broad swaths of the investment universe. Disaster myopia, also known as "recency bias," is the phenomena that behavioral economists identify to explain why individuals assign an unrealistically high probability to a recent negative event reoccurring.

Financials are still the sector most severely impacted by this stubborn investor fear. At the depths of the financial crisis, financials were priced as if they would be going out of business. Though they enjoyed strong performance during the latter part of 2012, and so far again this year, their valuations still reflect a deep skepticism around growth and profitability (Figure 2). It is our sense that not enough time has yet passed for disaster myopia to have worn off; history, improving fundamentals, and human nature lead us to believe that this will eventually occur, and we are likely only in the early stages.

Reasons for Optimism

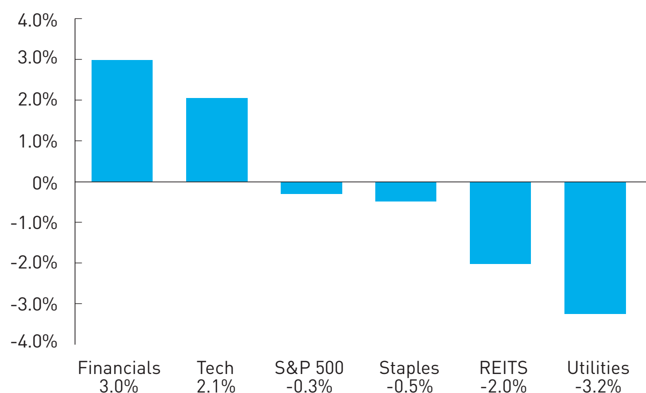
Though the lag of deep value over such an extended period can be discouraging, there is cause for optimism. As investors chased safety and stability in the wake of the U.S. and European financial crises, they left behind solid business franchises with strong balance sheets and high free cash flow that are sensitive to macroeconomic activity. To demonstrate this dichotomy, we analyzed earnings yields across a number of sectors as an indicator of valuation opportunity (Figure 3).

Although the earnings yield for the S&P 500 overall appears close to its average, there is a significant skew in the data, with "safe" sectors like utilities and REITS trading at yields well below history while financial and technology shares offer significant premiums. Despite recent strong returns, the financials sector remains deeply depressed, in the 93rd percentile of historical valuations (Figure 2).

The technology sector embodies both the promise and threat of a shift to tablet and cloud computing, creating opportunities for investors who are able to identify strong business franchises with the scale to harvest mature technologies and the resources to reinvest for the future. Twelve-month relative trailing price-to-earnings ratios are at the lowest point in 35 years (Figure 4), however, providing the disciplined investor an extraordinary opportunity to buy world-class franchises at considerable discounts. Many of these businesses are generating significant amounts of free cash flow and have solid balance sheets.

Consider Microsoft. The company currently has a 9.5% free cash flow yield despite being the largest software company in the world with a pristine balance sheet, generating $3.27 per share in free cash flow. Though the company faces challenges, investors overlook the company's undeniable strength in its enterprise software franchise which contributes 70% of earnings, and its responsiveness and determination to protect its consumer franchise. Even assuming low growth, we see the valuation as compellingly cheap.

Figure 3: Current Earnings Yield vs. Historical Average



Source: Capital IQ, Company Reports, Pzena Analysis

Figure 4: Relative Technology Valuations at Lows

Source: Bernstein Strategy Team (Zlotnikov)

Vast Stored Potential

The financial sector is a prime example of stubbornly strong disaster myopia among investors. Although we are finding very attractive opportunities across the sector (e.g., insurance companies, banks, investment banks, wealth management), nowhere is this more apparent than the U.S. banking industry. Despite significant improvements in safety and soundness, credit losses, and returns on equity, relative valuations continue to hover near the sector's historic low relative to the market. The possibility that we are at the threshold of a massive expansion in earnings, cash flow, and return of capital to shareholders in the banking industry remains unappreciated, presenting the long-term investor an extraordinary opportunity. To illustrate the point, we refer to our U.S. Large Cap Focused Value Portfolio, which we estimate has approximately 80% upside to reach fair value.

One of biggest drags on bank earnings for large deposit franchises has been compressed net interest margin (NIM), which is the spread banks earn between deposits and loans. Net interest margin has always been a key driver of bank earnings, but has been depressed by historically low interest rates. A good example is Bank of America. A rise in interest rates could be a huge boon to the company's earnings, as interest rates on loans tend to adjust upward faster than interest credited to their depositors. Today, Bank of America's NIM is 2.34%, versus an average of 2.96% since 2000. Just a return to the long-term average would have the effect of increasing the bank's earnings in 2012 by about $7 billion (all other things being equal) and would have increased the operating earnings per share from $0.79 to $1.39.

We see loan growth as another major driver of earnings for banks as the economy continues to mend and demand for credit increases. As capital ratios continue to build and regulations become more settled in the industry, we expect that these trends, coupled with a rising level of earnings, will translate into an increase in capital returned to shareholders either through dividends or stock buy-backs. Recognition of these improvements in the U.S. banking industry should yield an outsized return to shareholders.

Conclusion

Based on a careful review of the data, we believe the potential to earn significant returns in value stocks remains intact, and we appear to still be in the early stages of this value cycle despite its duration. Though the cycle has been both painful and protracted, we believe these investment opportunities are substantial, which should provide the raw material for strong returns for value over the remainder of the cycle. ■

DISCLOSURES

Past performance is no guarantee of future results. The historical returns of the specific portfolio securities mentioned in this commentary are not necessarily indicative of their future performance or the performance of any of our current or future investment strategies. The investment return and principal value of an investment will fluctuate over time.

The specific portfolio securities discussed in this commentary were selected for inclusion based on their ability to help you understand our investment process. They do not represent all of the securities purchased, sold or recommended for our client accounts during any particular period, and it should not be assumed that investments in such securities were, or will be, profitable.