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Panel Discussion Emphasizes Appeal of Value Investing

In early April 2016, the Brandes Institute hosted a Value Thought Leadership Summit in New York. The program featured a panel discussion on value investing that included:

- **Michael van Biema**
  Founder and Managing Principal, van Biema Value Partners
- **Charles Brandes**
  Founder and Chairman, Brandes Investment Partners
- **John D. Spears**
  Managing Director, Tweedy, Browne

In short, the panelists underscored their conviction in the benefits of the value approach. They acknowledged value stocks' recent struggles, but pointed to the philosophy's rational comparison of business value and stock price. They also stressed the need to think and act differently than most investors to generate market-beating returns and how behavioral biases continue to create opportunities for long-term investors.

The nearly 2-hour discussion, moderated by Brandes Institute Manager Bob Schmidt, included a number of multiple-choice polling questions posed to the nearly 100 institutional and private client investors and consultants who attended. Here are highlights from the conversation, select questions from attendees and panelist responses, and results from a couple of the polling questions.

Value investing has been out of favor for years. It would be easy to focus on what's "wrong," but what's "right" about value investing now?

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Spears: The idea of being able to buy into a business at a discount from a reasonable estimate of what an acquirer of that business would pay *always* has made a lot of sense. And it still does. This idea of low risk and a satisfactory return remains the basic premise. To us, value always makes sense because the future is unknown. Note that Benjamin Graham didn't say value offers market-beating returns every year.

Brandes: Everybody talks today about how different things are this time. It is different only in aspects of the information we can get and aspects of various investment techniques. But when you really come down to where wealth is produced in the world and how economies and businesses really operate, when you come down to how humans think short term and emotionally, nothing has changed. Value investing today is not any different than it has been for the last 75 years. It has been proven over and over again that in taking advantage of short-term thinking and behavioral aspects, value has worked very well.

van Biema: BlackRock recently did a study where they found that value stocks are selling at about a 35% discount around the world whereas the historical (10-year) average is on the order of 20%.[1] That's quite a difference. Value has become very, very cheap and one can hypothesize the reasons for that—part of it is the cheap money that's been available for quite a while, the search for yield and the move out of value and into higher-quality growth stocks. But I think it's encouraging to know that value is selling at a deep discount. I'd add to Charles' point: Sir John Templeton said the four most dangerous words in investing are "This time it's different." Value has not outperformed for an unusually long while, but do any of us believe the world has permanently changed? Hopefully, most of you are believers in Templeton's statement.

[1] As of March 2016. See page 10 of BlackRock's "Global Investment Outlook: Q2 2016," available here: https://www.blackrock.com/investing/insights/blackrock-investment-institute/outlook

An attendee asked, "Why haven't value stocks protected as much on the downside since 2007/2008? And will that reverse?"

van Biema: The underperformance of value has ceased this year [through the first quarter[2]] and that was after the Fed raised rates. That leads one to suspect that the very low interest rate environment is perhaps partially responsible for the lack of outperformance on the down side for value investors, but that's only a hypothesis. But there's no question that the very low rates have been causing a lot of money to flow into higher quality, higher growth stocks and that value stocks, which tend to be lower liquidity stocks, have been hurt by those flows.

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An attendee said, "So low interest rates are a headwind for value stocks. Given the action of various central banks around the world, won't rates continue to be a headwind for value?"

van Biema: Interest rates may stay low for a prolonged period and that will, to some extent, be a headwind for value stocks. But, again, it also tends to drive up the prices of so-called high-quality growth stocks—and it has driven them to a point where even the most confident investor is starting to question the multiples. The Shiller PE Ratio[3] in the United States for example is about 26x; the historical average is about 16.5x; so we're at about a 50% premium. That's a pretty hefty premium. It's my belief that eventually investors will wake up and say, "Hey, there is something wrong with this picture."

Audience members were asked to vote on their annualized return expectations for stocks over the next 10 years. Nearly half voted for "5% to 7%." That's looking ahead. Looking *back*, with value investing having been out of favor for so long, what have you told your clients?

van Biema: There's obviously been disillusionment among clients and concerns about performance, but what we tell our clients is if you look at 5-year rolling returns of value over a long period of time—and we do it from 1929 to the present—there have only been 11 times in that history of the U.S. market where growth has outperformed value.[4] In addition, when value outperforms growth, it typically does so for a much longer period and to a much greater extent. We tend to be apologetic to clients; I think that's probably a mistake. Chances are it's not the last time we will see value outperform growth.

Brandes: One of the other reasons that I believe value will continue to work is that it is very difficult to do. To think as a top investor you have to think differently than the majority of the investment world. You cannot think and accept what the conventional wisdom at the moment is. When thinking about future rates of returns, I think the majority of the opinions expressed here today are probably going to be wrong. And being an optimist, I think they are too low.

We always have pointed to the inconsistency of year-by-year results.

Spears: In terms of handling hot and cold periods of performance, we always have pointed to the inconsistency of year-by-year results. We are not perfect. For example, 1985 to 1990 was a crummy period, but the subsequent results were terrific. One of our colleagues did a study of all equity mutual fund returns over a 26-year period. At the end of the 26-year period,[5] 45% of the funds weren't in existence. But among the survivors, 10% of the funds outpaced the S&P 500 by 3.0% or more. Most of the funds that beat the market did so by less than 3.0% compounded. About 63% of the funds did not beat the market over the 26-year period. The 37% of funds that did beat the market over the entire 26-year period did so in about 51% of the years. This is just reality. We are truthful with our clients about the pattern of long-run satisfactory returns that we have observed: the long-run overall result is made up of returns from many slices of time—annual and multi-year periods of relative outperformance and annual and multi-year periods of relative underperformance—hot and cold periods of outperformance and underperformance as compared to a list of stocks that we don't own.

[2]According to FTSE Russell, the Russell 3000 Value Index gained 1.64% in the first quarter 2016 vs. a 0.34% gain for the Russell 3000 Growth Index. Since 2009, the Russell 3000 Growth Index had outperformed the Russell 3000 Value Index in five of the seven calendar years (2009 to 2015). Past performance is not a guarantee of future results. One cannot invest directly in an index.

[3]The Shiller PE ratio for the S&P 500 Index was 25.93 as of April 1, 2016; the historical mean is for the period January 1, 1881, to April 1, 2016. Data available at http://www.multpl.com/shiller-pe/

[4]Based on data for U.S. stocks provided by Prof. Kenneth French at his website: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data_Library/tw_5_ports.html. Analysis started on 10/1/1929 and ended on 12/31/2015. Value stocks defined as the quintile of stocks with the lowest P/B ratios; growth stocks defined as the quintile of stocks with the highest P/B ratios.

[5]"What is 'Good' Long-Term Investment Performance in Relation to Index Returns? How Often Have Market-Beating Funds Beaten (Or Been Beaten By) Year-by-Year Index Returns? A Study of the Investment Returns of Mutual Funds with 26-Year Track Records (January 1, 1975 through December 31, 2000) in Relation to Index Returns." by Tweedy, Browne Company LLC.

We tell our clients that we expect that favorable long-run results will continue to be comprised of annual returns that exceed benchmark returns on average, but certainly not in every year, and not in every single three-year or five-year or 10-year slice of time. Value investing has worked pretty well on average over long periods of time. The theory of buying into businesses at prices that are much less than what the businesses are truly worth makes a lot of sense to us. The theory, which guides us into a future which is always unknowable, combines low risk with the prospect of a satisfactory return. Seems like a sensible way to make some money, and to, hopefully, beat benchmarks—at least some of the time.

Underperformance and bouts of stock market volatility tend to trigger investor fears. What are your views on the relationship between price volatility and risk?

Brandes: One thing I have been talking about lately is how public and corporate plans believe they need to go a lot more heavily into private equity because they believe it's not as volatile—using the definition that is pervasive these days in the institutional investing world—that volatility *is* risk. Well, I would disagree very heartily with that. You might not have the same opportunities in private equity because, as John said, the public markets give you great opportunities to buy businesses at significant discounts. In private equity, you don't get those discounts.

And just so people understand, I wouldn't be completely against private equity investing because there is an element to it that makes sense from the fundamental standpoint of investing in businesses that create wealth. You just have to consider that private equity often uses leverage—which I find more risky. Private equity also has liquidity risks. In 2008 and 2009, we were a money manager that had a great deal of liquidity in our portfolios. Many clients needed liquidity and they ended up selling assets we purchased on their behalf because we were one of the few places where they could *find* liquidity. So there are a lot of risks that are not recognized when you look at so-called volatility as a risk.

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Spears: Think of a stock's intrinsic value as collateral against which a bank might lend money. For example, I buy a stock for $70, but think it's worth $100. What does it mean if the price drops to $50? If the business hasn't changed, it's just market movement; it's an opportunity. At $70 your "coverage" of intrinsic value to price is about 1.5 to 1. At $50, it's 2 to 1. From this perspective, it actually gets safer as the price goes down.

van Biema: You have less volatility in private equity because your book isn't marked every day. There may be a lot of volatility in the actual valuation of your private equity portfolio that goes away because the book is only marked occasionally. On the relationship between risk and variance, if you all imagine a simple graph of a sine wave equally distributed across the x axis, that wave has a certain amount of volatility. According to modern financial theory, it has a certain amount of risk. But what if you take that sine wave and shift it up above the X axis so there is no possibility of loss capital? But the risk of that sine wave is the same of the first one. It kind of shows you the absurdity of thinking about risk as volatility.

When asked to vote on whether global markets today are more efficient than they were 10 years ago, 43% of attendees said no; 40% said yes; the remaining votes were split between "It depends on the market" and "I'm not sure."

Brandes: Think back to 2008/2009; was the market more efficient with the S&P 500 Index at 600? You see the fluctuations in valuations over the last 10, 15 or 20 years—markets are no more efficient today. And I don't think that will change in the future. There's a lot more information available, and that information for us, as fundamental investors, is very good to have. But I don't think that information is being used correctly and it's not making markets more efficient.

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van Biema: There are certainly lots of instances of inefficiency that you can point to in less developed or emerging markets. On the other hand, if you go back and look at supposedly the most sophisticated market and presumably the most efficient market, which is the U.S. market, you see things like biotech stocks up 75% in 2013 and 33% in 2014 and, I believe, something on the order of 15% through July 2015. After that, they fell off a cliff.[6] It's very hard to believe that those types of price increases and that short-term price drop are the outcome of operating in a really efficient market. Even in the United States, we have ample evidence that things aren't that efficient.

[6] Biotech stock returns based on calendar-year results for the S&P Biotech Index Sub Industry Index GICS Level 4 (S5Biot Index). The "through July 2015" period reflects returns from 12/31/2014 to 7/31/2015. From 7/31/2015 to 4/30/2016, the Index fell 18.2%. Past performance is not a guarantee of future results. One cannot invest directly in an index.

If global markets are not efficient, where are you finding attractive investment opportunities?

van Biema: An area we are very interested in is Japan. We can buy stocks at a 40% discount to where the Japanese market is trading—and that's already at a substantial discount to much of the rest of the world. We are finding companies in Japan with huge net cash positions and are selling at huge discounts. Also there is much more focus on corporate governance. A number of large companies have made major governance changes recently. Those changes tend to filter down through Japanese society.

Some of the Asian markets like South Korea and Japan are pretty cheap.

Spears: We study them one at a time. Certain industries like industrial gas have attractive business characteristics such as a very stable annual income pattern. In acquisitions, industrial gas companies have often been sold at around 10 times EBITDA (earnings before interest, taxes, depreciation, and amortization) before the deduction of interest-bearing debt. Using this valuation standard, we recently bought into an industrial gas business that was priced at a 30% discount to our estimate of its net value to stockholders. If you look at statistics on individual companies in markets around the world, some of the Asian markets like South Korea and Japan are pretty cheap. I think it's hard to be an activist in Japan. There are essentially no unfriendly takeovers in Japan and there is very little merger and acquisition activity. There are a number of companies in Japan that have been sitting forever at very cheap prices in the stock market—trading in the market at half of the company's net cash and earning a very low return on equity. Many management teams in Japan seem not to care about shareholder value or their company's stock price in relation to underlying value. Corporate culture, governance and laws in Japan make it difficult to unlock shareholder value through an acquisition, liquidation or proxy fight. We take that into consideration.

[Later that afternoon, Brent Woods, Brandes Investment Partners CEO, and Ken Little, Managing Director, Investments, highlighted the following areas that they believed offered attractive opportunities: financials (especially in the United States), oil and gas and select emerging market companies.]

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Diversification does not assure a profit or protect against a loss in a declining market.

The margin of safety for any security is defined as the discount of its market price to what the firm believes is the intrinsic value of that security.

Price/Book: Price per share divided by book value per share.

Price/Earnings: Price per share divided by earnings per share.

Yield: Annual income from an investment (dividend, interest, etc.) divided by the current market price of the investment.

The S&P 500 Index with gross dividends measures equity performance of 500 leading companies in industries of the U.S. economy.

The S&P Biotechnology Select Industry Index comprises stocks in the S&P Total Market Index that are classified in the GICS biotechnology sub-industry.

The Russell 3000 Value Index is a market capitalization-weighted index that includes stocks from the Russell 3000 index with lower price/book and lower expected growth rates.

The Russell 3000 Growth is a market capitalization-weighted index that includes stocks from the Russell 3000 index with higher price/book and higher forecasted earnings.

Shiller Price/Earnings: Inflation-adjusted 10-year average price per share divided by earnings per share.

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