PRICEVALUEPARTNERS

**About time**

"**Breezy rhetoric**

You stated that Britain remains the world leader in offshore-wind power ("Hull of a wind behind it", September 16th). That would be contested by the Danes and the Germans who supply Britain with the turbines, the Italians who make the cables, the French who provide everything but the turbines, and the Dutch who install them. The subsidy, however, is 100% British.

A.J.MACKINNON
*Ely, Cambridgeshire*"

- Letter to The Economist, 30 September 2017.

**Eleven years before** its more notorious prison experiment, Stanford University introduced the world to a subtler but just as intriguing exercise – a landmark study in delayed gratification known now as the Stanford Marshmallow Experiment. Children aged between four and six were taken into an empty room, then presented with a treat of their choice – a cookie, marshmallow or pretzel. The children were allowed to eat this treat, but were told that if they could wait for 15 minutes without giving in to temptation, they would be rewarded with a second tasty reward.

A minority of children gave in to temptation almost immediately. They would go on to become investment bankers[1]. Or politicians[2]. Of those who tried to withstand temptation, one third displayed enough willpower to earn the second treat. They would go on to become successful value investors[3].

In follow-up studies, those children who possessed special discipline were described by their parents more than 10 years later as "adolescents who were significantly more competent". It also transpired that the ability to delay gratification correlated with higher SAT scores.

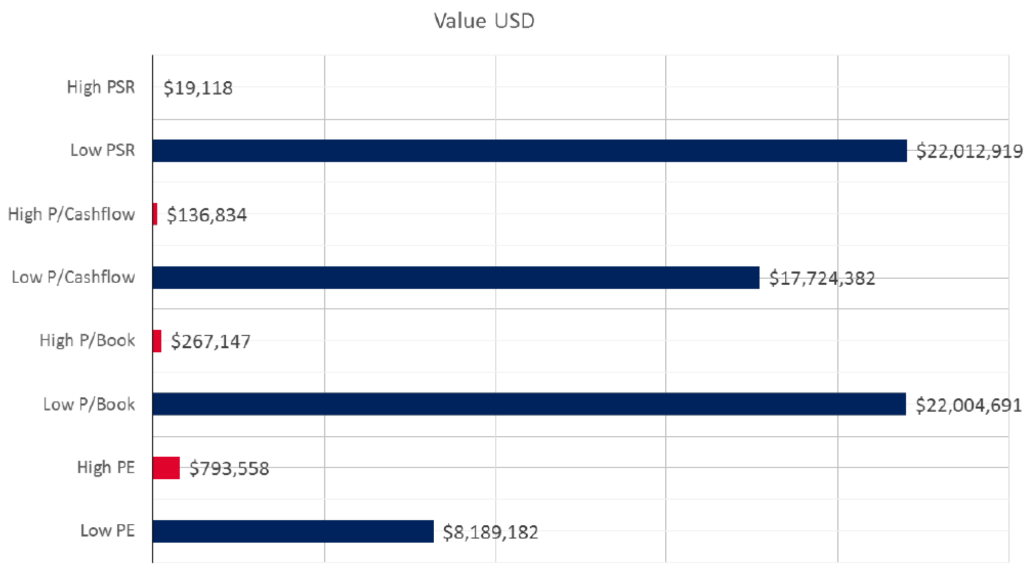
There are quantitative aspects of investment analysis that can be taught. How to read a balance sheet, for example, or the comparative significance of various earnings or revenue metrics. But there are some aspects of the investment process that cannot easily be taught, and having patience may be the most important. The famed Canadian value investor Peter Cundill once remarked,

> The most important attribute for success in value investing is patience, patience and more patience. THE MAJORITY OF INVESTORS DO NOT POSSESS THIS CHARACTERISTIC.

An example. James O'Shaughnessy in his book *What Works on Wall Street* performed the following analysis. For a period of over 50 years, he retrospectively selected the 50 stocks from the broad US market displaying the most expensive attributes by a variety of different metrics and the 50 stocks that were cheapest by those same metrics. He selected by price / sales ratios (PSR), by price / cashflow, by price / book, and by price / earnings. He then rebalanced these holdings annually, so that those 50 stock portfolios were continually either the cheapest, or most expensive, by category. The results are shown below.

**Value investing**

**Value of $10,000 invested in various strategies for the 52 years ending in December 2003**




Source: What Works on Wall Street by James P. O'Shaughnessy

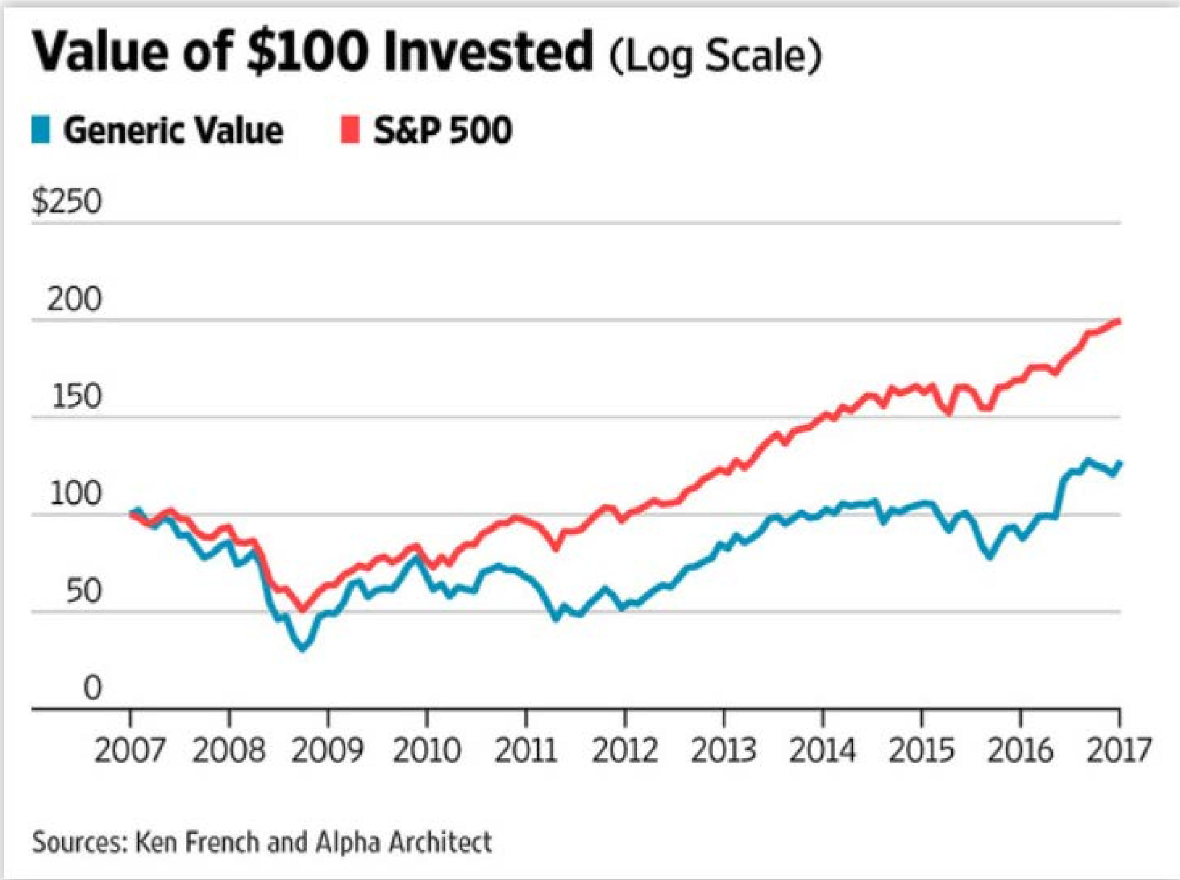
Take price / book – an assessment of whether a stock is trading above or below that company's inherent value (inasmuch as book value reflects that). A 'growth' portfolio with a starting value of $10,000 invested in the 50 highest price / book stocks would, after 52 years, be worth $267,147.

This sounds like a decent return until you see how a portfolio of $10,000 invested in the 50 ***lowest*** price / book stocks would have performed. The 'value' portfolio of $10,000 would, after 52 years, be worth $22,004,691. Select metric (growth or value). Pay money. Take choice. Some investors might prefer $267,000 over $22 million, but we are not among them. We would prefer to be long term greedy.

Time for two caveats.

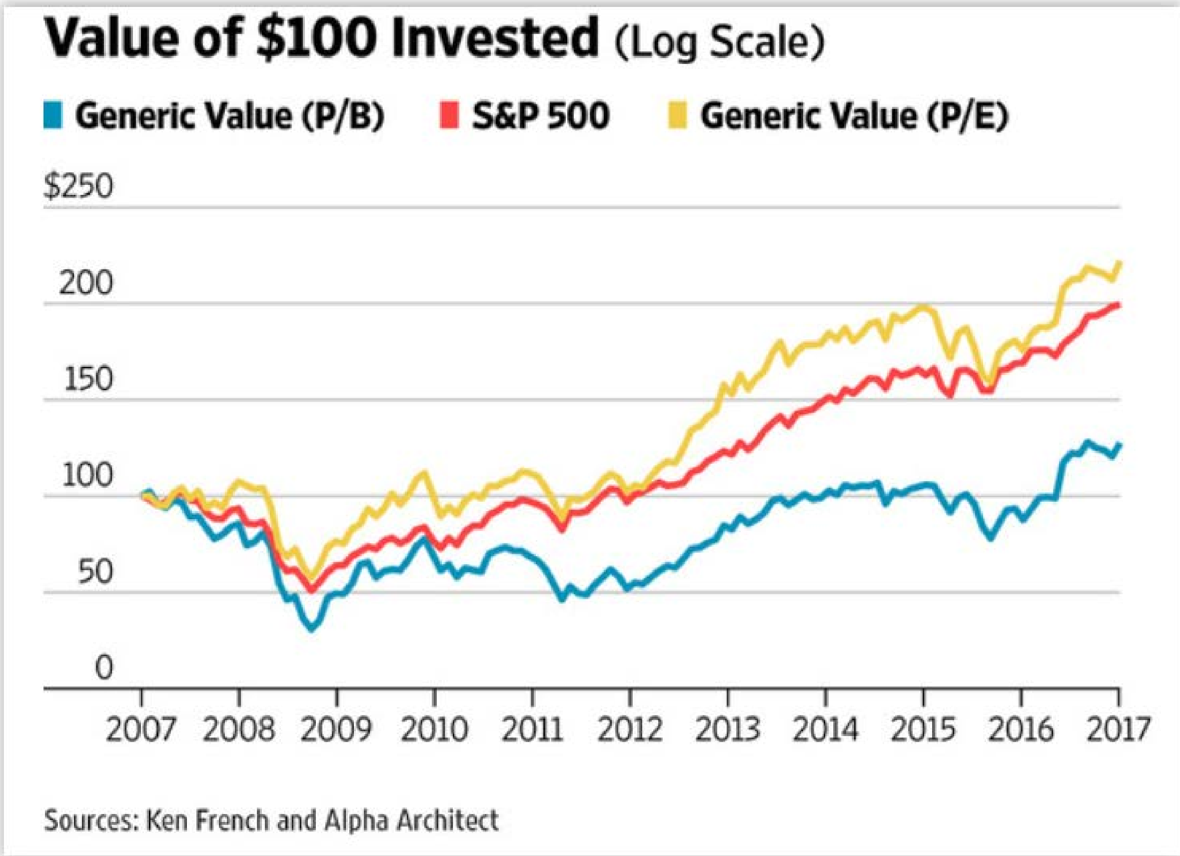
1: As Wesley Gray points out, there are periods when 'value' underperforms:

Over the last 10 years (June 1, 2007 to June 30, 2017) a generic portfolio of the cheapest stocks (labelled "Generic Value (P/B)" in the chart below) based on price-to-book ratios earned a compound annual total return of 2.44%, compared with the S&P 500's total return of 7.10%. And to make matters worse, the generic value portfolio achieved the returns with nearly twice the volatility (29% vs. 15% annualized).




Why did 'value' perform so poorly during the period in question ? Primarily because 40% of the 'value' portfolio was concentrated in financial stocks. (Conclusion: diversify.)

As Gray (and O'Shaughnessy) point out, price / book is only one of the metrics investors can use to assess comparative value. When expressed in the form of price / earnings ratios, 'value' actually outperformed the broader market over the same period:




Clearly, 'value' can be different things at different times to different people. As Gray rightly observes,

> The debate as to why value investing generates higher expected returns than other forms of investing will rage on, but one thing is clear: Value investing is extremely painful and difficult to hold through thick and thin.

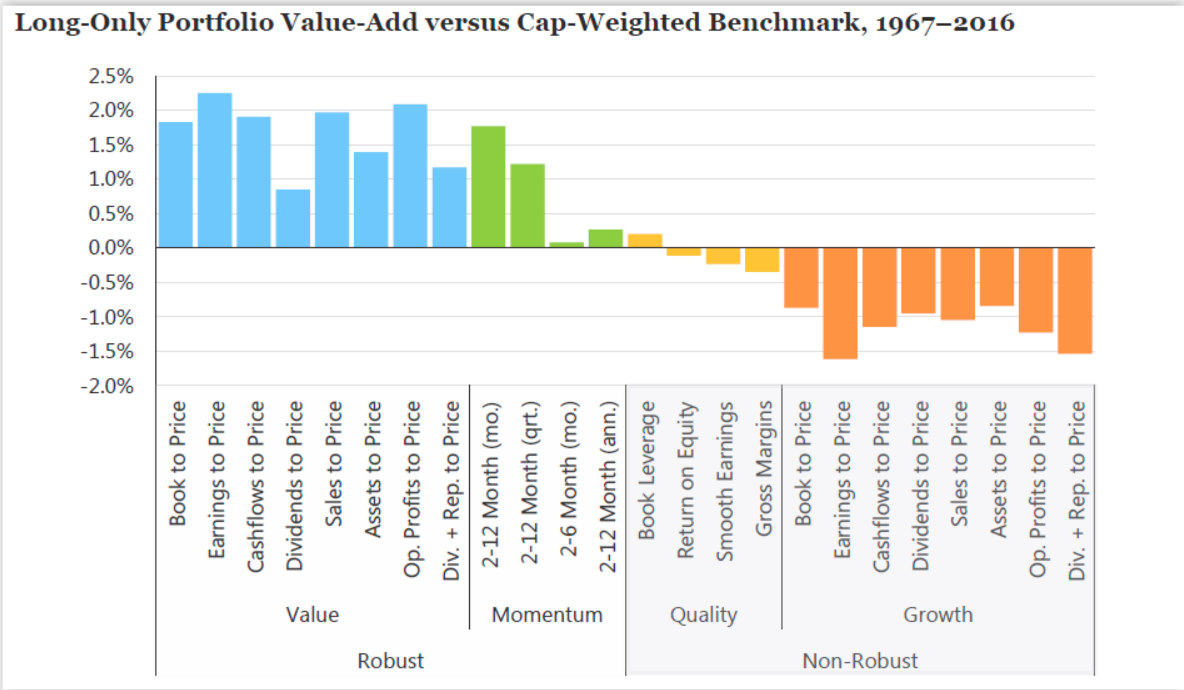
The investment journalist and author Jonathan Davis puts it slightly more bluntly:

> Periods of excruciating short-term underperformance are a burden that all genuine value investors have to endure.

In other words, ***no pain, no gain***.

2: In an intriguing supplement to these observations, Research Affiliates came out with an extraordinary article earlier this year, How not to get fired with smart beta investing, written by John West, Vitali Kalesnik and Mark Clements.

In the first instance, the authors demonstrated, similarly to O'Shaughnessy, that certain investment strategies and metrics led to sustained outperformance over time:




Source: Research Affiliates LLC, based on data from CRSP and Compustat.

Both 'value' and momentum strategies generated superior returns relative to the market, for the period 1967-2016. Interestingly, 'quality' and 'growth' ended up ***destroying*** investor returns relative to the market over the same period.

But their final observation was a killer. Despite the strong evidence that 'value' is the best performing investment strategy over the longer term, ***an adviser who recommends only value strategies has the highest chance of being fired by his client***. This is primarily because different 'value' strategies (e.g. price / book and price / earnings) are highly positively correlated, so that when one underperforms, they all tend to.

Our conclusions from the above, and in relation to the current market environment:

- "Investing" on the basis of predicting future market direction is always a waste of time, but is unusually dangerous when central banks are more than usually dominant in manipulating market prices, and thereby herd thinking, by way of monetary stimulus;

- When most stock markets look expensive on the basis of any historical analysis, it only makes sense to invest in defensive value, which must then be genuinely diversified;

- If you're unwilling to play a long game, you probably shouldn't be in the market in the first place.

Whether by way of geopolitics, the interest rate outlook, the economic growth outlook, or prevailing market valuations, this is shaping up to be an astonishingly challenging investment environment. We clearly believe in value.

Patience, however, may not just be virtuous now, but absolutely essential.

[1]This is a lie.

[2]So is this.

[3]And this. But it ought to be true, and probably is.

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