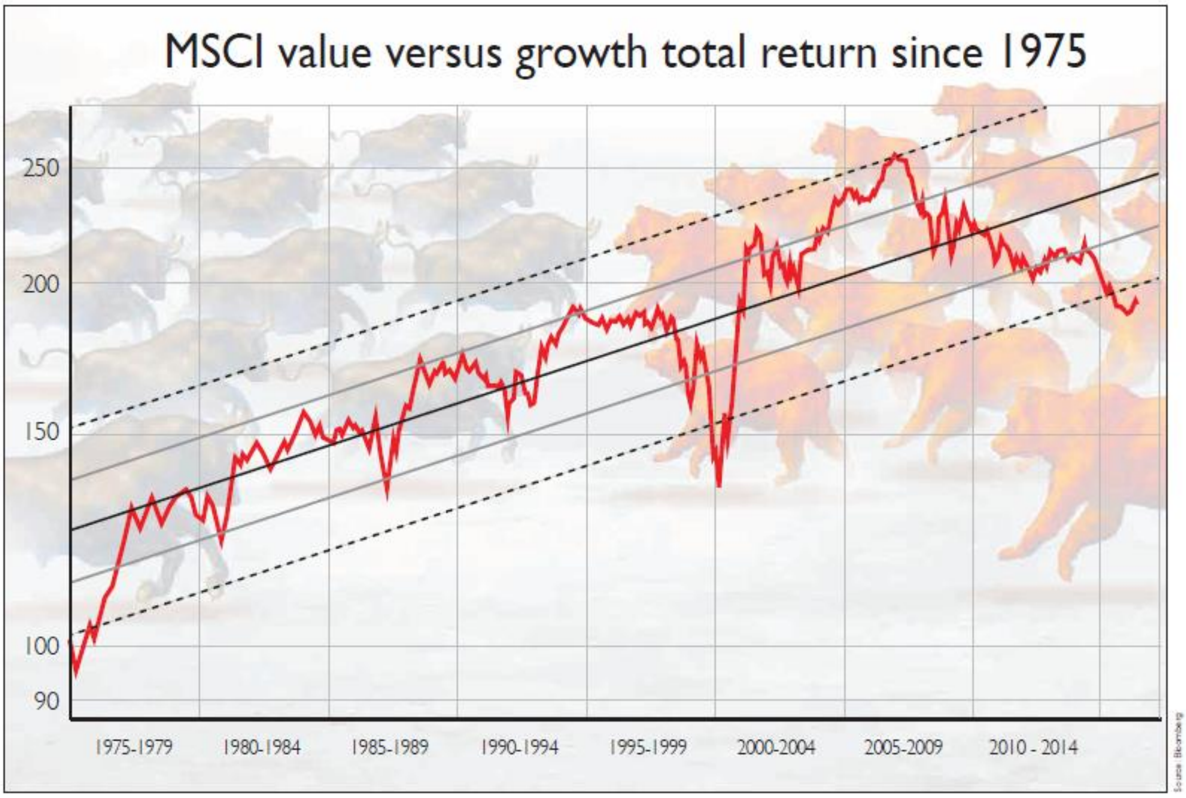
Opportunity knocks **23 May 2016**

"Value investing works. Buy bargains."

- Seth Klarman.

"If I could show you just one chart to illustrate the most important investment theme of 2016," asks Charlie Morris in the current issue of MoneyWeek, what would it be ? Not the dollar or the price of gold. It would be this:



This log scale chart shows how value stocks worldwide have fared by comparison with growth stocks since 1975. "When the red line is falling, value stocks are underperforming compared to growth, and vice versa when the red line is rising."

As the chart plainly shows, since 2007 value has underperformed growth. More to the point, value stocks now look exceptionally cheap, whereas growth stocks look particularly expensive.

"..as value investor Rob Arnott of Research Affiliates points out, in the three years to March 31 this year, value stocks in the MSCI World index underperformed growth stocks by nearly 11% – one of the worst showings since 1976. As a result, value now looks cheaper compared to growth than at any time other than during the last two mega-bubbles – the credit bubble that burst in 2008 and the dotcom one of 1999. That spells opportunity. As

Arnott says, experience shows that ***starting valuations similar to those we see today in value stocks have historically led to prolonged, massive outperformance**.*"

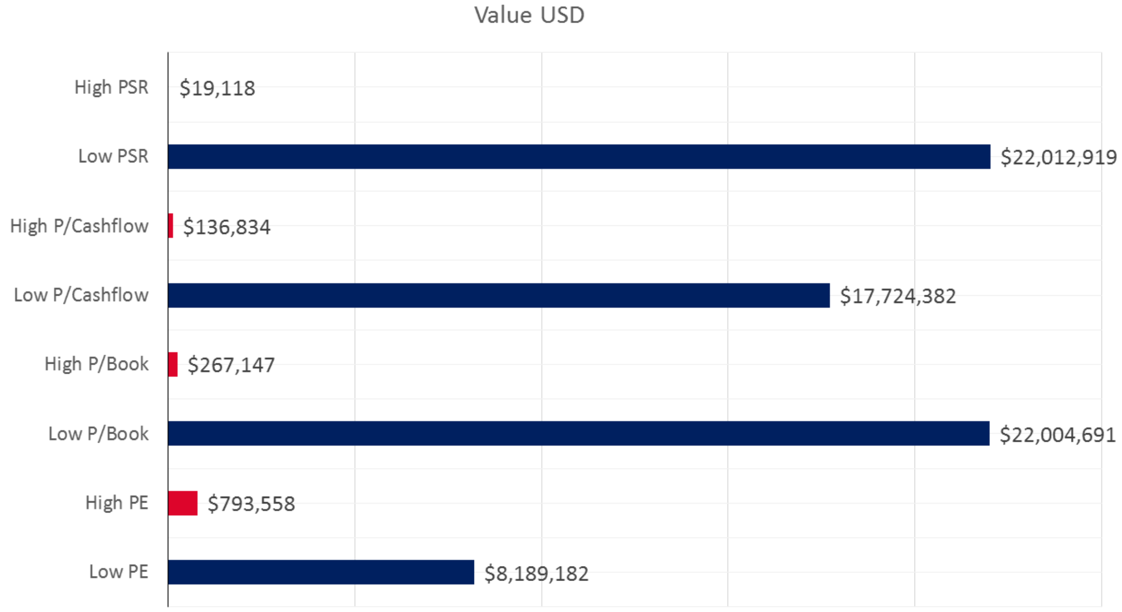
But value means different things to different people. To us, it means high quality businesses with an exceptional history of shareholder returns trading at well below their inherent worth, wherever in the world they might be available. To MSCI, on the other hand, the single largest components of their World Value Index comprise businesses like Microsoft (on a p/e of 23), Exxon Mobil (on a p/e of 28) or General Electric (on a p/e of 30). Those valuations are a little too 'growth'-like for our tastes. And if those businesses look suspiciously North American in origin, that's because they are: fully 59% of the MSCI World Value Index is accounted for by US stocks. Admittedly, the largest members of the MSCI World Value Index are not as flamboyantly expensive as those of its World Growth Index, like Facebook (on a p/e of 73) or Amazon (on a p/e of 289).

MSCI's 'value' businesses are also typically gigantic. GE has a market cap of $272 billion. Exxon Mobil sports a market cap of $372 billion. Microsoft enjoys a market cap of over $400 billion. We doubt whether genuine value opportunities will be as well recognised, and as widely covered by the research community, as these corporate leviathans.

Capital growth is one thing. Capital preservation is another. A recent report from the McKinsey Global Institute ('Diminishing returns: why investors may need to lower their expectations') suggests that the last three decades have been a golden age for investors; absent extraordinary developments in corporate profitability and perhaps the simultaneous onset of widespread deflation, future returns from both equities and bonds are likely to disappoint anyone used to the 7.9% annualised real returns generated by US and European stocks between the years of 1985 and 2014. Investors may find that the 'margin of safety' now offered by true value stocks trumps whatever prospects for future returns reside within the rest of the market – which might indeed be negative.

The investment case for value over the longer term is compelling. The following chart shows the returns from an initial portfolio of $10,000 invested in the 50 most expensive and the 50 cheapest US stocks as assessed by a variety of corporate metrics, such as price / sales, price / cashflow, price / book and price / earnings, for a period of over 50 years. Those 50 stocks are then rebalanced once a year to ensure that the portfolio continually captures the 50 most expensive, or cheapest, stocks.

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



Source: *What works on Wall Street*, James O'Shaughnessy

The bottom line ? If you had invested your $10,000 in the 50 stocks with the highest price / book ratio in the US market, you would ultimately have ended up with $267,147. That sounds impressive, until you realise what you could have earned by owning the 50 stocks with the *lowest* price / book ratio in the US market, whereby your $10,000 ended up being worth over $22 million. As Seth Klarman says, value investing works.

But you need to be patient. As Charlie Morris' article points out, value investing has much in common with contrarian investing, and human beings are simply not hard-wired to run apart from the herd.

I remember that 1999/2000 divergence between value and growth very well. Working then at Merrill Lynch, we identified a classic value opportunity in the form of shares of the savings and loan company Washington Mutual. The company had experienced 17 consecutive quarters of rising dividends; the most recent earnings quarter had been a company record; the stock was trading on a p/e of around 3. As investors at the time were obsessed with all things dotcom, all things *not* dotcom were being given away, shares of Washington Mutual among them. Over the next 12-18 months we ended up tripling or quadrupling our money on the stock. Washington Mutual is sadly defunct now, but back then it provided a great example of the power of contrarian, value investing.

Growth stocks have had a good and almost unprecedented run. It's time to cast the net wider. Unconstrained global value probably isn't the worst idea in the world.

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