The most dangerous word in investment

"China's surplus capacity in steelmaking, for example, is bigger than the entire steel production of Japan, America and Germany combined."

- The Economist magazine, February 27th, 2016.

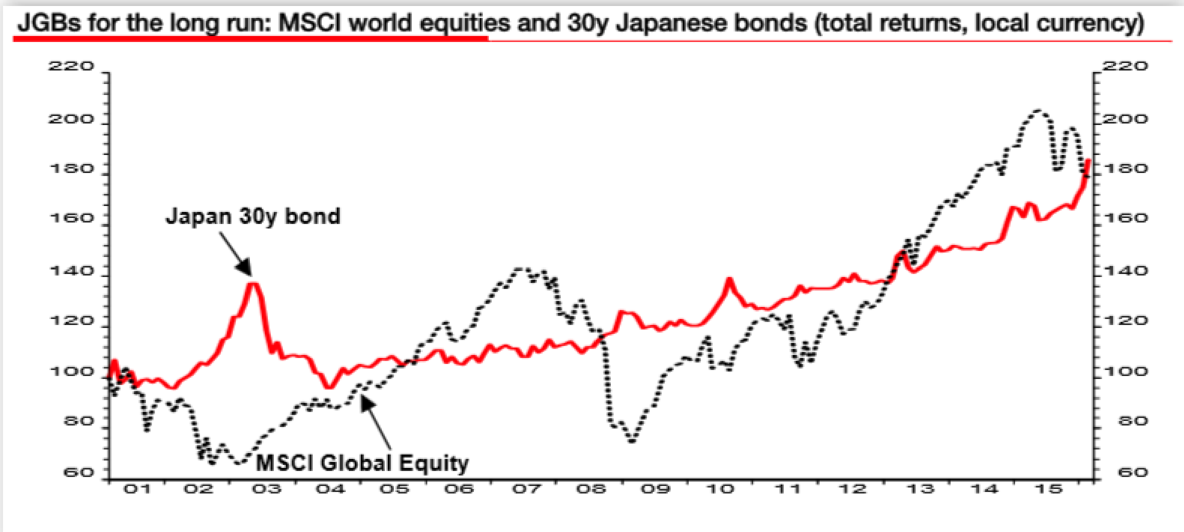
What is the most dangerous word in investment ? Is it a name, perhaps ? "Krugman." "Wolf." "Yellen." "Draghi." "Carney." "Goldman." "Sachs." Crowded field, admittedly. Could it be a phrase ? "Smart beta". Or the acronym "ETF" (a.k.a. "Just get me in at the top of the market, for God's sake, and lock me in 1:1 all the way down, just as long as my annual management fee is relatively low"). These are all plausible candidates. But we think it's a one-word answer: "***extrapolation"***.

Let there be no misunderstanding on this point. We are living through a golden age of absurdity. Bloomberg recently reported that US Treasuries had just beaten stocks over a period of 30 years. The last time that happened was in 1861. (The American Civil War had just begun. The Pony Express had just gone to live on a farm. The first industrial meat packing plant had just been established at Fray Bentos in Uruguay, a name we once thought was that of the inventor of the vacuum-sealed steak and kidney pie.)

SocGen's Albert Edwards makes a similar observation:

"Name me a major asset that has not seen one single year-on-year decline since the start of 2007? Clearly not equities or commodities. What about bonds? Again, clearly not corporate bonds. What about 10-year government bonds? I'll give you a clue. It's not the US, UK or Germany, all which saw negative year-on-year returns, most notably in 2013. The only major asset to have seen continuous positive year-on-year returns since before the Global Financial Crisis is 10-year Japanese bonds, now yielding -0.06%. In a world of negative policy rates, I am scratching my head as to where, if anywhere, yields will bottom. Why bother with global equities when you can own the JGB ?"

(See chart below.)



(Source: Datastream, Societe Generale Cross Asset Research)

Take that, Jeremy 'Stocks for the long run' Siegel !

But one of the problems with the fund management industry is that it cannot see a long-established bandwagon without wishing to throw together a product whose future investment success is wholly dependent on that bandwagon rolling on into the indefinite future.

Enter the Frankenstein's Monster known as "Smart Beta".

In a recent research piece, Research Affiliates ask the question, "How can 'Smart Beta' go horribly wrong ?" (Our answer: by aggressively promoting back-tested strategies that look fine on paper and on the back of perhaps many years of specific (freakish) returns, but that will disintegrate on first contact with mean reversion.)

We clearly come not to praise 'Smart Beta', but to bury it. But there is some good news for investors within Research Affiliates' article. The authors ask a secondary question:

"How many practitioners who rely on the value factor take the time to gauge whether the factor is expensive or cheap relative to historical norms? If they took the time to do so today, they would find ***value is currently cheaper than at any time other than the height of the Nifty Fifty (1972– 73), the tech bubble (1998–2003), and the global financial crisis (2008–09)."*** [Emphasis ours.]

Value is as value does, but we would attempt to define it straightforwardly, if somewhat simplistically, as buying dollar bills for forty cents.

In his book 'What works on Wall Street', James O'Shaughnessy analysed a variety of strategies that delivered market-beating returns in the US stock market.

Value investing proved to be one of the most outstanding.

O'Shaughnessy took a variety of metrics – the price / sales ratio (PSR), price / cashflow, price / book and price / earnings – and then collated the 50 stocks from the broad US market which displayed the highest, and lowest, for each metric. He then annually reweighted his two lists, and ran this portfolio of 'growth' and 'value' over a period of 52 years, ending in December 2003 (shortly before the third edition of his book was published in 2005).

The results of O'Shaughnessy's experiment are shown below.

(Source: 'What works on Wall Street' by James O'Shaughnessy)

Your hypothetical $10,000, starting 52 years ago, invested in the 50 stocks with the highest price / sales ratio (PSR) compounded up to $19,118. That may seem like a pretty good return, until you see what you could have won, by owning the 50 stocks with the ***lowest*** price / sales ratio from the same market. Your hypothetical $10,000 ended up with a terminal value of $22,012,919. Did someone say 'value beats growth over the longer term' ? Similar outperformance comes whether you're assessing stocks by price / cashflow, price / book, or price / earnings. In each case, over the longer term, 'value' doesn't just beat 'growth'. It wipes the floor with it.

Perhaps the 52-year period in question was a statistical anomaly. But we doubt it. More likely, the statistical aberration is the recent outperformance of bonds versus stocks, ***during an environment in which the supply of bonds has never been higher in recorded human history***.

The perversity of the O'Shaughnessy study is that it flies in the face of the idea that markets are rational or efficient. Logically, by taking more risk – in paying up to own 'growth' stocks at higher multiples than the market average – one should expect to achieve higher returns. But O'Shaughnessy shows that this didn't happen.

Which highlights the attractiveness of 'value' as an investment strategy at a time when many equity markets have become, in our view, unsustainably expensive as a result of monetary stimulus and the success – so far – of 'Smart Beta' and 'growth' strategies. 'Value' investing typically offers investors what Benjamin Graham called a "margin of safety", on the basis that high quality companies are being bought at a discount to their inherent value. 'Growth' stocks, on the other hand, are clearly being bought at a premium.

The renowned 'value' investor Seth Klarman once said,

"The hard part is discipline, patience and judgment. Investors need discipline to avoid the many unattractive pitches that are thrown, patience to wait for the right pitch, and judgment to know when it is time to swing."

With bonds now being essentially an uninvestable asset class, now is the time to swing. But only for the right kind of stocks.

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