Miles Capital
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Value Investing

Understanding the Difference Between Price and Value is the Core Principle of Value Investing

Imagine if on your way home from work you pull into your neighborhood and spot two lemonade stands on either side of your street. Both are offering a cup of lemonade for only a quarter. It's a sweltering hot summer day and you are feeling especially parched, so you can immediately recognize the intrinsic value of these products.

However, upon closer inspection, you identify some key differences between these two burgeoning operations. One is made with ice cold, filtered water, freshly squeezed lemons, and grandma's homemade simple syrup. The other is made from a giant container of powdered lemonade mix and water from the garden hose on the side of the house (using questionable proportions). The price is the same. The value, not so much.

Price Is What You Pay… Value Is What You Get

Understanding the difference between price and value is the core principle of value investing. Popularized by famous investors such as Benjamin Graham and Warren Buffett, value investing seeks out stocks of strong companies thought to be undervalued by the market and advocates holding them for the long term.

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Value investing is not just about buying stocks at a low price and selling them at higher price. Whereas price can vary wildly depending on the emotions of the crowd, value investing is like buying quality merchandise when it is marked down. Value investors purchase stocks in companies with excellent management and business with a good pattern of growth in the long run.

Value Investing

Value investing is often contrasted with growth investing, a strategy primarily focused on the growth of an investor's capital. Growth investors generally invest in companies whose earnings are expected to grow at an above-average rate compared with its industry or the overall market.

Value stocks have historically presented less risk than the broader market.

Many investors have astutely noticed that value has underperformed over the past several years, sometimes rather significantly, and have wondered whether value investing still makes sense in today's environment.

At Miles Capital, we offer both growth- and value-oriented strategies, and we do not generally believe clients should be all-in on either strategy. Both approaches have a place in a diversified portfolio, although clients may prioritize one or the other based on their specific needs.

We believe that despite recent headwinds, value remains a strong investment strategy. While it's impossible to predict when value is going to turn around, there are a number of long-term benefits to the strategy. Additionally, the space may be well-positioned for an upswing and warrants a closer look by investors — particularly those who prefer the lower volatility and dividend income stream that value stocks frequently offer.

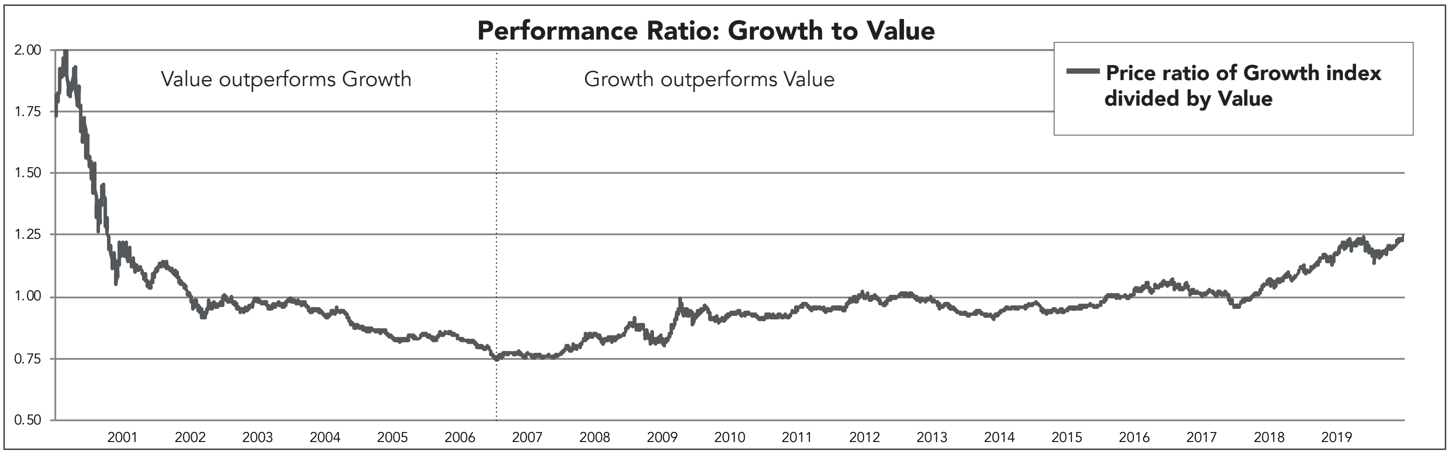
Characteristics of Value

Value stocks are generally lower "priced" — based on both price-to-earnings (P/E) ratio and price-to-book (P/B) ratio — compared with overall markets. They also have historically presented less risk than the broader market. This is why investors, both individuals and institutions, targeting lower downside volatility and interested in regular cash flows often have a value tilt.

Most often value stocks are the stock of established companies with a consistent business, and often, though not always, pay out part of their earnings to shareholders in the form of dividends. Prominent examples of value stocks include JPMorgan Chase, Cisco, Pfizer, Wells Fargo, Johnson & Johnson, Walmart, and AT&T.

There's a wealth of research showing that value stocks have outperformed the market over extended periods of time, but this is not the case in every cycle. From 2000 to 2006, value outperformed growth, while growth outperformed value from 2006 to 2018 (see chart 1).

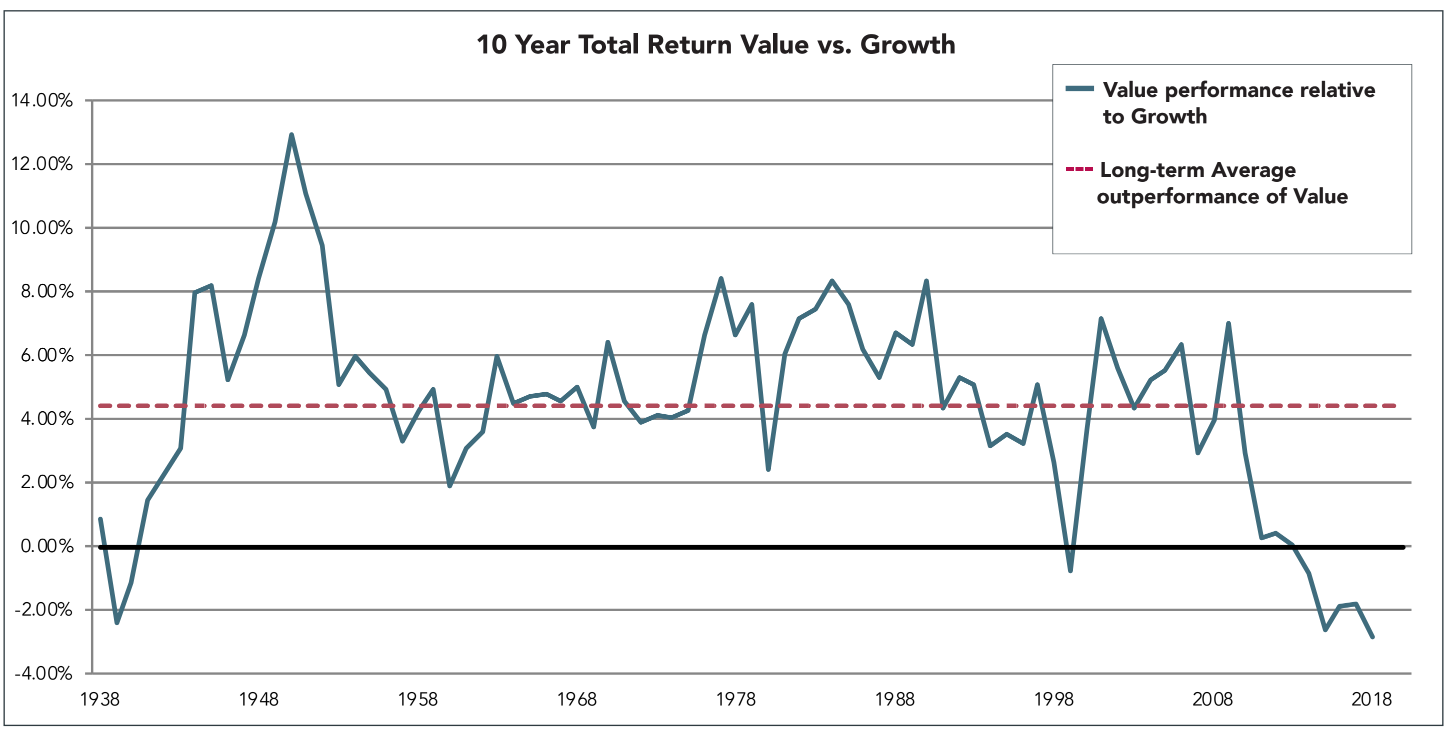
CHART 1



SOURCE: Yahoo! Finance, Miles Capital
Growth = IWF (iShares Russell 1000 Growth ETF)
Value = IWD (iShares Russell 1000 Value ETF)

In fact, over the past century, there have been only eight rolling 10-year periods in which growth stocks have outperformed value stocks — including two during the Great Depression, one during the tech boom of the late 1990's, and in each of the past five years. Even with those eight periods, the average outperformance of value over growth is 4.44% per year (see chart 2).

CHART 2



SOURCE: Kenneth French (Dartmouth University), Miles Capital

The historical context in chart 2 reveals just how much of a deviation the past decade has been for value stocks, as they have underperformed growth on average by 2.86%. This represents the largest margin of 10-year under-performance in over 90 years. To get back to the historical average of 4.44% in three years, value would have to significantly outperform growth by over 17.5% on average each year. Value stocks may not get there in three years, but they may be poised for out-performance.

Characteristics of Growth

In contrast to value stocks, growth stocks tend to be higher "priced", based on P/E ratio, relative to overall markets. Earnings growth of these companies tends to be high, although typically they are more volatile as well.

Growth companies often reinvest earnings back into the business, which may not yet be profitable, rather than paying a dividend. Prominent examples of growth-stock companies include Amazon, Netflix, Tesla, Square, Google, Nvidia, and Facebook.

Sector Differences

Understanding the key differences in the types of companies found in each investment strategy helps illuminate what's really driving the recent divergence in performance between value and growth.

The financial sector was the worst-performing sector over the past decade, while energy was the worst over the past five years — both sectors are among the most prominent allocations in value investments. For example, the Russell 1000 Value Index currently has about one third of its index in financials and energy stocks.

Conversely, information technology has been the best-performing sector over the past five years and second-best over the past decade, and plays a prominent role in growth investing. The Russell 1000 Growth Index currently has about one third of its index allocated in IT.

Well-Established Research

Value investors focus more on substance, such as the high quality lemonade ingredients and production, and believe the value will flow from there. They subscribe to the philosophy of buying companies below their intrinsic value and waiting for the market to realign. Intrinsic value is, in its simplest form, the discounted present value of future cash flows. And since these are generally high-quality companies, their stock prices eventually catch up.

This approach is supported by an extensive body of research. Most notably, Professor Eugene Fama and researcher Kenneth French found in 1992 that value stocks outperform growth stocks over time, and represented one of three strategies shown to outperform markets. [1]

French today still contends that a company's P/B ratio — the stock price relative to a company's tangible assets, ignoring non-tangible assets such as intellectual property and customer base — is the best measure of a firm's value.

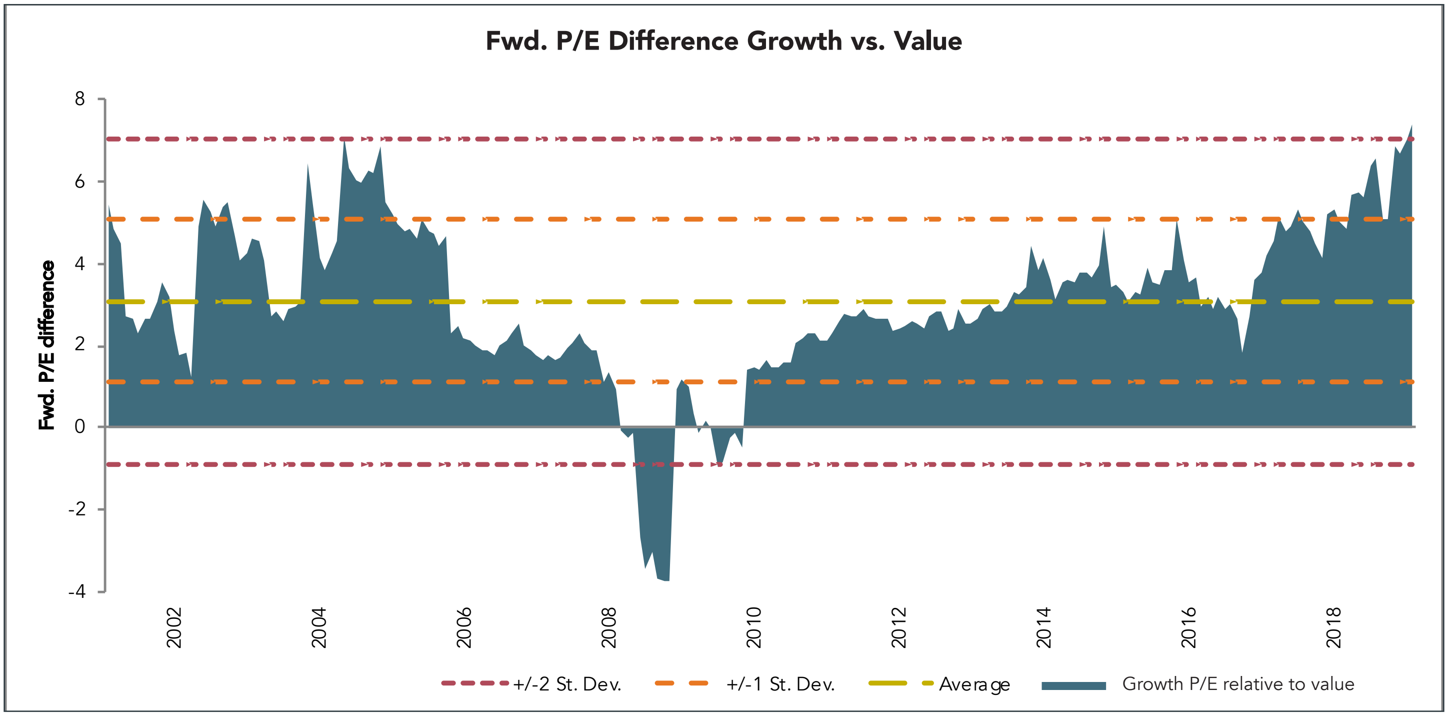
Intrinsic value is, in its simplest form, the discounted present value of future cash flows.

Growth stocks generally perform better when interest rates are falling and company earnings are rising. Growth stocks benefit from lower interest rates for similar reasons that long term bonds benefit from lower rates. Growth companies are focused on innovation and market share, not current earnings. For growth companies, the earnings are expected to occur longer into the future. Discounting (or translating to today's dollars) the future earnings and cash flows at a lower interest rates implies that growth stock's prices benefit more from lower rates. Alternatively, value stocks may do well early in an economic recovery but are more likely to lag in a sustained bull market, similar to the one the U.S. has enjoyed for the past 10 years.

1 Fama, Eugene F., and Kenneth R. French. "The Cross-Section of Expected Stock Returns." The Journal of Finance, vol. 47, no. 2, 1992, pp. 427–465. JSTOR, www.jstor.org/stable/2329112.

Relative to value stocks, growth stocks are expensive, as representative by forward P/E. As shown in chart 3, growth stocks have a relative forward P/E well above historical averages. In fact, the growth indices are hovering at a valuation approximately 2 standard deviations higher than long term averages. Value, on a relative basis, is at one of the "cheapest" levels in history.

CHART 3



SOURCE: Bloomberg, Miles Capital
Fwd. P/E ratios for S&P 500 Growth minus S&P 500 Value

Reversion to the Mean

Generally, when markets deviate from historical trends, such as the under-performance of value relative to its historical out-performance of 4.44%, we eventually see a reversion toward long-term trend-lines. Currently, value is at the cheapest level ever relative to growth, at over two standard deviations away from the mean based on P/E ratios (see chart 3), suggesting we could be near a shift.

Economic and market cycles appear to be late-stage, but they haven't ended yet. Pinpointing the bottom or inflection point is impossible, but historic trends suggest that value is poised for a rebound of some sort. Given that past rebounds in value stocks have been sharper than declines, it may not be time to give up on value just yet.

Conclusion

While value has a proven record of performance over an extended period of time, recent market trends show that is not always the case. Given that no investment approach is successful all of the time, this should not come as a surprise.

But despite value's under-performance over the past decade, this long-proven investment strategy has several key benefits - lower volatility and higher income - and often merits a place in a well-diversified investment portfolio. We recommend continuing to take the long view, as the next 10 years will certainly not look like the last 10 years. We believe that given where we are in the economic cycle, there is considerable potential in value investing in the coming years.

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