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What Comes Around

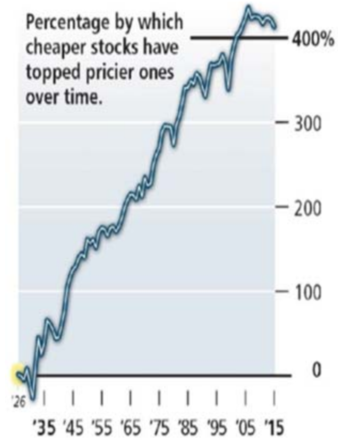
Last January, history found itself at odds with bullish market forecasters. As 2015 began, consensus was predicting that the S&P 500 would rise for the seventh consecutive year – a feat that had never occurred going back to 1871. As 2015 ended, history (and likely fundamentals) prevailed as the S&P 500 lost -0.7% for the year while the median company fell -3.1%.

Early in 2016, US equity markets were bumping up against yet another historical precedent. According to Barron's, at the end of 2015 US 'value stocks' had underperformed US 'growth stocks' for eight years and seven months – the longest period going back to 1926.

Recent returns indicate that this run may be ending. Year to date, the Russell 3000 Growth Index has fallen by -1.4%, underperforming the Russell 3000 Value Index by -2.5%. Within small caps, the underperformance is much more pronounced at -7.7%. Short term return differentials aside, there are fundamental reasons why 'value' may outperform 'growth' going forward.

Since the Financial Crisis, economic growth has been consistently underwhelming. In such an environment, businesses which can sustain abnormal earnings growth relative to the average company are intuitively more valuable. As a result, investors have successively bid up the multiples of growth companies in the last few years, exacerbating excess returns relative to value stocks. Currently, growth stocks' valuations hover near historical peaks while value stocks' valuations remain slightly below average. On a relative basis, this means value stocks are the cheapest they have been relative to growth stocks since the Tech Bubble in 2000.

Although there have been periods of similar underperformance in the past, value investing has historically been a superior way to generate long term returns. Going back to 1927, data collected by Kenneth French has shown that value stocks as measured by low price to book ratios (P/B's) have outperformed growth stocks with high P/B's by more than 4.6% annually. While there are many explanations for this result, the simplest is mean reversion. Companies trading at high multiples during periods of abnormal growth tend to have their profitability eroded over time by changes in competition, regulation, market structure or technology. As growth diminishes, multiples contract. Conversely, value stocks are typically priced as such by low expectations based upon often transitory dislocations in profitability. Over time however, earnings tend to revert to more normal levels as costs are realigned with revenues, capital investments drive new profit streams or cyclical end markets recover. Valuations and stock prices rebound in response.



Sources: Ken French, Nomura

At QV we don't buy a company because a valuation ratio appears depressed. In many cases, low valuations merely reflect below average franchises. Instead, we buy a business because we expect that its normalized earnings power in relation to its current valuation will provide satisfactory risk adjusted returns over time.

While we aren't certain when value stocks will outperform growth stocks again, our investment process remains consistent. Our risk management discipline has compelled us to exit great businesses at record high valuations in the last few years despite a market that has continued to reward these types of companies. While it can be frustrating to sell great businesses only to watch their stock prices continue to rise, remaining committed to our value philosophy is the right decision for managing risk over the long term. At the same time, we continue to redeploy capital into strong businesses at attractive valuations where we believe the market is underappreciating their long term economics in favor of near term earnings results.

While a change in the market's preference for value or growth will likely affect near term performance, as long term investors it isn't a factor we should worry too much about. By focusing instead on owning businesses at reasonable prices which can sustainably compound their earnings, we expect consistent results over time irrespective of the market's style preference.