Harvesting value premia requires diligence and patience

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In brief

- The value factor's place among established factors is supported by long standing academic evidence.
- The definition and construction of the value factor can impact performance.
- Value is a diversifier in a multi-factor context including momentum and quality.

A key theme in quantitative asset management is the continued underperformance of the value factor that is also harming the performance of multi-factor strategies. By end of July 2020, the drawdown of the global value factor was at historically low levels, having declined by approximately -45% with respect to its last high (see figure 1).

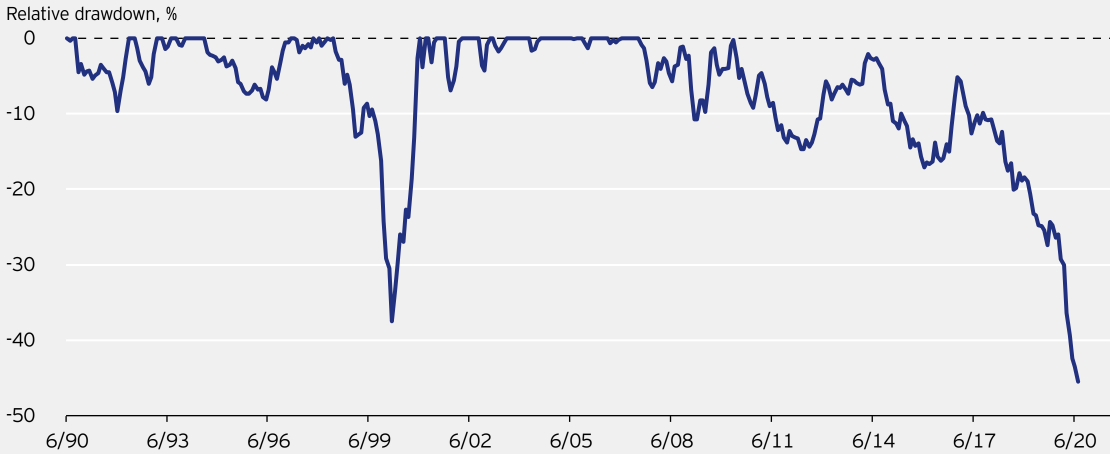
Such developments are a concern for value investors who simply wish to identify inexpensive stocks based on their fundamental valuations. However, we believe that the investment thesis underlying value investing is intact. Empirically, all previous value drawdowns have been followed by a full recovery of the factor, a recovery which has overcompensated for the previous accumulated losses. In fact, research has established that value is among the factor themes which have generated significant long-term excess return. Furthermore, Hou et al. (2020) show that value is one of the few factors in the "zoo of over 400 quantitative signals" which can (still) be replicated in practice[1] and Harvey et al. (2016) find value to be statistically robust.[2] These attributes have ensured that the notion of value investing has not only proven meaningful in equity markets but has extended to other asset classes, such as fixed income, see Asness et al. (2013).[3]

Definition & construction of value factor can impact performance

Capturing value calls for a thoughtful approach. As regards the choice of value metrics, the academic default metric is the book value of assets to market capitalisation (B/M) ratio. However, this ratio is increasingly criticized for not reflecting intangible assets, like human capital and brand, especially as these intangibles are becoming more relevant. For instance, if items like research and development are not reflected in the balance sheet, a value assessment solely based on the B/M ratio can be misleading.[4]

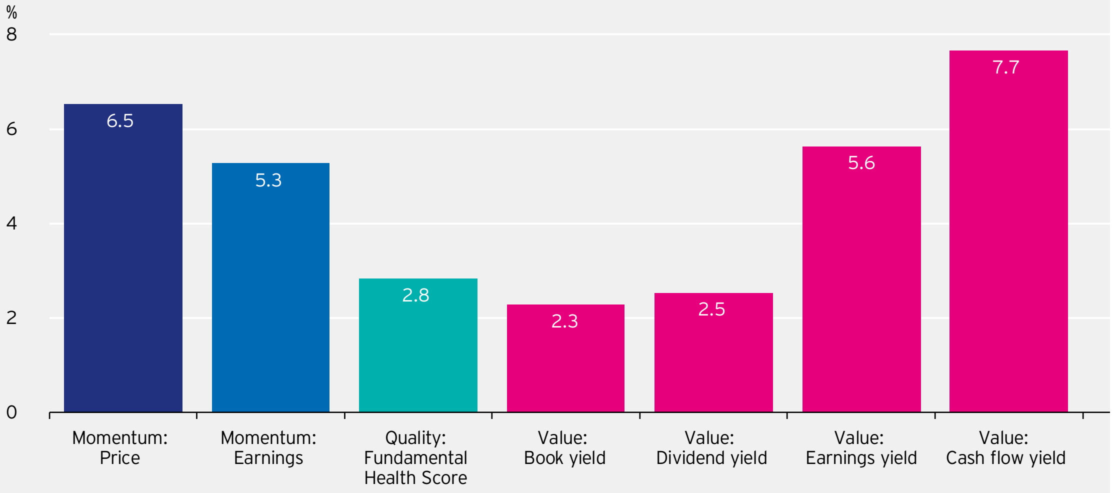
Conversely, several measures using adjusted-earnings metrics like cashflow yield are not affected by such accounting practices. We have analysed multiple measures to harvest the value premium and our findings have confirmed that the cashflow yield measure scores highly compared to the B/M ratio. As such, the long-term premium, as well as riskiness (in terms of drawdown), varies notably across different

Figure 1
Drawdown of the Global Value factor



Source: Invesco, as at 31 July 2020. As a proxy for Value we use the HML factor of Fama and French (1992), constructed as long -short factor, downloaded from Kenneth French's website: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html.

Figure 2
Annualized factor returns in Developed Markets



Source: Invesco. Period: 31 January 1996 - 30 May 2020. The underlying investment universe comprises 3,293 stocks. Returns correspond to decile spread portfolios that are long the most attractive 10% and short the least attractive 10%, based on a selected factor variable. **Past performance is not a guide to future returns.**

value definitions (see figure 2 and 3). As there are multiple ways to embrace value, we prefer to apply a basket of different value measures, with a tilt towards the cashflow yield metric.

Value is a diversifier in a multi-factor context

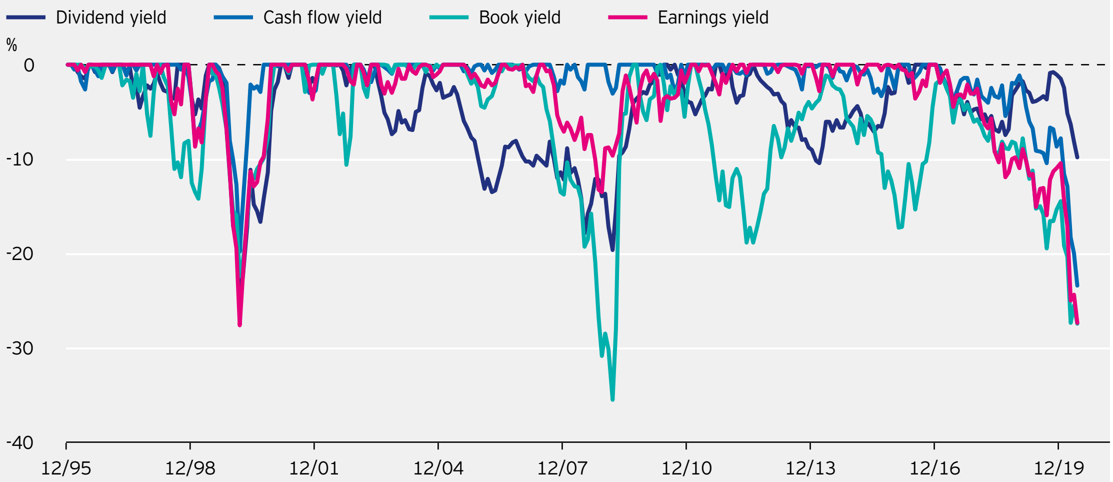
A value investor seeks to exploit discounts, which naturally come with exposure to cyclical companies and sectors, such as primary commodity producers or capital-intense equipment manufacturers. The heightened earnings volatility of these companies during difficult times ensures that investors demand a premium to invest in such value stocks. Consequently, a value portfolio currently exhibits a tilt towards the energy, materials and financial companies with less exposure to glamour stocks like FANMAG[5] and the IT and consumer discretionary sectors. However, the performance of value is not sector dependent. Within all major sectors, we find a large performance differential between value and growth stocks, particularly in the IT sector. Thus, even within sectors, value is a good diversifying agent.

So, whilst the return volatility of the value factor is testing investors' risk tolerance, value has its place as a diversifying building block within a multi-factor strategy next to momentum and quality (see the long-term factor returns in figure 2). In particular, given the low to negative correlation between value and momentum strategies, multi-factor strategies can offer a smoother investment outcome.

Looking forward

Against this backdrop, we take a cautious look at the near-term future performance of the value factor. In particular, investors' assessment is key for a turnaround in the value factor's performance. For value stocks to outperform, it is a prerequisite that they are confident about future economic growth, and thus corporate earnings growth. Note that confidence does not necessarily rely on facts (i.e. factual growth) but is a function of positive expectations, such as the view that the global economy has reached its trough. A market rebound coincides most often with a narrowing of the gap between the valuation of growth and value stocks. To gauge the current level of this gap, one can

Figure 3
Drawdowns of various value definitions for a global portfolio



Source: Invesco, as at 30 May 2020. The underlying investment universe comprises 3.293 stocks. The graph presents drawdowns of respective value variables. Underlying returns of variables are measures as decile spreads, i.e. long the most attractive 10% in our universe and short the least attractive 10% based on a selected factor variable. **Past performance is not a guide to future returns.**

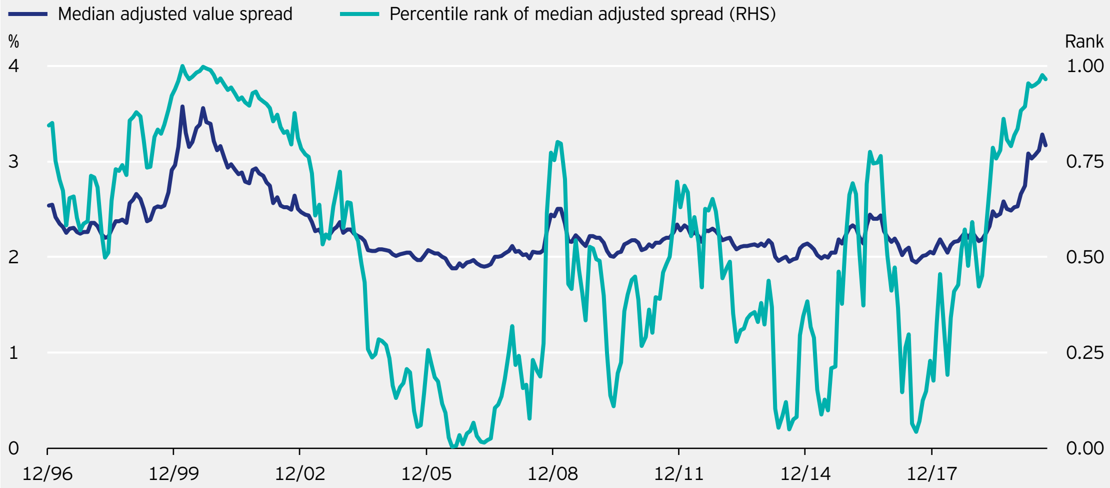
consult the value spread over time, highlighted in figure 4 below based on the cashflow yield metric. Obviously, the current gap in valuation levels between growth and value is stretched and close to the level it was during the dot.com bubble.

Finally, a lot of effort has been put into forecasting factor returns in an attempt to predict the best time to invest in a factor. However, such factor timing attempts have proven notoriously difficult, according to our own research,[6] hence the attraction of a multi-factor approach.

It is interesting to note that when investors are considering the rationale for the value factor, they tend to ignore similar debates in the past associated with other factors. For example, momentum strategies were heavily questioned in 2009, following a considerable drawdown. Yet, the momentum factor enjoyed decent performance over the subsequent decade. Similarly, the most important driver of stock returns, the equity premium, has shown negative returns over 10-year periods in the past.[7] However, no one would dare to question its existence.

What is the bottom line? If a given factor's rationale is intact, we can be hopeful that we can earn a premium and this applies to the value factor, in our view. In order to systematically harvest factor premia, we follow a disciplined quantitative investment process. This includes constantly investigating the set of factors, as well as, efficient ways of capturing their associated premia. This process lends itself naturally to addressing clients' preferences, including the combining of factors with tailored risk overlays or ESG considerations. Finally, to reap the benefits from time-tested factor investing strategies, one must be diligent in their implementation and patient in their pursuit.

Figure 4
Global cash flow yield spread and percentile ranking



Source: Invesco, as at 31 August 2020. The underlying investment universe comprises 3.293 stocks. The graph presents the median adjusted value spread (left-hand side) next to the respective percentile ranking (right-hand side). **Past performance is not a guide to future returns.**

Notes

1 Kewei Hou, Chen Xue, and Lu Zhang, 2020, Replicating Anomalies, Review of Financial Studies, Vol. 33, 2019-2133.
2 Campbel R. Harvey, Yan Liu, and Heqing Zhu, 2016, … and the Cross-Section of Expected Returns, Review of Financial Studies, Vol. 29, 5-68.
3 Clifford S. Asness, Tobias J. Moskowitz, and Lasse Heje Pedersen, 2013, Value and Momentum Everywhere, Journal of Finance, Vol. 68, 929-985.
4 Baruch Lev, and Anup Srivastava, 2019, Explaining the Recent Failure of Value Investing, Working paper.
5 FANMAG is an abbreviation used for the stocks of Facebook, Apple, Netflix, Microsoft, Amazon and Google, expanding the original FANG group of stocks by recent outperformers.
6 Hubert Dichtl, Wolfgang Drobetz, Harald Lohre, Carsten Rother, and Patrick Vosskamp, 2019, Optimal Timing and Tilting of Equity Factors, Financial Analyst Journal, Vol. 75, 84-102.
7 For example, considering two market crashes (dot.com bubble, global financial crisis) the global market premium was negative between October 2008 to November 2010 based on a 10-year rolling window.

Risk warnings

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