Institutional Perspectives

JUNE **2020**

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Has Value Had Its Last Dance?

If we no longer have to care about the price we pay for a company, then Value is dead. If the prices paid for businesses are impervious to human emotion and the fear and greed to which we have previously been susceptible, I suppose we can read Value its last rights. And if opportunities don't exist to find good companies under a temporary cloud, or avoid ones where too much optimism is baked in or too much is paid for safety, go ahead and turn off the life support machine.

Even before the recent rout of equity markets, there were an increasing number of market pundits calling the "Time of Death" for Value as an investing style. Value had the upper hand coming out of the technology bubble in the late 90s, which set it up well to beat Growth in the 2000s but detractors have pointed to Value's struggles in the last decade, and so begun to question the relevance of the investment approach today. Like the iconic Chicago Bulls of Netflix's current hot documentary, have we already witnessed ***The Last Dance*** for Value managers? Are the best times behind us and must we pass the ball to others – ones who "get" this new world better than we do?

In a word, no.

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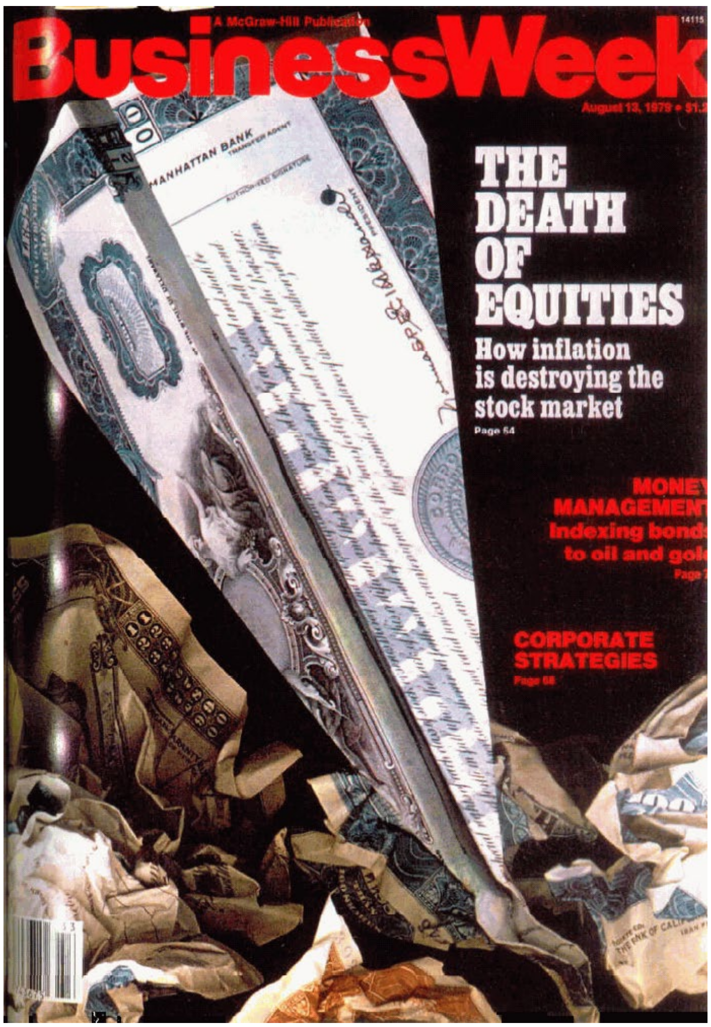
The most recent claims that Value is dead are an over-confident over-reaction to 4-year performance. Prevailing wisdom can be, and often is, plain wrong. For example, in reflecting on the 40-year anniversary of *BusinessWeek*'s August 1979 cover, titled "The Death of Equities," Bloomberg recently mused that "three years after that article appeared, the stock market hit bottom and then began a remarkable resurgence. The total return on the Standard & Poor's 500-stock index since its 1982 low, with dividends reinvested, has been nearly 7,000%. Not bad for a corpse."



Source: [Bloomberg *BusinessWeek*.]

Equity investors also do not have a monopoly on being wrong. In 2018, many experienced investors reasonably worried that bonds might be in a valuation bubble, that interest rates could not go much lower than their already incredibly low levels. Of course, they did go lower in 2019 and much lower still in 2020. Real estate was supposed to be a great diversifier to equity risk and a beneficiary of lower interest rates but in March we saw a reassessment of risk and reward among multiple asset classes, including private assets like real estate that are proving vulnerable in a pandemic.

Value's underperformance this Spring has also reignited skeptics. While it is disappointing that Value lagged the market through the recent downturn, as Mercer's chart in Figure 1 shows, it is not the first time. As discussed below, the nature of the downturn also disproportionately favoured technology stocks, stacking the odds against traditional Value companies.

Figure 1: Performance of Value During Crises and Recoveries

Event description		MSCI World Value Index	MSCI World Index	Relative performance of value	Time
1987 stock market crash	Crash	-17.1%	-20.4%	3.3%	3 months
	Recovery	33.1%	28.2%	5.0%	12 months
2000 – 2002 tech bubble	Crash	-35.5%	-46.3%	10.8%	30 months
	Recovery	106.3%	90.9%	15.3%	39 months
2007 – 2009 global financial crisis	Crash	-56.3%	-53.7%	-2.6%	15 months
	Recovery	123.6%	120.9%	2.7%	50 months
COVID-19	Crash	-26.8%	-20.9%	-5.9%	3 months
	Recovery	-	-	-	

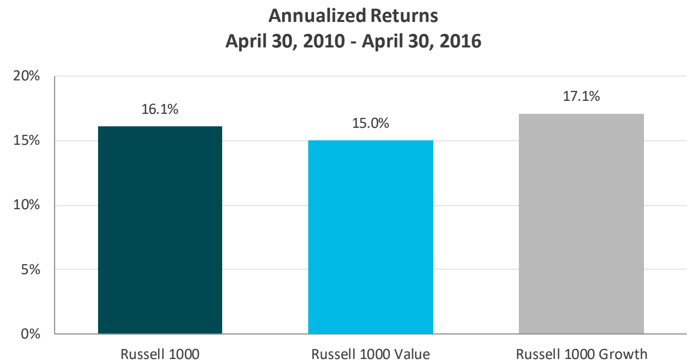
Source: MercerInsight. Crash and recovery periods for each crisis determined based on the peak and trough of the MSCI World Index for the period January 1, 1975 to March 31, 2020.

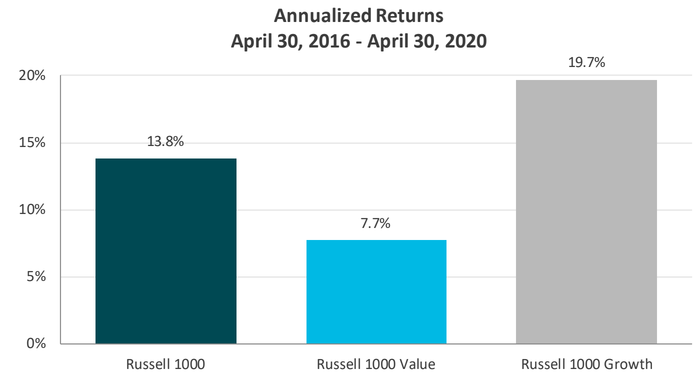
The Value Gap

Value has lagged Growth for some time, but reports of 10 years of gross underperformance is not entirely accurate. As Figure 2 illustrates, over the first six years of the decade, Value and Growth strategies earned relatively similar returns and the "value gap" in performance only opened in earnest over the past four years – a short time period in the context of financial history, and not a good test of permanence.

From 2016-2020, the FANMAG stocks (FANGs plus Microsoft and Apple) were up over *35% per annum* as a group, and their weight has grown larger in the indices (from 9.3% of the Russell 1000 in 2016 to 17.6% in 2020). Given their large size, these stocks have been disproportionate drivers of market returns, via an expansion of those P/E multiples. They have held up better in the pandemic as well, as we sit at home doing business online and meeting on Zoom.

Figure 2: Performance of Growth, Value, and Broad Market Indices, 2010-2020





Source: Bloomberg

The Stats Back It Up: Value Stocks at Historically Cheap Levels

When sitting down to write this article, it was tempting to get buried in anecdotes, but we thought it was important to look at how Value stocks as a group are being valued from a historical perspective, relative to Growth ones. Figure 3 shows some excellent work by AQR Capital Management which demonstrates a measure of relative expensiveness of Value versus Growth based on price-to-book multiples. Over the 50+ years studied, the "expensive" stocks were at times less than 4x more expensive than "cheap" stocks, on average ~5.4x, and today nearly 12x more expensive.

Figure 3: Price-to-Book Spread, December 31, 1967 – March 31, 2020

Source: AQR, CRSP, XPressFeed. "Cliff's Perspective: Is (Systematic) Value Investing Dead?" May 2020.

Value stocks are the cheapest they have been over this timeframe, at levels consistent with a 4.5 standard deviation event. For reference, the attack on Pearl Harbour prompted a sell-off in markets consistent with a 5 standard deviation event.[1] In other words, this level of deviation from the norm is ***high***. AQR looked beyond price-to-book to see if valuations were stretched on other measures. Unsurprisingly, as shown in Figure 4, they were.

Figure 4: Other Value Spreads, December 31, 1967 – March 31, 2020

Value Spread Measure	Current Percentile	Current Standard Deviation Event
Price-to-Book	100%	+4.5
Price-to-Sales	83%	+0.7
Price-to-Earnings (trailing)	100%	+4.7
Price to Earnings (forecast)	99%	+3.9
Composite	100%	+4.3

Source: AQR, CRSP, XPressFeed. "Composite" is a combination of the four value measures in this table. Forecasted Price-to-Earnings starts January 31, 1976. The 100th percent represents the most extreme level of valuation disparity.

In short, Value as a style has never been cheaper in the vast majority of current investors' experience.

How Did We Get Here?

There have been powerful forces on both sides of the equation, helping push that valuation spread above 12x. As a Value manager, it is tempting to chalk up the multiple disparity versus Growth as pure hubris on the part of Growth investors; however, it's not quite so simple. There is no obvious villain, no emperor with no clothes. The AQR study asserts:

> "Value is super cheap today and this is not coming from the potentially "broken" price-to-book measure (it isn't even very dependent on it) nor is it due to a group of winner-take-all monopolistic companies. It is not coming exclusively from the tech industries, it is not coming from mega-caps, and it is not coming from the most expensive stocks. Rather it is a pervasive phenomenon. ***Investors are simply paying way more than usual for the stocks they love versus the ones***

1 Source: Finger, Christoper C. RiskMetrics Group. "Doomed to repeat it?" November 2008.

they hate (and measured using our most realistic implementation this is the clear maximum they've ever paid) and doing it in a highly diversified way up and down the cross-section of stocks."[2] (emphasis mine)

What FANMAGs are Not

Those still stinging from the 2000 implosion of the tech bubble sometimes lump the FANMAGs together as "expensive tech" but this is not entirely accurate. They are oligopolies with strong balance sheets that buy new technologies and reinvest massive amounts without increasing debt. Consensus earnings growth estimates for these businesses generally tops out at 12%, which is high but not outrageous. Fat cash reserves could also allow continued share buybacks to support the price.

Some exposure to these names is warranted and we currently own Google, but we are underweight the FANMAG group as a whole, as we find most to be too expensive relative to other opportunities. Microsoft, for example, recently had a market capitalization larger than the entirety of London's FTSE 100 Index. After hitting its all-time high, we exited the name. The good times may continue to roll for the group, but a good dose of optimism is already priced in.

Those that trade at multiples of 60 times earnings or more, like Amazon or Netflix, are bought on the expectation of **significant future** earnings growth. This is the purview of the Growth manager. As a Value manager we would rather own many solid businesses trading at 12 times earnings or less, where expectations are more modest and surprises tend to be positive. At an earnings yield of 8% to 10% for an established business, in an inflation world of 1%, the risk-reward looks very attractive compared to an earnings yield of below 2% for a pricey Growth stock.

The Leith Wheeler Approach to Value

The (wrong) stereotype of Value companies is that they are exclusively old-tech, possibly broken "old winners" that savvy investors are willing to own until they are "less bad" if/when valuations revert to the mean. This is not how we invest. We look for quality businesses with engaged, aligned management that are trading below our estimate of intrinsic value. Often, this can be due to short-term company-specific issues that attract excess investor pessimism – and so creates an opening for us to buy. By repeating this process, we're able to create a portfolio of stocks that are cheap relative to the broad market.

Human emotion has always pushed valuations too far on the way up and down, yielding price points that allow contrarians like us to take advantage. A perfect example of this phenomenon is today's belief that high-multiple Growth stocks will continue to lead the way going forward, at the expense of Value portfolios.

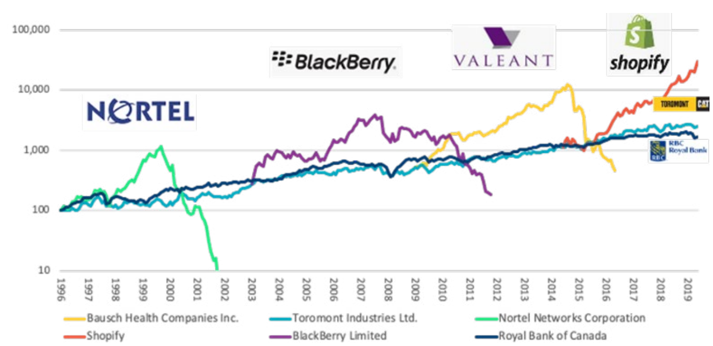
It is particularly ironic that the current extremes of fear and greed, moments that we Value managers need and indeed celebrate, are leading to suggestions today that Value is dead.

Avoiding the Growth Trap

Value investors need to avoid the value trap, businesses that are cheap but in permanent decline. For their part, Growth investors need to avoid the growth trap, businesses that won't meet the optimism that justifies the premium price. Most businesses inevitably hit peak growth levels, and then growth slows. **Both require insight, judgement and humility as the future is a wide funnel of doubt.**

Figure 5 shows examples of Canada's troubled history with growth traps, many of which ranked as the TSX's largest weight for their time in the limelight. We have preferred to own stable growers like Toromont and Royal Bank, two companies that have delivered superior returns without the drama.

Figure 5: Canada's Troubled History with Growth Traps



Source: Bloomberg, Leith Wheeler estimates.

We sold Blackberry while it was flying high, as we identified that their incumbent advantage was under significant pressure from Apple and have not bought back into the

2 Source: AQR, CRSP, XPressFeed. "Cliff's Perspective: Is (Systematic) Value Investing Dead?" May 2020.

stock since, as it then became a value trap – cheap for good reason.

Value Will Prove Its Name

For us, the story today is less about Shopify and the FANMAGs being overpriced than about the large swathes of the rest of the market being underpriced. While it may feel like we are at the beginning of a totally new era where our work environment, shopping habits, travel plans, and entertainment choices will change completely, the structure of the overall economy is not entering a wholesale metamorphosis. We need cellphone towers to deliver the data on our phones. We build cellphone towers with raw materials, and finance these in traditional ways. We own many businesses engaged in the chain of design, finance, construction and ownership of these assets. The market overly punished many of these companies during the pandemic sell-down but they will survive and thrive in the future. The catalyst that will allow us to win in the future is recognizing their persistent value.

The pandemic sell-off was tough for many of our companies who do very well in a normal economy, especially the Consumer Discretionary stocks. As an actuary, I can appreciate that you can only model so much downside into a diversified collection of assets; otherwise, you will just put cash in the mattress. For example, if I said to you we need to model the risk of cyberterrorism (or actual terrorism) taking down major cellphone towers, disrupting Google and Amazon for six months and making them uninvestable, you would probably say I was crazy. If it happened, you would probably give me a break for not modeling that risk. By the same logic, while we model a wide variety of potential outcomes for every investment, the meteor that hit consumer businesses in March was just that – a very low-probability event. With that said, this is not a permanent problem for our companies.

We know Value hasn't been dominant lately, like that great Bulls team after Jordan. The investing crowd would rather own Amazon today, or Apple, than own the examples outlined in the Appendix to this article. But as Mark Twain once famously quipped, the reports of our death are greatly exaggerated. The value gap has created the next opportunity for competitive value managers. We appreciate your patience as we work hard to close the gap.

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APPENDIX

A Small Sample of Companies We Own

Manulife, a life insurance business with an established presence in Asia – a source of growth going forward where scale is needed. Despite its much stronger financial position today, it traded down to levels last seen during the financial crisis of 2008.

Brookfield Asset Management, a leading asset manager with deep global expertise and scale in real estate, infrastructure and private equity. As money continues to flow into these areas, they are well positioned to lengthen their track record of growing fees and sharing in superior returns.

WPT REIT, an investment trust with exposure to industrial real estate, which is very much in demand as warehouses are needed for e-commerce storage and distribution.

AECOM, an infrastructure business which engages in the design, build, finance, and operation of infrastructure assets for governments and businesses.

Frontdoor, a home appliance business which is furthering its competitive advantage by building out a technology platform that allows contractors to view and troubleshoot appliance problems remotely.

Broadcom, which supplies a diverse collection of semiconductor chips and business critical software solutions. Its 5% dividend yield is one of the highest in the Technology sector.

ASGN, an IT staffing firm, is capital-light and less cyclical than a more cyclical staffing business. Supply for IT talent remains tight and scrutiny is high on compliance and data security, which leaves this leading firm well positioned to grow.

Keysight, which is involved in testing prototypes of communication devices, including cellphones. Decades of R&D brings strong barriers to entry, this business is poised to benefit from the new 5G wireless cycle.

Checkpoint Software, which provides cyber security solutions, is currently helping customers navigate their transitions to the cloud.

FANUC , one of the largest global manufacturers of industrial automation equipment used to control machine tools on a factory floor. In a post-COVID-19 world, automating production can reduce factory downtime and improve efficiency.

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