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Modern Value Investing

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In 1934, Benjamin Graham bestowed upon the world an extraordinary approach for preserving and growing financial wealth using the public securities markets. Along with core *principles* that should be applied to any investment strategy, he outlined specific *techniques* of individual security analysis that defined his value investing approach.

Graham's core principles are timeless.¹ Over the 82 years since his landmark book *Security Analysis* was published, millions of investors have benefited from his wisdom.

But his value investing techniques (identifying, organizing, and analyzing data released by U.S. corporations to the general public) became so popular that they are no longer effective. As the proportion of U.S. public securities managed by professional investors has risen from under 10% of market capitalization prior to 1950 to 70% today, "undervalued" and "overvalued" stocks have disappeared. This is confirmed by the very high rate at which stock pickers and other "active" investors consistently fail to beat a simple market index over time.²

(Old-school) value investing is dead

Graham acknowledged this essential fact in 1976, just prior to his death.³ He was asked, "In selecting the common stock portfolio, do you advise careful study of and selectivity among individual issues?" He responded, "In general, no. I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity, say, 40 years ago, when our textbook 'Graham and Dodd' [*Security Analysis*] was first published; but the situation has changed a good deal since then. In the old days any well-trained security analyst could do a good professional job of selecting undervalued issues through detailed studies; but in the light of the enormous amount of research now being carried on, I doubt whether in most cases such extensive efforts will generate sufficiently superior selections to justify their cost."

Long live (modern) value investing

The king is dead, but value investing didn't die with him. It thrives in a small corner of the investment world, kept alive by a team of brilliant academics, one major mutual fund company, and a small cadre of forward-thinking financial advisors who deliver the benefits of value investing in varying degree to their clients.

Equius is one of those financial advisors. According to peer group studies, our client portfolios are more heavily tilted to value stocks than the average advisor, and our plan is to increase this tilt even further for clients with appropriate risk/return preferences.

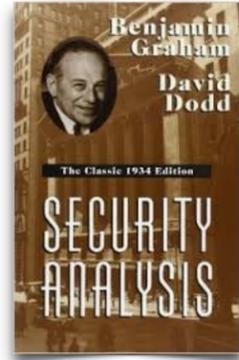
But the key to exploiting the benefits of value investing in the modern era is to reject Graham's stock-picking techniques while embracing his general investing principles and those of efficient market theory. This allows investors to benefit from the higher expected returns of value stocks using low-cost mutual funds that are significantly more diversified, employ "passive" indexing techniques to select appropriate stocks, and are not dependent on the perceived talents of old-school investing gurus.

The big leap in understanding the benefits of value investing is in rejecting the notion that some stocks in this modern era are systematically mis-priced and only certain experts can find them, while accepting that value stocks outperform as a group because they are *riskier*.

Higher risk leads to lower price in an efficient market. Lower price leads to higher *expected* return. Modern value investing diversifies among thousands of low-priced stocks. As some of these stocks become less risky (better management, less debt, etc.) over time, their prices rise to the point where they're no longer value stocks and are sold. This discipline of buy low, sell high in a structured, disciplined, and *highly diversified* way is what fuels the modern value investing strategy.

Continued on page 4

The Road to Modern Value Investing



The Great Depression

1934

1946

1960

1981

1992

1992

2013

The Securities Act of 1933 required issuers of securities to fully disclose all material information that a reasonable shareholder would require in order to make up his or her mind about the potential investment.

Ben Graham began teaching at Columbia University in 1928. After realizing huge losses in the 1929 stock market crash, he teamed up with David Dodd to write the definitive book on analyzing securities as long-term investments.

ENIAC was the first electronic general-purpose computer. Today's computer (Bloomberg terminal shown) can replicate ENIAC's power on a single small chip.

Since 1960, the **Center for Research in Security Prices (CRSP)** has provided research-quality data to scholarly researchers and advanced the body of knowledge in finance and economics.

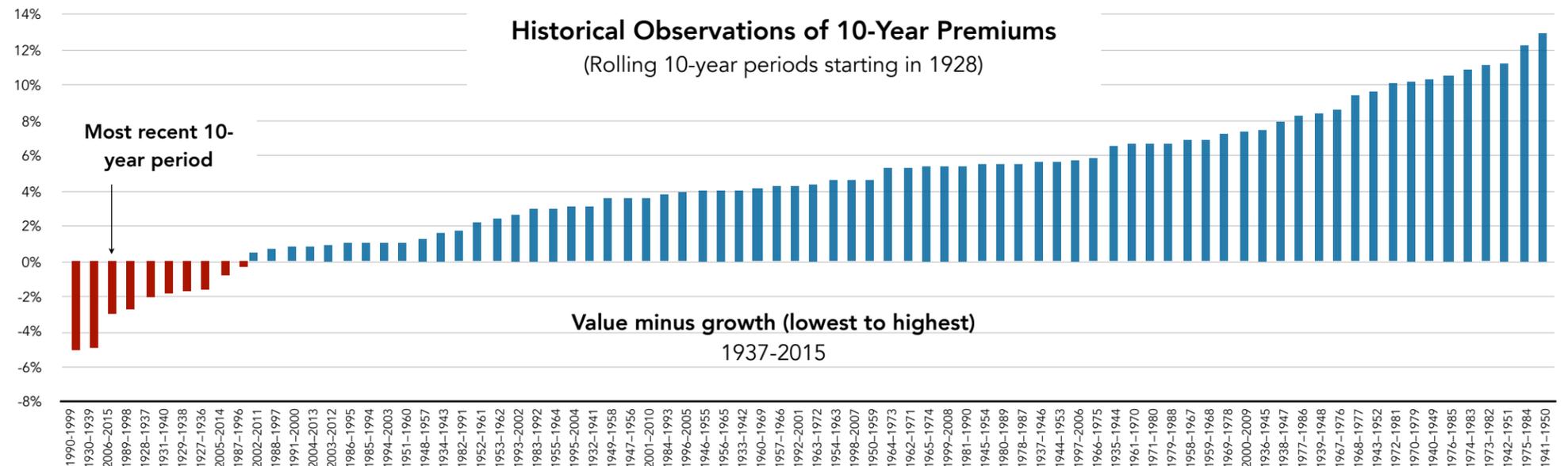
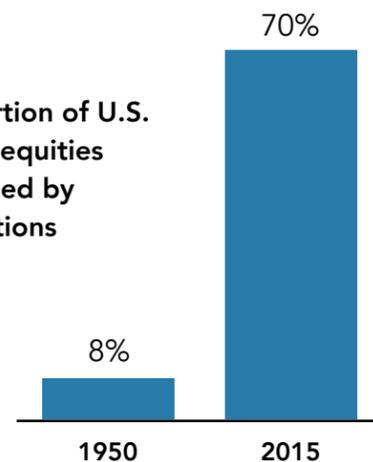
Dimensional Fund Advisors was founded. In the early 1990s it began offering its institutional asset class funds to retail investors through approved financial advisors.

Eugene Fama and Ken French published their research on the Three-Factor Model showing historical risk premiums for small-cap and value stocks.

Equius Partners became one of the first financial advisors approved by Dimensional to use its funds and apply a pure asset class investing strategy to manage client portfolios.

Fama was awarded the **Nobel Prize in Economics** for his work on efficient market theory.

Proportion of U.S. public equities managed by institutions



Information provided by Dimensional Fund Advisors LP. In USD. The 10-year rolling relative price premium is computed as the 10-year annualized compound return on the Fama/French US Value Index minus the 10-year annualized compound return on the Fama/French US Growth Index. Fama/French indices provided by Ken French. Index descriptions available upon request. Eugene Fama and Ken French are members of the Board of Directors for and provide consulting services to Dimensional Fund Advisors LP.

Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results.

Consider that the opposite happens with growth stock-dominated portfolios like an S&P 500 index fund. Stocks come into these funds *after* their prices have risen substantially and are kicked out only after they've become market laggards. (I refer to these as “roach motels” in our [February 2008](#) issue of *Asset Class*.)

We are confident in these observations and conclusions because of the quality of the research and the data behind them. The big evolutionary step in this regard was the creation in 1960 of the Center for Research in Securities Prices (CRSP) at the University of Chicago. Without this excellent database, it's unlikely that Eugene Fama could have developed The Efficient Market Hypothesis to the degree and in the time frame he did (and for which he was awarded the Nobel Prize in 2013). Ditto for his and his colleague Ken French's work on the Three-Factor Model, which launched the modern era of value investing.

The Record

So how have value stocks performed relative to the total stock market since Graham published *Security Analysis* in 1934? Let's start by breaking down returns by decade.

Table 1: Market vs. Value By Decade

Decade	Market Index	Value Index	Difference
1934-1939	9.4%	6.1%	-3.3%
1940s	9.5%	15.8%	6.2%
1950s	18.4%	19.4%	1.0%
1960s	8.3%	11.7%	3.4%
1970s	6.3%	13.2%	6.9%
1980s	17.2%	20.5%	3.4%
1990s	18.0%	16.7%	-1.3%
2000s	0.0%	7.6%	7.6%
2010-2015	13.0%	11.8%	-1.2%
Ann. Return	10.9%	14.0%	3.1%

Market = Dimensional US Market Index and Value = 60% Dimensional US Large Cap Value Index and 40% Dimensional US Small Cap Value Index rebalanced annually. All returns are annualized. See other disclosures on this page.

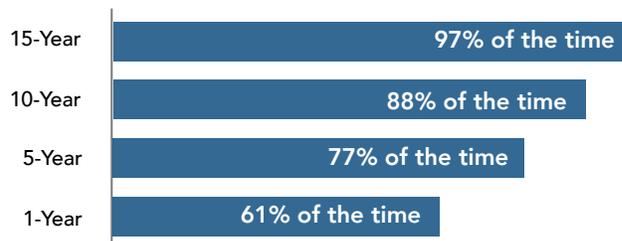
The decade of the Great Depression, the 1930s, was brutal for all stocks, but particularly value stocks, and especially small value stocks. The market recovered dramatically in 1933, but dropped sharply again in 1937. Even though value stocks as a group lagged the market for the remainder of the decade after *Security Analysis* was published, it's quite possible that Graham's individual stock picks did better.

For the next five decades, however, Graham's “elaborate techniques of security analysis” were simply not necessary (except for the real-world fact that investors did not have index funds available to them at the time!).

The decade of the 1990s ended with large, high-priced growth stocks dominating the market, yet value stocks still delivered returns higher than their historical average. The hangover from the irrational exuberance of the '90s resulted in the “Lost Decade” for stocks—with the notable exception, however, of value stocks. The stock market has performed well since the decline of 2008-2009, with value stocks lagging so far.

The chart below shows the historical performance of the value premium over rolling periods from 1928 to 2015.

Chart 1: Value Beat Growth



Value is Fama/French US Value Index. Growth is Fama/French US Growth Index. There are 877 overlapping 15-year periods, 937 overlapping 10-year periods, 997 overlapping 5-year periods, and 1,045 overlapping 1-year periods. Based on rolling annualized returns using monthly data. Rolling multiyear periods overlap and are not independent. This statistical dependence must be considered when assessing the reliability of long-horizon return differences.

When we isolate 10-year rolling periods using *annual* data and rank them from worst to best, we find that the most recent period, 2006-2015, is the third worst. Only the 1990-1999 and 1930-1939 periods saw value stocks lag growth stocks by a greater percentage (see “Historical Observations of 10-Year Premiums” on pages 2-3).

A challenge for investors today is to structure portfolios to generate higher expected returns in an era of exceptionally low interest rates on fixed income securities and the potential for lower *market* returns due to slower economic growth. As always, Equius is committed to doing all we can to align our clients' return goals and risk tolerance with portfolio allocations that optimize potential outcomes. Greater portfolio tilts to value stocks is one way to enhance our value to clients.

¹See “Valuable Roots” and “Value Investing 2.0” in the [July](#) and [August](#) 2010 issues of *Asset Class*.

²*False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas*; Barras, Scaillet, and Wermers, 2009.

³*Financial Analysts Journal*; September/October 1976; Volume 32, Issue 5.

Equius Partners is a Registered Investment Advisor. Please consider the investment objectives, risks, and charges and expenses of any mutual fund and read the prospectus carefully before investing. Indexes are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Past performance is not a guarantee of future results.

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