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NOVEMBER 2015

Factors In Focus

Sizing Up The Value-Stock Slump

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Clients who review their portfolio progress with us for the first time will notice that *relative* results have not corresponded with long-term expectations. Specifically, we have not seen the higher-expected returns of value stocks over growth stocks materialize. More surprisingly, even clients who have been with us for longer periods will find that the value stock "premium" has not shown up over the last decade. Now seems to be a good time to size up the "slump" in value stocks.

Periodic Data

Let's start with a review of asset class and portfolio returns for recent periods ending in October (except where noted).

Table 1: Annualized Returns (through 10/2015)

Asset Class/ Portfolio Mix	1-Year	5-Year	10-Year	20-Year	Nov 1995 to Oct 2005
S&P 500 Index	+5.1%	+14.2%	+7.8%	+8.5%	+9.2%
US large value stocks	+1.2%	+14.6%	+7.4%	+9.8%	+12.1%
US small value stocks	-2.8%	+12.5%	+7.1%	+11.5%	+16.0%
Int'l Index	-3.1%	+4.1%	+4.0%	+5.1%	+6.3%
Int'l large value stocks	-5.6%	+2.5%	+3.6%	+6.4%	+9.3%
Int'l small value stocks	+3.3%	+7.8%	+6.3%	+8.1%	+9.9%
Index Mix	+2.8%	+11.3%	+6.8%	+7.6%	+8.4%
"Asset Class" Mix	+0.0%	+11.1%	+6.8%	+9.5%	+12.4%

Table 1 reports that large cap growth stocks (S&P 500 and Int'l Index), especially those in the US, have performed much better than the average of their large and small value stock counterparts over the last one and five years.

But when we look at portfolio results ("Index Mix" and "Asset Class Mix"), we don't find the results to be that far apart: there's a -2.8% deficit to the value-tilted asset class portfolio over the last year and -0.2% per year over the last five years. Importantly, at the five-year mark, returns in both cases above 11% are more than sufficient to fund reasonable financial goals.

Over the last 10 years, a period long enough that most investors would expect to be compensated for the higher risk of value stocks, we still see that result has failed to materialize. Both large and small value stocks have underperformed in the US, and only international small value stocks performed better than their market/growth-stock equivalent.

Because of the significant international small value premium as well as the diversification benefit achieved from a multi-asset class portfolio, at the 10-year mark we see that the asset-class mix has actually matched the index allocation. So while not achieving "outperformance" is disappointing, it hasn't had a dramatic negative effect on portfolio outcomes.

Perspectives

Naturally, the question is: why haven't value stocks achieved their historical rate of outperformance over the last several years? I attribute this to a number of different factors, explained in detail below.

The Previous 10 Years: A Return To Normal

First, let's look at the final column in Table 1 that covers the 10-year period from November 1995 through October 2005, which immediately preceded the last decade. Over this stretch, we see a considerable premium for value stocks, especially small value stocks in the US—they returned +16.0% per year compared to just 9.2% for the S&P 500. But US large value as well as international large and small value stocks also beat their relative market index by about 3% per year. Averaged across an entire portfolio, the value-inclusive asset class mix beat the index allocation by 4% per year. This is about twice what we'd expect based on long-term historical data.

So we can look to the last 10 years as a "catch up" for growth stocks—the index and asset class mixes matched each other but this simply served to bring the 20-year overall results (reported in the second-to-last column in Table 1) down to a more normal level. The value-inclusive asset class portfolio mix outperformed the index version by 2% per year since October 1995, about what we would expect based on a review of historical data.

The Financial Crisis

The 2007/2008 financial crisis and resulting bear market was not kind to stocks in general, but value stocks were hit particularly hard, losing more than the market and beginning their downward descent even earlier. While the S&P 500 shed about 51% from November 2007 through February 2009, US and international large and small value stocks lost 7% to 12% more. In the seven months leading up to the bear market, the S&P 500 was up more than 11% while US small value stocks actually declined by 4%. This significant value-stock underperformance can take some time to overcorrect.

2007/2008 was not an outlier. History teaches us that financial crises are a bad environment for value stocks. If we look back to the Great Depression, we find that US large and small value stocks underperformed the S&P 500 by 4% and 6% per year respectively for the decade beginning in 1929. It took +3.3% and +10.0% per year outperformance (relative to the S&P 500) during the decade beginning in 1939 for US large and small value stocks to "catch up."

Lower Inflation/Interest Rates

I don't need to remind anyone that interest rates have continued to trend lower over the last 10 years in the face of below-average inflation. The rate of increase for the Consumer Price Index through October has only been +1.8% per year for the last decade, 1.2% less than the long-term average of 3%. If we look at all 10-year rolling periods since 1928 where inflation has averaged 1.8% per year or less, we find that a value-tilted US stock index failed to outperform the S&P 500 on average—with both producing returns of +8.9% per year.

It's only during periods when inflation is average or above average that we see the value-stock premium show up. In all 10-year rolling periods since 1928 when inflation has been at least 1.2% above average (4.2% per year or more), we find that a value-tilted US stock index outperformed the S&P 500 by 4.8% per year. Not a single 10-year period of higher-than-average inflation saw the value-tilted US stock index underperform the S&P 500.

Chance

Finally, we cannot rule out the role of chance in relatively short-term investment results. Value stocks have never outperformed growth stocks over every period of time. The same holds true for the higher returns expected from holding stocks over bonds. There are many periods of five years, 10 years and longer where investment risks have not been rewarded. All we can say is that, on average, the longer you wait, the more likely it is that you will be compensated for bearing risk.

More specifically, if we look at all 10-year rolling periods since 1928, we find that 16% of them saw a value-tilted US stock index fail to outperform the S&P 500. Similarly, 19% of these periods saw the S&P 500 underperform bonds (5-Year Treasury Notes).

We should first be encouraged that both of these underperforming outcomes are relatively infrequent. We should be further encouraged that, on average, during all 10-year periods where the S&P 500 underperformed bonds, the value-tilted US stock index outperformed the S&P 500 by an average of +2.1% per year, helping to overcome some of the stock-return deficit. And finally, we should take solace in the fact that we have not (yet) experienced a 20-year period in the US where the value-tilted stock index underperformed the S&P 500. We cannot say the same for stocks in general; almost 2% of all 20-year periods saw the S&P 500 underperform bonds.

Take-Aways

The case for diversifying across large and small value stocks globally has not been diminished in any way by the lackluster results of late. No portfolio can consistently be expected to produce positive absolute or relative (to a market index) returns. Patience and a long-term perspective are always required to achieve the outcomes that are expected.

There is no reason to believe the higher-expected returns from value stocks have disappeared; it is more likely that they have simply been on hiatus. This is not the first five or 10-year period where value stocks have failed to deliver the expected outperformance. Periods coinciding with a previous stretch of above-average results or a recent financial crisis commonly produce less-than-stellar value returns.

What's more, their significant sensitivity to inflation makes value stocks a huge benefit to investors whose liabilities are tied to rising consumer price levels—pretty much all of us but retirees in particular.

Now's the time to remember that good things generally happen to investors who are prepared, have a plan and can stick with it.

***Source of data*:** DFA Returns 2.0

Table 1: S&P 500 = DFUSX, DFLCX prior to 2010, US large value stocks = DFLVX, US small value stocks = DFSVX, Int'l Index = DFALX, Int'l large value stocks = DFIVX, Int'l small value stocks = DISVX. "Asset Class Mix" = 21% S&P 500, 21% US large value stocks, 28% US small value stocks, 18% Int'l large value stocks, 12% Int'l small value stocks, rebalanced annually. "Index Mix" = 70% S&P 500, 30% Int'l Index, rebalanced annually.

Historical rolling data: "value-tilted US stock index" = 30% S&P 500, 30% DFA US Large Value Index, 40% DFA US Small Value Index, rebalanced annually

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