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WEALTH MANAGEMENT

Value Investing: Is It Valuable?

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The idea of "value investing" is not new, and its benefits for investors may seem intuitive. The basic principle of value investing can be summarized by a maxim attributed to nineteenth-century investor and financier Russell Sage: "I buy my straw hats in the winter."

In other words, value investors seek out investments that have sound fundamentals but are nonetheless currently undervalued by the financial markets. The objective of value investing is to purchase these assets while they are out of favor and hold them until the market's opinion of them is more in line with their underlying fundamentals. Notable persons who incorporate value investing into their portfolio philosophy include Warren Buffett, Laurence Tisch, Martin J. Whitman, and Bill Gates.

Recently, however, value investors have largely failed to see their expectations materialize. Over the past 10 years, the value sector of the stock market has underperformed in all major equities markets: the United States, developed-international markets, and emerging markets. Similarly, the sector emphasizing companies with smaller market capitalization ("small-cap") has been underperforming, drawing many of the same types of conjecture and criticism as the value sector. This long dry spell has led many pundits and even some analysts to declare that "value and small-cap are dead" as profitable avenues for investors.

But are they really?

To answer this question, it's worth reminding ourselves of several principles. First, value and market capitalization are only two of several dimensions that should be considered when constructing a well-diversified portfolio. In addition, growth characteristics and economic sector (domestic, foreign-developed, and emerging), along with others, are also important vectors of market performance. Moreover, investments characterized by different dimensions are typically not correlated —

are important to consider when trying to assemble a portfolio with maximum diversification.

Second, it is important to keep time and perspective in mind. It is impossible for any individual to accurately predict the price movement of a stock within a given time period. For example, the current 10-year underperformance of value and small-cap stocks may seem sufficient justification for giving up on them, but the risk-reward ratio of stocks in general has gone through much longer periods of negative performance.

For example, from 1966 through 1981, stock price performance failed to justify the greater risk of holding stocks when volatility was measured against the rest of the market (a measure referred to as “beta”). But imagine that you had sold all your stocks in 1966, when the Dow was at 969. On the date of this writing, it closed at 25,954. In other words, all assets with risk (that is, **all** assets) sometimes go through long periods of underperformance. The trick is to own a diversified portfolio that allows you to benefit more overall than the underperformance of any single sector.

One reason investors may conclude that “value and small-cap are dead” is a behavioral trait called “recency bias.” This originates from the universal human tendency to give greater credence to more recent information than to older information. We see recency bias in financial behavior all the time. For example, when a certain stock appears to be on a “hot streak,” many will jump on the bandwagon and buy the stock. The most recent information persuades them that it has nowhere to go but up. We frequently observe, however, that these stocks become overpriced or suffer declines for other reasons. Not surprisingly, when this happens, many of those same buyers who eagerly bought when the news was encouraging will get right back out, because the most recent information seems to be telling them that’s what they should do.

Obviously, such "see-saw" buying and selling behavior is not predictive of long-term success in the financial markets. Although a 10-year trend may seem the opposite of “recent,” it is not at all unusual for a particular sector, or even a market as a whole, to go through even longer cycles before changing trajectory.

Finally, long-term investing success must also rely on patience and diversification. When investors have established an appropriately diversified and balanced portfolio that aligns with their long-term goals, needs, and tolerance for risk, they must have the patience to permit that portfolio to do its work. A well-designed portfolio will include a variety of sectors, which will tend to diverge in performance based on different influences and factors. Furthermore, this variety protects against powered by iContact

sector at a particular time.

At present, value and small-cap are underperforming for various reasons. But other sectors, such as growth stocks, are exhibiting more robust price performance. These sectors may remain in the same position relative to each other over the coming months, or they may switch places. But rather than trying to decide which one is the "winner" and which is the "loser," investors would be well advised to appropriately diversify their holdings to benefit from as many scenarios as possible.

If you are confused about how to find the right approach to investing, let us help you get a clearer view of your goals and needs. With your destination in mind, you'll be able to discern the path that will take you there. We are committed to providing the guidance and support our clients need, delivered in a way that always puts their needs first.

Stay Diversified, Stay *Your* Course!

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