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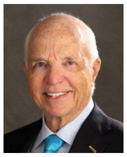
What Do We Mean When We Talk About "Value?" (Abridged*)

Steven D. Bleiberg
Managing Director, Portfolio Manager



William W. Priest, CFA
Chief Executive Officer, Co-Chief Investment Officer & Portfolio Manager

David N. Pearl
Executive Vice President, Co-Chief Investment Officer & Portfolio Manager

** This article is excerpted from our white paper, "What Do We Mean When We Talk About Value?" December, 2017.*

It has long been common practice in the investment world to divide the market up into two camps of stocks, one called "Value," and the other called "Growth." But what do these labels really mean? "Value" connotes that the stocks in this category are undervalued, and should therefore outperform over time. "Growth," meanwhile, pretty clearly implies that these are stocks with faster earnings growth potential. There is a logical non sequitur here – growth and value are not opposites. Surely a stock can be overvalued while experiencing slow growth, or undervalued while growing quickly. Putting that aside, though, are the broad categorizations even true? That is, do value stocks outperform consistently over time, and do growth stocks experience faster earnings growth? We decided to find out, using the Russell 1000 Growth and Value indices.

Performance

Over the almost 39-year life of the indices, from their inception on 12/31/78 through 9/30/17, the Russell 1000 Value index has had an annualized total return of 12.3%, while the Russell 1000 Growth index has returned 11.3% per year. On the surface, then, it looks like Value is aptly named. Looking more closely at the path of the index returns over the years, however, the picture becomes more ambiguous. **Figure 1** shows the cumulative relative performance of the Value index versus the Growth index; when the line is rising, Value is outperforming Growth, and when the line is falling, Growth is outperforming Value. The truth is that while Value has outperformed on a cumulative basis, it can all be attributed to the short burst of strong outperformance in the early 2000s as the tech and telecom bubble came undone. Outside of that period, there have been long stretches (such as the last ten years, or the 12-year period from 1988 to 1999) where the Value index underperformed, sometimes by wide margins.

If "Value" was capturing some sort of systematic undervaluation in the stocks that make it into the Value index, we would expect to see Value come out ahead much more

Value outperformance confined to a narrow period

FIGURE 1: Relative Performance—Russell 1000 Value vs Russell 1000 Growth

Source: Bloomberg

often over short to intermediate periods. As it turns out, over rolling 5-year periods, Value has only outperformed Growth 52% of the time. The historical evidence does not suggest that the Value index, as constructed (a subject we will return to), captures any kind of systematic undervaluation.

Earnings Growth

The earnings data that we have for the two indices goes back to 1995, and presents a similar story to what we saw with the performance data. The cumulative earnings growth for the Growth index has indeed been greater than that of the Value index, but a look at the details shows that all of the advantage came in a short window of time; outside of that window, the Growth index has generally shown slower earnings growth. **Figure 2** shows the relative growth in earnings for the Growth index versus the Value index. In this case, the short burst of outperformance came during the financial crisis of 2007–2009, when earnings in the financial sector (which is heavily skewed toward the Value index, for reasons we will get to) largely disappeared. Outside of that short period, earnings for the Value index have grown faster more often than not. When we look at the rolling five-year earnings growth figures, Value has actually come out ahead 54% of the time, even including the financial crisis period.

What Do These Indices Measure?

If "Value" stocks do not outperform "Growth" stocks with any consistency, and "Growth" stocks experience slower earnings growth a majority of the time, what do these indices actually tell us? The answer is limited; the methodology Russell employs to construct these indices is very heavily driven by price/book ratios. The Value index is mainly companies with low price/book ratios, and the Growth index is mainly companies with high price/book ratios. But price/book ratios are strongly correlated to return on equity—the "equity" in the ROE calculation is the same as the "book value" in the price/book ratio. Not surprisingly, companies with low ROE trade at low multiples of their equity, and companies with high ROE trade at higher multiples of their equity. (This explains why financials are so skewed toward Value—they generally produce low ROE, and trade at low price/book ratios as a result.) Clearly, though, this metric is not very useful at predicting either relative performance or earnings growth.

Is There a Better Definition of Value?

We believe there is a way to measure value that has a better record at identifying stocks that are likely to outperform. Epoch's philosophy, reduced to two essential principles, is that 1) it is the ability of a company to generate free cash flow that makes it worth something to begin with, and 2) it is how management allocates that free cash flow (between reinvestment in the business or distribution to shareholders) that determines whether the company's worth grows or shrinks. That philosophy tells us that a true measure of value should not be dependent on accounting-

Higher earnings growth for the growth index confined to a short period of time

FIGURE 2: Relative Earnings—Russell 1000 Growth vs Russell 1000 Value

Source: Bloomberg

based measures like earnings or book value. Accounting figures are too easily manipulated within GAAP rules, are distorted by accruals and ignore the time value of money. A better measure of value is one that relies on the free cash flow that a business throws off.

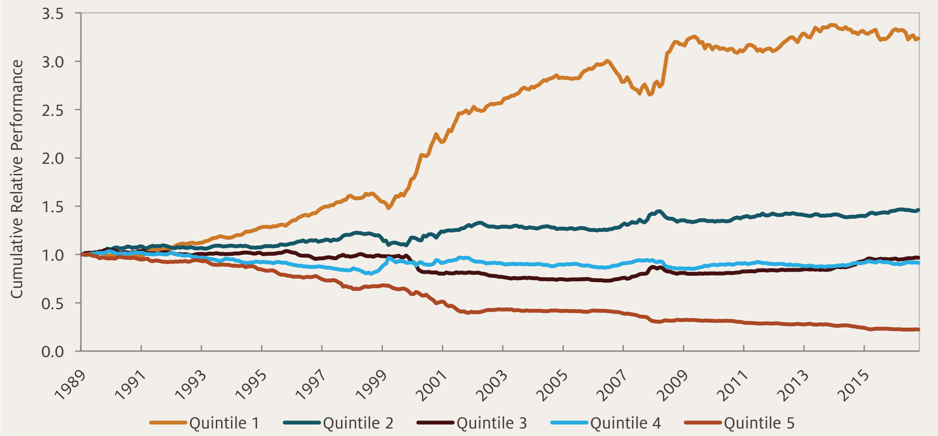
In our 2016 white paper, “Free Cash Flow Works,” we demonstrated that companies with high free cash flow yields have outperformed the market by a wide margin over the years, while companies with low free cash flow yields have underperformed. **Figure 3** updates a chart from that paper, showing the cumulative relative performance of the stocks in the Russell 1000 Index, divided into quintiles every month based on their trailing one-year free cash flow yield (with the stocks normalized by industry and equally weighted). We can think of this chart as showing five different value indices, ranging from “most attractive” to “least attractive.”

Free cash flow yield (the inverse of the price/FCF ratio) has been a much more reliable measure of “value”—defined as a price-sensitive characteristic that is likely to lead to outperformance—than the measures like price/book that are commonly used in widely followed Value indices.

Clients and consultants, hearing us describe our strategies as employing a “Value” approach, often compare our portfolios and our results to traditional Value indices,

Using free cash flow yield to measure value, we see that companies with higher FCF yield tend to outperform

FIGURE 3: Free Cash Flow Yield Quintiles, Russell 1000, Equal Weighted



Source: Epoch Investment Partners

and are puzzled by what at times seems to be a mismatch. Underlying that variance is the fact that Epoch defines value based on free cash flow characteristics, rather than on traditional accounting metrics. In the long run, we believe our way of defining value is both more meaningful and more likely to lead to good returns.

For the full white paper, visit:

http://www.eipny.com/assets/pdfs/What_is_Value.pdf