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Waiting for Dawn

I started using our value approach to investing back in 1986. Every major market decline in my career was reliably, and often significantly, diminished in our portfolios by adhering to our relative value discipline. I have witnessed market downdrafts where undervalued stocks stood still or declined less, while growthier securities (with speculative excess priced-in), declined much more significantly, leading to growth's relative underperformance.

We, along with many of our value peers, were surprised in this latest dramatic market decline, that value did not provide the same reliable defense it had previously. The following graph demonstrates that the trends in place since 2009 perplexingly continued in this recent correction.

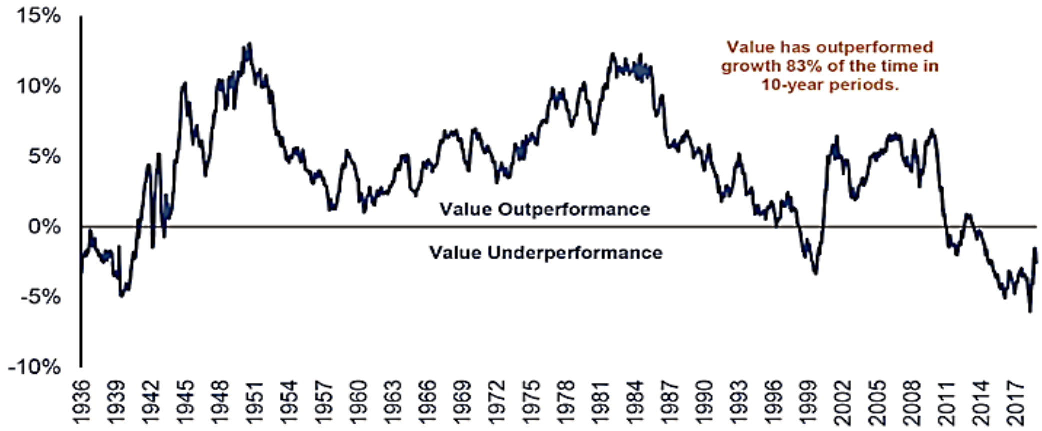
Source: Bloomberg.

Thus far in my career, when the overall markets would draw down so dramatically, a rotation to value would occur; with the bear market correction being the hallmark of a shift in investor perspective. However, during this latest bout of market volatility, this shift in perspective to favour a more conservative value approach has not yet emerged. We remain confident it will. However, it is impossible to pinpoint exactly when.

Is value permanently broken? Has value underperformed for this long or this deeply before?

The last period with as lengthy and as dramatic a draw down in value, was the deflationary period that bottomed in 1941. The attack on Pearl Harbor on December 7, 1941, led to the entry of the United States into World War II. That event marked the lowest bond yields in that financial history at 1.95%, and around that period, value began its remarkable, lengthy and sizeable recovery. The stock market bottomed shortly thereafter on April 28, 1942, with "no single event" being blamed for the turn.

Eugene Fama and Kenneth French's research on value versus growth styles partly contributed to Fama's Nobel Prize win. The following chart illustrates the relative 10-year annualized performance of value versus growth since June 30, 1926 (to December 31, 2019).



Source: Eugene Fama & Kenneth French. Ronald Blue Trust.

This chart illustrates that value outperforms growth more frequently (shown when the line is above 0%). However, in strongly rising speculative bullish phases, growth outperformance exceeds value (when line is below 0%) and growth performance dominates at the end of a cycle peak. It's interesting to note that despite the lengthy underperformance of value through the 1930s, it dramatically recovered and enjoyed a subsequent lengthy period of outperformance. Today, value is more undervalued relative to growth (on a total annualized return basis) compared to any other time period since 1936, cheaper even than 1940 or 2000.

Throughout human history, irrational investors have fluctuated between fear (value) and greed (growth speculation). Behavioural psychology of finance demonstrates we are more frequently and strongly collectively moved by fear of loss. This type of emotion has not been present in our markets for a long time; however, we firmly believe it will return and will benefit patient value investors who are focused on the long term.

We have been trading modestly into this correction, mostly trimming some names that have held up well relative to the market and reinvesting into quality names that have fallen further. In effect, buying a better future for our investors.

Charlie Munger has said, "Be prepared, on a few occasions in a lifetime, to act promptly in scale." In this market, is a switch towards the currently out-of-fashion value style one of those times?

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