The History and Future of Value Investing

Avion Wealth

Confidence in every last detail

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Value Investing Defined

In the investment world, there is no shortage of philosophies claiming to have cracked the code to optimal returns. The following discussion revolves around the oft-referenced strategy of value investing, championed by the likes of Benjamin Graham and Warren Buffett.

Exactly what is value investing?

Simply defined, value investing is choosing stocks that are trading for less than their intrinsic/book value.

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intrinsic/book value. It leverages the idea that inexpensive stocks will outperform expensive stocks over time. Value investing lends itself strongly to long-term asset allocators who have the patience to wait while a currently undervalued asset returns to its average intrinsic value or more.

There remains significant gray area as many companies have been considered both value- and growth-oriented at different times in their histories. Perhaps the greatest example of this duality is Microsoft, which is a large component of both value and growth indexes.

Exhibit 1

Value vs. Growth Stocks

Growth Stocks	Value Stocks
• Are overvalued • Have above-average P/E and P/B ratios • Have low book-to-market ratios • Have low or no dividend yields • Are usually more volatile	• Are undervalued • Have low price-to-earnings (P/E) and price-to-book (P/B) ratios (see Exhibit 1) • Have high book-to-market ratios (as defined by the Fama French Three-Factor Model described below) • Have higher dividend yields • Are usually less volatile
Current Examples: Netflix, Amazon, Facebook, Alphabet (Google)	Current Examples: Johnson & Johnson, Procter & Gamble, Berkshire Hathaway, JP Morgan, Chase

Fama French Three-Factor Model

In the early 1990s, Nobel laureates Eugene Fama and Kenneth French developed their Fama French Three-Factor Model, an asset pricing model that considers size risk and value risk in addition to already-used market risk.

[1] HTTPS://WWW.INVESTOPEDIA.COM/TERMS/V/VALUEINVESTING.ASP.

The value premium, or High Minus Low (HML), as Fama and French call it, posits that companies with high book-to-market ratios outperform those with low book-to-market ratios. (The book-to-market ratio is simply the inverse of the price-to-book ratio detailed below.)

Exhibit 2

Defining, Calculating, and Comparing P/E and P/B Ratios

Price to Earning (P/E) Ratio: A company's valuation relative to its earnings per share	Price to Book (P/B) Ratio: A company's valuation relative to its book value
P/E Ratio = $\frac{\text{Earnings per share}}{\text{Market value per share}}$	P/B Ratio = $\frac{\text{Market price per share}}{\text{Book value per share}}$

Johnson & Johnson P/E Ratio: 25.82 vs. Netflix P/E Ratio: 53.12
Johnson & Johnson P/B Ratio: 6.78 vs. Netflix P/B Ratio: 16.37

An important caveat regarding this model is that investors must be able and willing to ride out periods of underperformance and volatility to reap the rewards of the premiums identified.

In 2019, Fama and French released a paper titled "The Value Premium" that includes updated research and findings. See the section titled "The Future of Value Investing" for more information on "The Value Premium."

SOURCE: YAHOO! FINANCE. RATIOS AS OF JULY 2021.

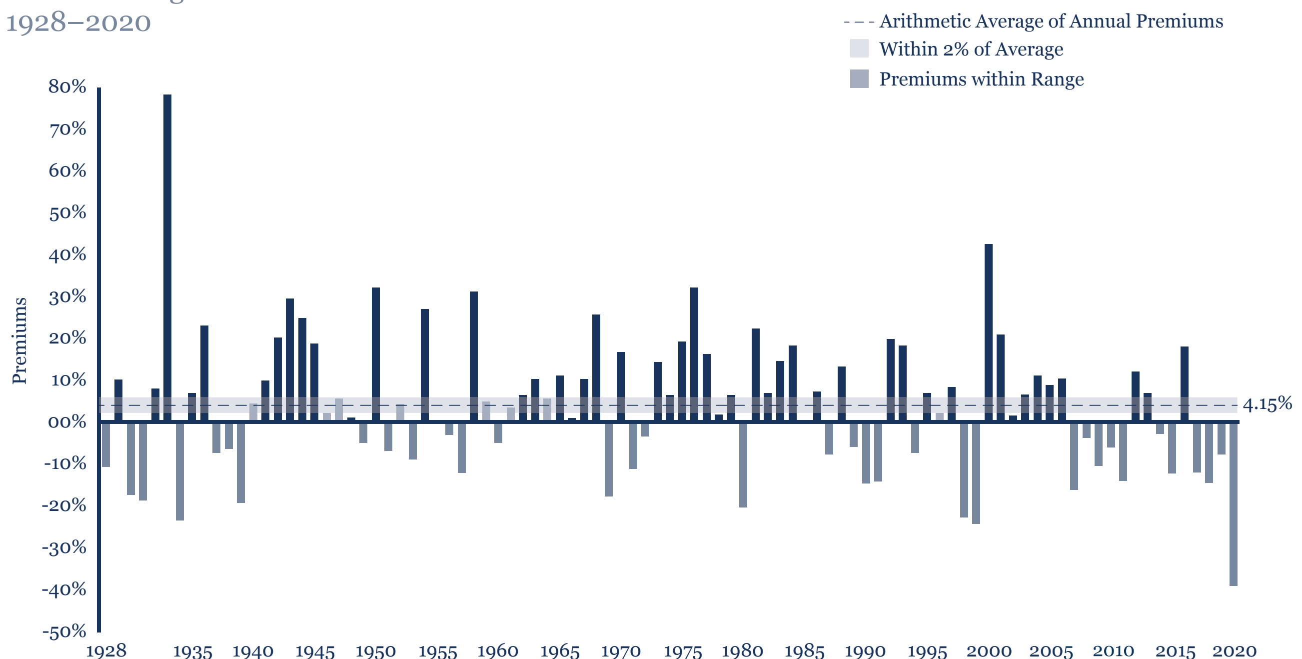
The Historical Performance of Value Investing

An analysis of value versus growth starting in the late 1920s reveals why value investing gained traction and a significant following. Value has outperformed growth by an average of 4.15%, and sometimes by significantly more. Periods of underperformance were few and usually far between until 2007.

Exhibit 3

Yearly Observations of Premiums

Value minus growth: US Markets



INFORMATION PROVIDEDB YD IMENSIONAL FUND ADVISORS LP

PAST PERFORMANCE IS NO GARANTEE OF FUTURE RESULTS. ACTUAL RETURNS MAYB EL OWER.

"Performance of Premiums." Dimensional Fund Advisors LP.

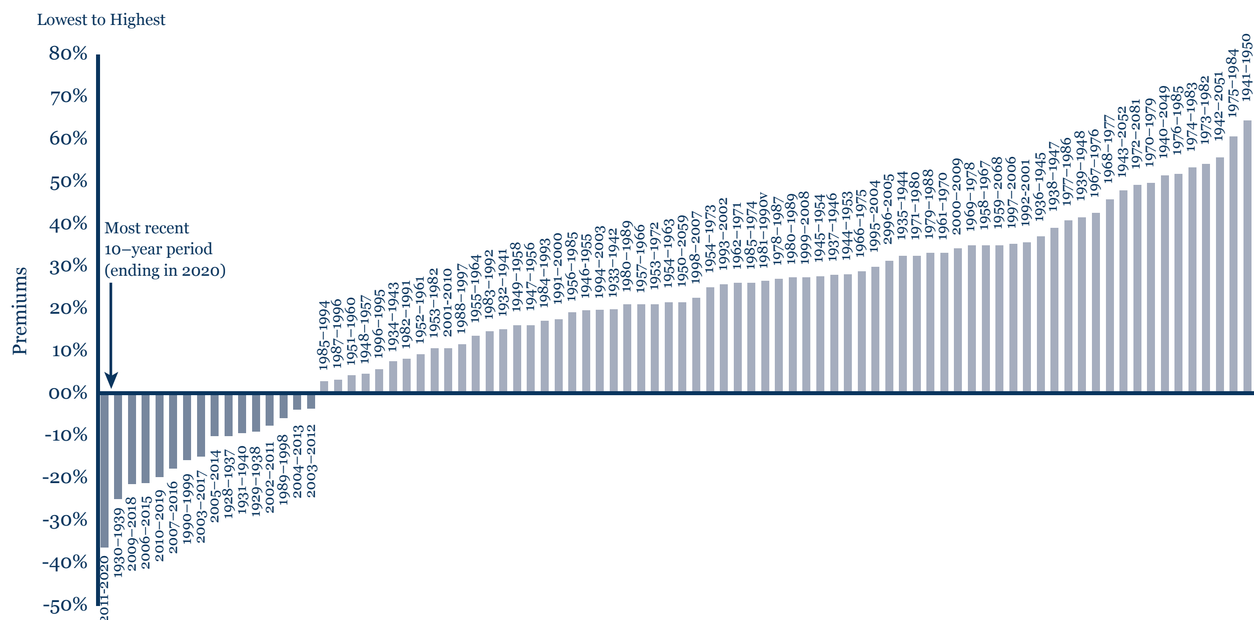
Recent history has caused an identity crisis in value investing. Exhibit 3 illustrates how the Great Recession, starting in 2007 and continuing through its recovery, resulted in more than a decade of significant value underperformance compared to growth. In 2020, growth assets recovered much more quickly from the sell-off caused by the COVID-19 pandemic.

Investors with long-term asset allocations and buy-and-hold mentalities can chalk up single-year fluctuations to market noise. An alternative view in Exhibit 4 groups rolling decades together for a longer-term outlook of value versus growth.

Exhibit 4

Historical Observations of 10–Year Premiums

Value minus growth: US Markets
1937–2020



information provided by dimensional fund advisors lp
past performance is no garuntee of future results, actual returns may be lower.

It is worth noting that at the time of this writing, year-to-date 2021, the Russell 3000 Value Index is up 17.67% as compared with the Russell 3000 Growth Index at 12.17%.

HTTPS://WWW.FTSERUSSELL.COM/PRODUCTS/INDICES/RUSSELL-US-STYLE

Emergence of the FAANGs

How much of the recent decades' value underperformance can be attributed to the massive outperformance of Facebook, Apple, Amazon, Netflix, and Google (FAANGs) as compared with the performance of the entirety of the domestic market?

To put the FAANGs' market capitalization into perspective, at the time of this writing, these five companies make up approximately 17% of the S&P 500 Index—an index intended to be indicative of the economy as a whole.

Exhibit 5

	S&P 500 Index	Russell 3000 Growth Index	Russell 3000 Growth Value Index	Facebook	Apple	Amazon	Netflix	Google (Alphabet)
Annualized 5-Year Returns	14.96%	23.31%	11.99%	23.75%	43.5%	37.33%	42.90%	27.60%

Exhibit 5 shows that, each individual FAANG company outperformed not only the S&P 500 Index as a whole but also the overall Russell 3000 Growth Index over the past five years. Even the two worst FAANG performers, Facebook and Google, outpaced those two indexes and the Russell 3000 Value Index.

SOURCE: MORNINGSTAR.COM. RETURNS AS OF JULY 2021.

If these companies can dramatically alter a leading index's performance, what happens if—or when—they falter? For many investors, this calls to mind unpleasant memories of the dot-com bubble of the late '90s and early 2000s. Fortunately, as compared to the big players' valuations back in 2000, the FAANGs' valuations have not soared nearly as high relative to the rest of the market, as the dot-com players did. The risk is not the same, but there is still risk when any asset becomes such a significant portion of the market.

The Future of Value Investing

"The Agony of the Value Investor"
The Economist, October 2018

"Covid Condemns Value Investing to Worst Run in Two Centuries"
Financial Times, October 2020

"Is Value Investing Back From the Dead?"
Financial Times, January 2021

"Will 2021 Be the Year for Value Stocks?"
Kiplinger, April 2021

"Value Investing Is a Winner From Tech Wreck on Wall Street"
Bloomberg, May 2021

The above headlines accompanied only five out of the hundreds, if not thousands, of speculative articles debating the merits and drawbacks, as well as the future, of value investing. Like so many other aspects of life, the stock market is cyclical, and its performance in 2010–2020 indicated a harsh swing away from value stocks. Year-to-date 2021, however, value stocks have made a comeback, with the Russell 3000 Value Index outperforming the Russell 3000 Growth Index by a comfortable margin.

https://www.evidenceinvestor.com/what-the-latest-research-tells-us-about-the-value-premium/

Exhibit 6

Equities	Return Projection	Median Volatility
U.S. Equities	3.7% - 5.7%	16.9%
U.S. Value	4.8% - 6.8%	18.7%
U.S. Growth	1.1% - 3.1%	18.1%

Vanguard's economic and market outlook for 2021 currently calls for the above 10-year projected returns.

These projections are pleasant to consider but also are strictly academic. They will, of course, be updated annually as new information arises and world events unfold. Vanguard, like so many other financial advisors, assumes an eventual regression to the mean: What goes up will eventually come down, and vice versa.

There are too many variables and too many unknowns to allow for forecasting, even in the most obvious forecast environments. It's easy to follow great reasoning, but that reasoning doesn't always pass the test of time, for a variety of reasons:

- Unexpected policy responses or impacts (e.g., interest rate drops, asset purchases)
- Impacts of fear and greed
- News outlets persistently exaggerating the negative
- Nobody really knowing what's coming next

Research on forecasting shows that the value of forecasts fades rapidly over time, with those more than a year old deemed worthless. Similarly, accuracy drops significantly just five to six months out. Hence, statements about what the market will be like in 18 months are no more accurate than what you or I could predict beyond the next few months.

The market is tabulating investors' consensus not just about the health and prospects of publicly traded companies, but also about the views of other investors in an effort to get one step ahead of them.

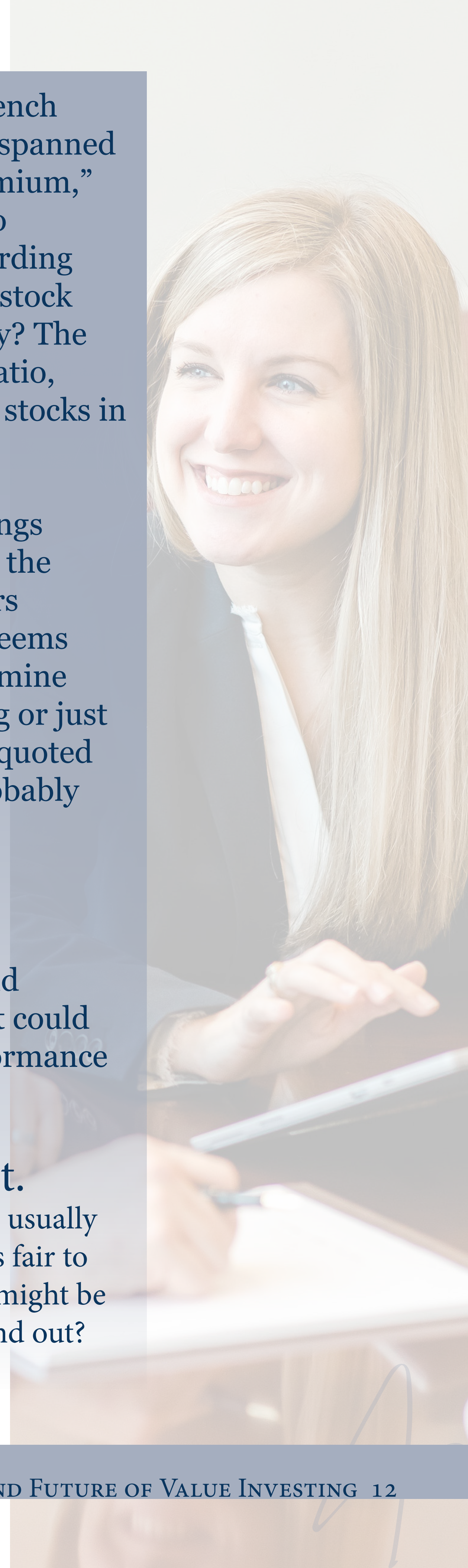
The market is looking at a billion things, and we know only a small fraction of them. While the philosophical conversation is valid that there should be some fundamentals relative to a stock's price, how the market prices different fundamentals, different sentiments, and different flows is a mystery.

Is value dead? Resurrected? On the precipice of either doom or boom? It's impossible to say.

There is cause to be cautiously optimistic, but it would be wise to adequately hedge and diversify so as to prevent significant underperformance and tracking errors.

Arguments against value investing include:

- Network economics: Natural monopolies and an increasing concentration of economic power in a handful of large companies aren't necessarily good public policy, but a neutered Department of Justice isn't curtailing these very real threats. Such companies are growth opportunities, and technological innovation supports growth. As such, most natural monopolies are in tech or depend on tech.
- Old-school accounting: Traditional GAAP doesn't do a good job of accounting for intangible assets, which are a significant component of tech and intellectual property–driven organizations. In fact, with more accurate accounting, such organizations wouldn't look so overvalued.
- Interest rates: Value investing appears to be most successful in a high-interest-rate environment. It uses a "pseudo short" strategy. Low long-term interest rates significantly favor growth companies, given their need for both capital and manageable servicing costs.



The original data Eugene Fama and Kenneth French studied in developing their Three-Factor Model spanned 1963–1991. In their 2019 article "The Value Premium," referenced above, they revisited their research to determine what had changed since the '90s regarding the value premium. They determined that value stock returns were significantly lower in 2019. But why? The spread in High Minus Low, or book-to-market ratio, significantly declined between value and growth stocks in recent decades.

Like so much research, Fama and French's findings remain inconclusive because volatility can cloud the ability to make definitive statements. The authors acknowledge the decline in the value premium seems large, but they still do not know enough to determine whether the value premium has stopped working or just had a run on bad luck in recent years. French is quoted as saying, "If I get to ask God a question, I'm probably not going to ask this one."

Regardless of whether the premium is truly mathematically disappearing or perhaps just experiencing bad luck, a safe path forward should include well-diversified portfolio allocations that could reap the benefit of further growth stock outperformance and any swing back to the value premium.

Don't put all your eggs in one basket.

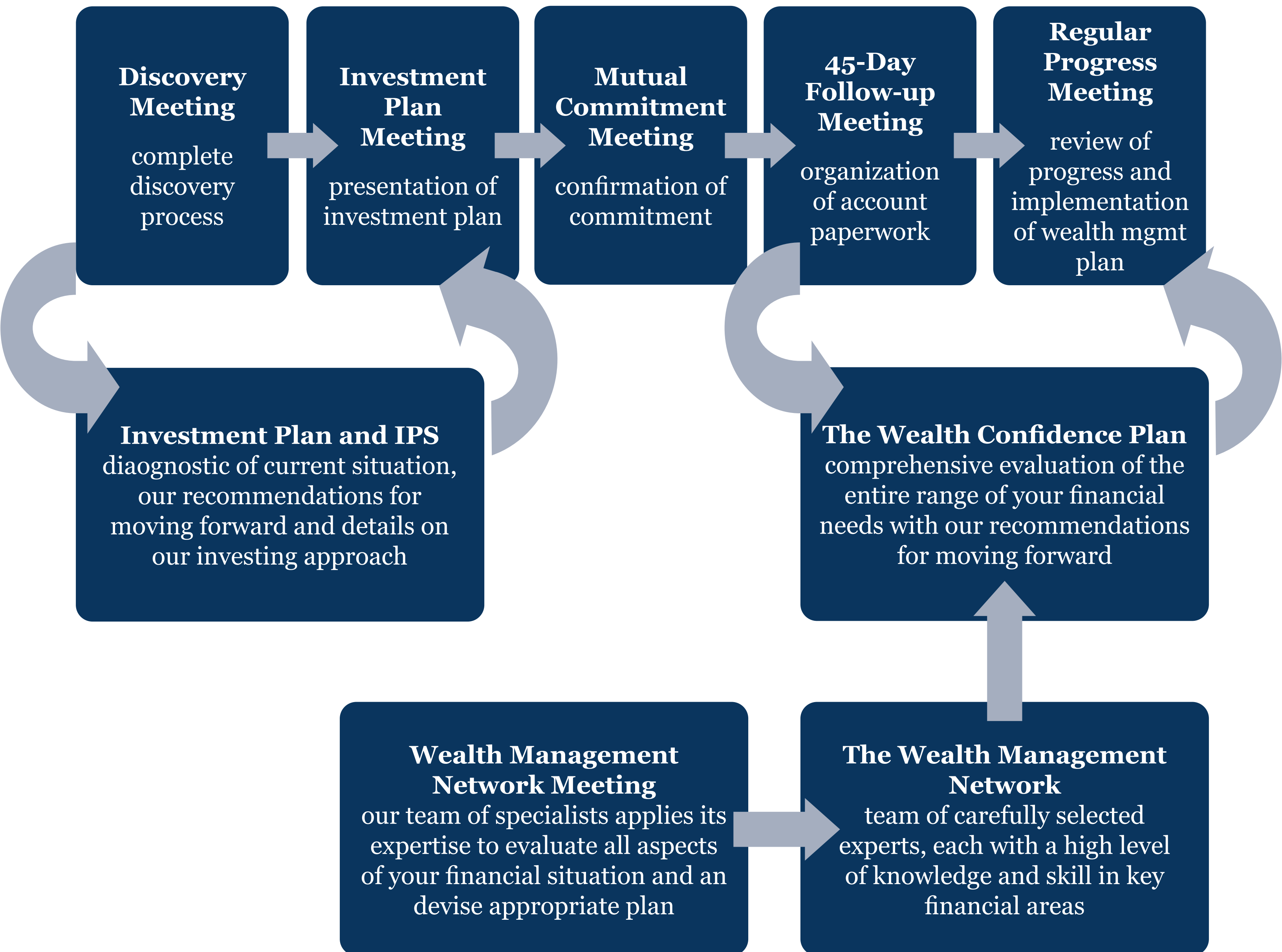
It's trite but true. As this adage relates to investing, it's usually in reference to holding concentrated positions, but it's fair to say that it also applies to investing philosophies. You might be right in the long run, but how long will you wait to find out?

The Wealth Management Process

As a result of recent market uncertainty and unprecedented events in 2020 and 2021, many investors feel underprepared to take on or continue sole management of their portfolios. When surveyed, most investors say protecting their accumulated wealth is their number one concern. The consultative wealth management process usually unfolds over a series of meetings, as shown in Exhibit 7:

1. A Discovery Conversation during which you discuss with a wealth manager your current financial situation, your goals, and the obstacles you face in achieving them.
2. An Investment Plan Meeting, during which your wealth manager presents a complete diagnostic review of your current financial situation and a plan for achieving your investment-related goals.
3. A Mutual Commitment Meeting, during which you and your wealth manager agree to work together. At this point, your wealth manager becomes your personal CFO.
4. A 45-Day Follow-up Meeting, during which your wealth manager helps you organize your new account paperwork and answers the inevitable questions that arise.
5. Regular Progress Meetings, during the first of which your wealth manager presents your Wealth Confidence Plan: a comprehensive plan developed in coordination with your wealth manager's network of insurance, legal, and tax experts. During subsequent meetings, you and your wealth manager discuss your progress toward your goals and your wealth manager recommends changes to the plan.

Exhibit 7



What Makes a Wealth Manager?

Many professionals in the financial services industry call themselves wealth managers, but few offer anything more than the most basic investment management.

So how do you know you are working with a true wealth manager?

Credentialed

First, the advisor should be credentialed; this is not the same as licensed. Remarkably, the Series 63 or Series 65 licenses most investment advisors hold focus primarily on compliance and require little investment understanding. A reasonably intelligent individual with no financial background could study the appropriate preparation materials and pass the tests in a matter of weeks. The gold standard for financial planning, however, is the CERTIFIED FINANCIAL PLANNER™ credential. To earn the CFP® credential, an advisor must pass a difficult exam that covers six major areas of investment and financial planning. A CFP® professional must also have at least two years of supervised full-time experience.

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Formal Education

Second, additional formal education in finance, economics, or investment analysis suggests an advisor's professional orientation and demonstrates commitment to his or her clients' futures.

Fiduciary Standard of Care

Third, the advisor should be held to a fiduciary standard of care.

A core tenet of the CFP Board's Code of Ethics and Standard of Conduct is that clients' interests come first. This somewhat ambiguous rule becomes clearer when you consider the impact of an agency relationship with a broker whose legal standard of care is "Do no harm," thereby allowing commissions to drive that broker's advice. By no means is it impossible to be a fiduciary and receive commissions. Even the most honest practitioner, however, will find it difficult to make recommendations that don't dovetail with their own income considerations. To avoid possible conflicts, many financial advisors have adopted a fee-only approach.

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Consultative Approach

Fourth, the advisor should use a consultative approach in working with you and acting as your Personal CFO. This approach will help you identify your true financial needs and goals, craft a long-range wealth management plan to meet those needs and goals, and build an ongoing relationship with your advisor to ensure your plan meets your needs and goals as they change over time

Consulting & Planning

Finally, the advisor should offer a wealth management process that includes not only investment consulting but also advanced planning and expert relationship management. A true wealth manager will work with a veritable team of experts to ensure the quality of the advanced planning process.

About the Authors

Sarah E. McIvor, CFP®
Partner and Wealth Manager at Avion Wealth

As a Wealth Manager, Sarah assists high-net-worth individuals and families in navigating the ever-changing financial terrain. She delivers personalized recommendations for each situation to help her clients meet their desired financial goals. Sarah's goal is to act as a trusted resource for her clients as they face the many choices, challenges, and opportunities in their financial lives.

Sarah graduated from Texas A&M University with a Bachelor of Business Administration in Management. After beginning her career in the banking industry, she joined Avion Wealth in 2014. Sarah is a CERTIFIED FINANCIAL PLANNER™ professional and state-registered Investment Advisor Representative, and she holds her Series 65 license.

Paul J. Carroll, CFP®
Principal and Founder of Avion Wealth

Paul provides consultative wealth management solutions to successful, well-informed professionals. Working with his multidisciplinary team of experts, Paul helps successful leaders address their biggest financial concerns, including preserving their wealth, mitigating taxes, taking care of their heirs, ensuring their assets aren't unjustly taken, and managing charitable giving.

Paul uses a consultative process to gain a detailed understanding of his clients' deepest values and goals. He then employs customized recommendations to address each client's unique needs and goals.

Paul is uniquely positioned to understand the needs of his clients. He is the author of a number of articles and white papers dedicated to successful leaders and their families, including "Platform for Retirement." Paul is a CERTIFIED FINANCIAL PLANNER™ professional with a master's degree in finance from Texas A&M University. Previously, he was a financial advisor with Smith Barney.

About Avion Wealth

Based in The Woodlands, Texas, Avion Wealth is a boutique, fee-only Registered Investment Advisor that provides wealth management services to discerning professionals and business leaders in all areas of their complex financial lives.

Founded in 2005, Avion Wealth implements wealth enhancement, wealth transfer, and wealth protection strategies through a consultative, process-driven approach. The firm has been named a Top Wealth Management Firm by the Houston Business Journal for seven years running, including 2021.

At Avion Wealth, we've developed a consultative approach in which we work with a team of experts to help professionals and business leaders manage their unique financial and retirement needs.

Not only do we help protect their wealth through investment consulting, we also work with them to mitigate their taxes, take care of their heirs, protect their assets, and maximize the impact of their charitable planning.

We know that you want to be confident in your financial choices. In order to do that, you need to protect and build your wealth. The problem is that you're not getting the communication you deserve and the details of your situation are not being adequately addressed which leaves you feeling frustrated. We believe you should be heard. All the details—even the small ones—matter.

We understand the frustration of not being heard and of having details fall through the cracks, which is why we have built a team with the credentials and experience to get you where you need to be. Our culture ensures all the pieces are in place. Here's how we do it:

Exhibit 8

If you think our wealth management process might fit your needs, please contact us to set up a Discovery Conversation to explore your future—together.