For value investing to thrive again, all you really need to believe is that cash flows and profitability ultimately determine stock valuations

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Value Investing and the Philosopher's Stone

After five tough years, there are increasing signs that a powerful recovery of value stocks is imminent. Investors should consider allocating funds before a rebound gathers steam.

When J.K. Rowling finished her first manuscript of *Harry Potter and the Philosopher's Stone* in 1995, she submitted it to 12 publishers, who all rejected the book. In time, those publishers would regret missing the chance to back an unknown author who would later take the world by storm.

In recent years, many investors around the world have shunned value equity strategies, which focus on undervalued stocks that face controversy yet have promising long-term prospects. Like the publishers who passed over Harry Potter, we believe that many investors today risk missing a historic opportunity to invest against the grain in attractively valued stocks across the globe.

Contrarian thinking is at the heart of value investing. For decades, value investors have profited by unearthing opportunities in unpopular stocks. Since the financial crisis in 2008, as investors fled to safety and away from the riskiest stocks, the most attractively valued stocks on global markets slumped (*Display 1*).

But we think the tide is bound to turn again, and in-depth fundamental research will be the key to generating outsized returns as value comes back into favor. This paper will explain why we believe that market conditions are ripe for a rebound and investors should consider allocating funds to value investing strategies despite five years of subpar performance. The discussion will explore three facets of the value investing environment:

- Market distortions: why have trends in global markets undermined value?

Display 1
Is the Value Slump Near Its End?

Through December 31, 2012
Historical analysis does not guarantee future results.
**Rolling three-year returns of a composite of half the lowest quintile of the Bernstein global stock universe, based on price/book value, and half the lowest quintile based on price/trailing earnings*
Source: Center for Research in Security Prices (CRSP), MSCI and AllianceBernstein

- Value conditions: what makes the value opportunity unique today?
- Finding winners: how can investors get back in the game?

Market Distortions Create Payback Potential

Ever since the financial-market collapse in 2008, investors have been extremely risk averse. While this reaction is understandable, it went too far. The crisis prompted a seismic shift in how investors think about returns, as people lost faith in the ability to profit from the capital appreciation of stocks. This flight to safety has created profound market distortions.

Fund flows illustrate this point. Over the last four years, flows to fixed-income funds have dwarfed flows to both US and non-US equity funds (*Display 2*), as investors preferred assets perceived as safer. Passive equities have become increasingly popular, while investors have shunned active strategies. And investors flocked to equity strategies focused on stocks with higher dividend yields while abandoning large-cap value equities, which are considered among the riskier types of stock investments.

By piling layer upon layer upon layer of safety, investors may have actually achieved the opposite. The perceived shelters of government bonds and high-yield equities are both sensitive to the same market forces: macroeconomic concerns and interest rates. When sentiment shifts and interest rates begin to rise, the layers of safety are likely to unravel; in this scenario, investors may discover that their diversification was an illusion and that they have less protection than expected.

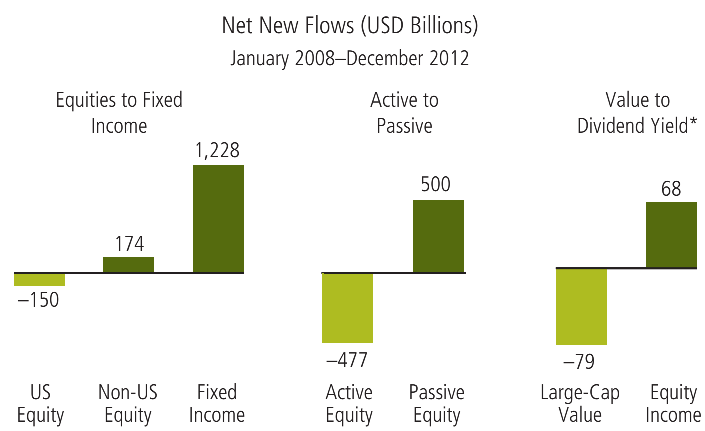
Even investors shifting toward passive equities have unwittingly exposed themselves to the same risks. For example, by late 2012, 42% of the S&P 500 Index's total market capitalization was invested in high-dividend-yield stocks, near the top of its historical range since 1970. Meanwhile, only a quarter of the market was invested in stocks with low price to book (P/B) values, toward the bottom of its historical range (*Display 3*).

What's behind this preference for high-yielding stocks? In the past, investors typically bought stocks to benefit from future growth and earnings. But in an environment where nobody believes that the economy or corporate profits can grow again, riskier higher-beta stocks have been shunned.

Here's another way to look at the market distortions. Real estate investment trusts (REITs) receive special tax treatment and, as such, are required to distribute most of their earnings to shareholders. REITs offer a highly liquid way to invest in income-generating real estate, either directly or through mortgages, and have been wildly popular in the US since the market crash.

Display 2

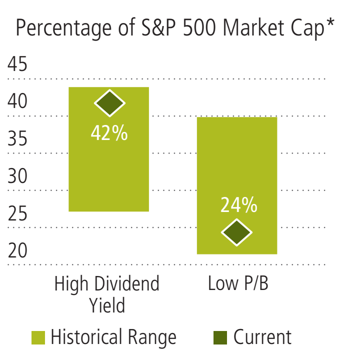
Investment Flows Have Reflected Lingering Anxiety



As of December 31, 2012
Historical analysis does not guarantee future results.
Includes US-domiciled mutual funds and ETFs; excludes closed-end funds, sector and specialty equity funds.
**Based on Lipper categories; large cap value includes US, international and global large cap value; equity income includes US, international and global equity income.*
Source: Lipper, Strategic Insight and AllianceBernstein

Display 3

Flight to Safety Has Created Huge Distortions



Global Stocks: Price/Book**

	Dec 2012	vs. Long-Term Average
Low Beta	2.17	+21%
Market Avg.	1.70	+14%
High Beta	1.15	–45%

**From January 1, 1970, to December 31, 2012; high dividend yield represents stocks where yield is 120% or more of market average.*
Low P/B represents stocks where P/B ratio is 80% of market average or less.
***P/B ratios of the highest and lowest quintiles of monthly beta within the AllianceBernstein global large-cap universe of stocks; historical average since January 1970*
Current analysis does not guarantee future results
Source: Bloomberg, CRSP, FactSet, MSCI, S&P and AllianceBernstein

Does Behavioral Investing Make Sense Anymore?

Are the tenets of value investing that were first described by Benjamin Graham and David Dodd in 1934 still relevant? Although value investing has been successful over the last four decades, perhaps, argue critics, the fundamental drivers of value stock performance may no longer work.

We think the opposite is true. Traditionally, value opportunities are created when a company faces a controversy that triggers a decline in profits and its share price. Value investors use research to determine whether the market reaction has been exaggerated, meaning the stock is likely to rebound in time, or whether the company's troubles are likely to continue to push the stock down further into a value trap. Behaviors that create opportunity include:

- Loss aversion: the pain of losing money is often perceived as greater than the pleasure from making money
- Trend extrapolation: investors may wrongly conclude that a recent negative trend will have enduring consequences for the future
- Short-term focus: during times of crisis for a company or for markets, it becomes more difficult for investors to establish confidence in long-term forecasts

Investor loss aversion was heightened by the severe crash of 2008 and the ensuing volatility. An abundance of bad economic and corporate news has made erroneous trend extrapolation even more ubiquitous. And as markets have lurched from crisis to crisis, with recurrent spikes in volatility, investors' time horizons have become extremely short. In other words, markets are saturated by behavioral biases that are likely to eventually correct themselves and reward investors who have stuck to their knitting and dared to defy the crowd.

Many things have changed in the markets in recent years. Trading costs have fallen and technology has made it easier than ever to buy and sell stocks quickly. Instant information on economic developments and companies flows around the world, often adding unreliable noise to markets. Since these changes promote emotional reactions by investors, we think that traditional research-driven behavioral investing makes more sense than ever in the 21st century.

As investors chased income and safety, the operating cash-flow yields of REITs plunged to some of the lowest levels in 20 years. For S&P 500 stocks, however, those same yields have soared to near-record highs—and now exceed the cash-flow yield of REITs by nearly 500 basis points. That's the widest spread between the two in 20 years.

Investors are assigning a much lower value to the cash flows of common stocks because they don't trust managements to deploy cash wisely. They find much greater value in investment structures like REITs that force the return of cash at the expense of future growth. In contrast, during the crisis years, common-stock companies were retaining earnings at a near-record pace; even after companies began to increase dividends, payout ratios remained well below average in late 2012.

These trends all reflect a deep skepticism about the future and low investor tolerance for uncertainty. In the past, a relatively narrow range of outcomes for a given investment scenario gave investors confidence to put their money in assets that would take a longer time to pay back a larger reward. But after the recent crisis, the range of outcomes seems much wider—and the downside is much more frightening. Lower tolerance for uncertainty and a lingering concern that the environment remains highly uncertain have led many investors to rein in their time horizons substantially. Against this backdrop, deep-value stocks, which typically take a very long time to work their way out of controversy and deliver big returns, are simply not on many investors' radar screens.

Deep Value Overdue for Comeback

While the deep insecurity that investors feel has undermined value investing, we think the recovery potential for deep-value stocks will be huge when market distortions unwind. Since the distortions are so acute, a repricing of deep-value stocks could happen very quickly.

We measure this opportunity by looking at P/B spreads. First, we divide a global universe of stocks into quintiles based on their P/B values. Then, we measure the difference between the highest and lowest fifth of the market in terms of valuation. A higher ratio signals a bigger opportunity in attractively valued stocks. Typically, when this ratio has narrowed and the line has declined, the cheapest quintile of stocks has outperformed strongly. Today, P/B spreads are wider than at any time in nearly 50 years (*Display 4*), aside from the technology bubble in 2000 when valuations reached extreme highs. These spreads are also wide across sectors.

For simplicity, we've divided the market into four supersectors: financials, resources, defensives and cyclicals. In each supersector, P/B spreads are very wide compared with the historical average. This means that you don't have to take concentrated positions in specific areas in order to capture the opportunity.

What's more, the quality of the cheapest stocks is unusually good. For example, the cheapest quintile of stocks has lower debt and stronger free-cash-flow yields than usual. So the inherent risks of investing in the most attractively valued stocks are lower than usual.

Against this backdrop, we think it's just a matter of time before markets recognize that many undervalued stocks have been unfairly punished by negative sentiment amid macroeconomic fears. By the end of 2012, value stocks had slumped for five years—interrupted by a brief recovery in 2009—much longer than a typical downcycle. In contrast, periods of value outperformance tend to run for four consecutive years. So history suggests that there's plenty to look forward to when a recovery materializes.

Identifying Catalysts for Recovery

But what would it take for a value recovery to actually happen? We think there are two key ingredients that could each prompt a revival of deep-value stocks, and could together trigger an even stronger rebound:

1. **Market Confidence**—In recent years, the market has swung between risk-on and risk-off modes, with sentiment being driven primarily by macroeconomic fears or momentary optimism. A lack of sustainable confidence has prevented investors from rewarding attractively valued stocks. When market confidence returns, we think this will change.

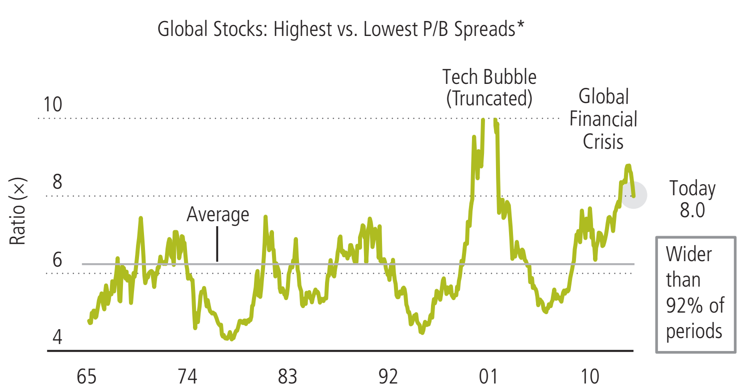
2. **Focus on Fundamentals**—Profitability, cash flows and debt positions of individual companies have simply not been the main focus of investors' attention. Fears of another recession or market crisis have obscured investors' view of stocks—especially in light of their prevailing appetite for short-term rewards. This means that undervalued stocks with strong long-term fundamentals have remained cheap, and are likely to benefit from a revaluation should investors reward them for their earnings prospects.

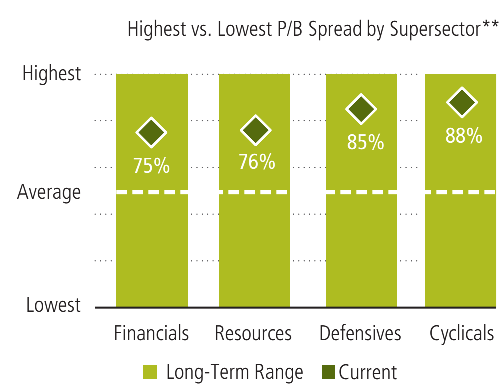
In some areas that were hardest hit during the recession, confidence is beginning to rebound and providing a powerful example of value investing at work. Take the auto industry, which faced an epic crisis back in 2009, as demand collapsed while carmakers like Ford, GM and Chrysler were fighting for their financial survival. Annual unit sales in the US fell below 10 million—a 25-year low—from more than 16 million before the crisis. At the time, it seemed ludicrous to suggest that by 2012 US car sales would ever reach nearly 15 million units a year again.

Yet that's exactly what happened in 2012. And investors could have predicted the recovery by focusing on underlying trends while the market was caught up in doom and gloom and stock prices were tumbling (see box: *Contrarian Investing and the US Auto Rebound*). The bust and boom in US auto sales remind us that applying disciplined research in fear-stricken markets can pay off.

Display 4

A Tremendous Opportunity for Deep Value





As of December 31, 2012
Historical analysis does not guarantee future results.
**The difference between the highest and lowest quintiles of stocks in the Bernstein global large-cap universe based on P/B value*
***Percentile ranks within the fifth (lowest) and 95th (highest) percentile of P/B spreads from January 1, 1971, to December 31, 2012. Resources consists of energy, industrial commodities and gold; defensives consists of consumer staples, medical, telecom and utilities; and cyclicals consists of capital equipment, construction & housing, consumer cyclicals, technology and transportation.*
Source: CRSP, MSCI and AllianceBernstein

Contrarian Investing and the US Auto Rebound

When US auto sales were in the dumps three years ago, an investor predicting a rebound was considered about as credible as a used-car salesman. Today, a bumper year for car sales is providing a great example of the enduring principles of long-term value investing.

Detecting a Recovery amid Deep Recession

Several indicators pointed to a potential rebound during the recession. First, demand fell to unsustainably low levels. Americans held onto their cars for longer as the crisis dragged on, and the average age of cars on the road rose to about 11 years, from a longer-term average of 8.4 years before the recession. More cars were being scrapped than sold (*Display, left*). At some point, demand was likely to snap back at least to a level of replacement demand.

Second, as people held onto cars for longer and manufacturers slashed output, supply of both new and used cars was curtailed. This helped sustain price levels in the industry.

Third, fears about the future led many young adults to stay at home for longer than usual. The number of new household formations declined from about 1.5 million annually during the previous decade to 0.4 million in 2009. We waited to see when new household formation would perk up again as a potential leading indicator for consumer confidence that would prompt a bounce in car sales.

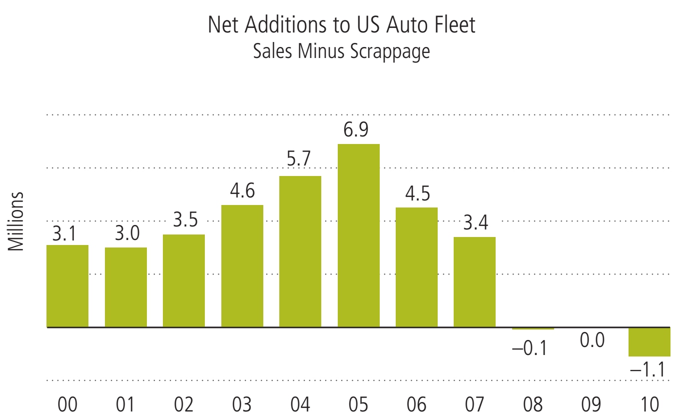
Finally, even in the credit crisis, car loans were relatively stable. While losses did increase, car owners prioritized car payments ahead of mortgages, which limited the damage. Since car loan quality was relatively untainted, credit availability rebounded quickly for auto purchases, unlike in the mortgage market.

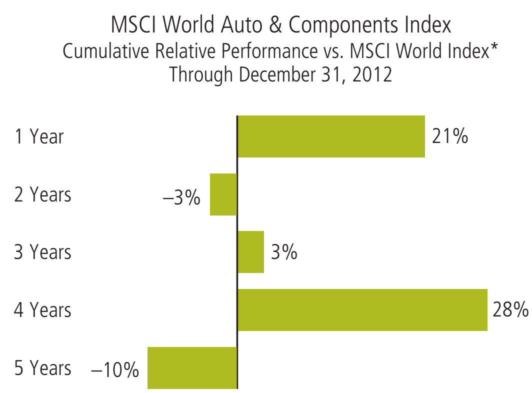
These factors paved the way to a recovery, and in 2012 shares of global automakers outperformed the market by 21% (*Display, right*). What really happened was that the destruction of demand came alongside a decline in used-car supply, as people drove their cars for longer and cash-strapped carmakers reduced output. After massive restructuring and cost cuts, the big three US carmakers can now break even on annual nationwide sales of about 10 million units a year, so profitability is much more sustainable than in the past. We believe that at the end of 2012, the rebound in auto stocks had not yet run its course, as the sector was still trailing the MSCI World Index on a five-year basis.

Disciplined Research Is the Key

With disciplined research—detached from emotional market whirlwinds—the US auto recovery could have been predicted long before it happened. As markets refocus on fundamentals across many other sectors, we expect investors who have consistently connected their research dots to be increasingly rewarded for reaching contrarian conclusions.

Pent-Up Demand During Recession Set Stage for Recovery





Historical analysis does not guarantee future results.
As of December 31, 2012
**Total return*
Source: FactSet, MSCI, Polk, Ward's Automotive and AllianceBernstein

Shares of global automakers rebounded in 2012, with the MSCI World Auto & Components Index outperforming the MSCI World by nearly 2,100 basis points. Shares of Volkswagen, Toyota and GM led the gains. GM, which was in bankruptcy in 2009, returned 45% since hitting its trough, and by the end of 2012 traded at an enterprise valuation of 2.5 times earnings before interest, tax, depreciation and amortization (EV/EBITDA), which would have been unthinkable three years ago—and is still very low in historical context.

And who would have imagined in 2011, when financials were tainted by the euro sovereign–debt crisis, that bank stocks would lead the markets in 2012? For several years, shares of banks traded at extremely depressed valuations because investors were scarred by the subprime mortgage crisis, the collapse of Lehman Brothers and the euro crisis.

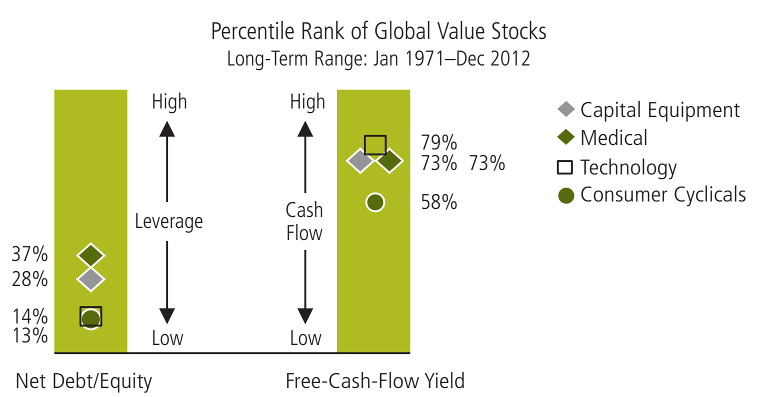
Yet in 2012, global financial stocks surged by nearly 30% and led an equity market rally, as investors gained confidence that the world economy was not heading for another disaster. Banks with resilient business models that had rebuilt their balance sheets through several tough years performed especially well. Investors who dared to buy into select banks during the aftermath of the global financial crisis—and who had the ability to withstand a period of turbulence—were generously rewarded for their patience and perseverance.

But we think this is just the start. Since bank and auto stocks were among the hardest hit during the financial crisis, they were also among the first to bounce back strongly from extremely low valuations. In our view, it's only a matter of time before investors discover similar mismatches between valuations and profitability in other industries.

Using P/B measures as a proxy, the value opportunity is higher than the 40-year average in every single global sector. And in many sectors, measures of debt and cash flow show that companies are much healthier than they were in the past. Examples include the consumer cyclicals, medical and technology sectors, in which many companies boast especially low debt and relatively high free-cash-flow levels compared with history (*Display 5*). In our view, these companies' stocks are like a coiled spring waiting to bounce back. All it will take is for enough investors to identify the unjustified gulf between their attractive prices and underlying fundamentals. These stocks are generally inexpensive because they face some controversy, which is why research is vital to gaining confidence to invest.

Display 5

Fundamentals Are Strong Across Sectors



Metrics for the top quintile of stocks (ex financials) within the Bernstein global stock universe, based on P/B value, from January 1, 1971, to December 31, 2012
Historical analysis does not guarantee future results.
Source: CRSP, MSCI and AllianceBernstein

In addition, while falling volatility and stock correlations helped create better conditions for research-driven value investing in 2012, the flight to safety hadn't fully reversed. As more investors return to riskier assets such as stock funds, we believe market conditions will gradually become more conducive to a powerful recovery of value stocks.

It's worth pointing out that you don't need geopolitical stability or a powerful burst of global economic growth to prompt a revival of value investing. In fact, value recoveries have often coincided with periods of geopolitical turbulence and economic recession.

For example, in 1982, the cheapest quintile of global stocks (based on P/B and price/trailing earnings value) outperformed the most expensive quintile by 11% during a global recession and in one of the coldest winters on record for the US and UK, as well as during a US embargo of Libyan oil and a Mexican debt default. The following decade, value stocks outperformed by 18% in 1991, a year marked by recession, the first Gulf War and the dissolution of the Soviet Union.

Fast-forward to 2001: another global recession, Argentina defaulted on its debt, the International Monetary Fund bailed out Brazil and the US was hit by the September 11 terrorist attacks. And how did value stocks do that year? They beat the most expensive stocks by 29%.

So while a stronger economic recovery might add gusto to a value rebound, it isn't a prerequisite. Just as carmakers and banks were rewarded in 2012, there are still many controversies in other sectors that are primed for a rebound.

Some manufacturing stocks are depressed because of questions about the dynamics of their industry cycle. Other companies face concern about the viability of restructuring efforts. Still others may trade at low valuations because they face a regulatory or legal process that has yet to be completed. In such a case, a catalyst for a recovery may be identified that doesn't depend on a broader cyclical economic recovery.

During 2012, bank and auto stocks fueled the beginning of a turnaround in value stocks. From August to December 2012, the cheapest quintile of global stocks based on P/B value outperformed the most expensive quintile by 10.5% (*Display 6*). This was a big shift from trends earlier in 2012 and over the previous five years. Our research on valuations and fundamentals of global stocks suggests there could be much more to come.

Why Stay Active?

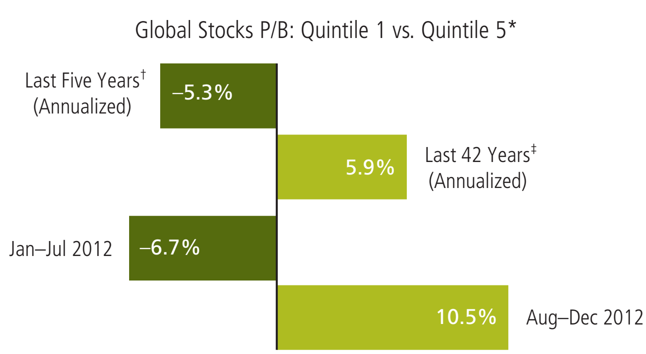
Many investors have turned to passive investing strategies that emulate an index. These can be effective, if used to invest in a value index or in a so-called smart passive approach that calibrates exposures by company fundamentals.

However, there are risks to going passive. By following an index, these strategies may be heavily concentrated in ways that augment risks or mute return potential. Indeed, by the end of January 2013, financial stocks accounted for nearly 29% of the MSCI World Value Index—about 56% more than the MSCI World. Meanwhile, utilities stocks made up 6.7% of the MSCI World Value, or 69% more than the broader benchmark. So investors in the passive value benchmark would be exposed to heightened risks in financials *and* a tilt toward safety in utilities, which could limit returns in a value recovery.

Active strategies can steer portfolios away from such pitfalls toward pockets of outsized opportunity. For example, we think management action will be a key catalyst to unlock value by deploying capital reserves. In the pharmaceutical industry, cheap companies that focused on dividends and share buybacks outperformed in 2012, while other attractively valued companies that used cash for non-accretive acquisitions were punished by the market. Passive value indices would include both types of companies. They would also ignore patent loss risks, pipeline potential and the effects of government regulation changes, all of which differ between companies. With fundamental research and company meetings, active strategies are much better equipped to forecast the dramatically different outcomes that management decisions can create.

Display 6

Increasing Signs of a Value Recovery



Historical analysis does not guarantee future results.

**Rolling hedged returns in USD based on the Bernstein global large-cap universe of stocks, sorted monthly by P/B ratio, measuring the difference in returns between the cheapest quintile of stocks (Q1) and the most expensive quintile of stocks (Q5). Periods of more than one year are annualized.*

†From January 1, 2008, to December 31, 2012

‡From January 1, 1971, to December 31, 2012

Source: CRSP, MSCI and AllianceBernstein

Today's Controversies Are Tomorrow's Winners

The legendary philosopher's stone upon which the Harry Potter book was based was a substance that was said to be capable of turning base metals into gold or silver. While no investor possesses the powers of alchemy, diamonds in the rough can be identified in stock markets to generate premium long-term returns. As markets transition from being driven by top-down macroeconomic issues to being driven by bottom-up fundamentals, deep research will be the key to turning today's controversial undervalued stocks into tomorrow's winners.

Since it's almost impossible to time when a value recovery might develop or accelerate, we think it's important for investors to have a strategic allocation to value equities. History has shown that missing just a few of the best days of returns can leave a lot on the table. Moreover, the high concentration of high-yielding stocks in market indices suggests that many investors may have more bond-like exposure in their portfolios than they realize.

It's very easy to be paralyzed by hindsight when the wounds of the recent crisis are still raw. Yet it doesn't require a fantastic imagination to look forward and conceive of a scenario in which behavioral investing principles reassert themselves on global markets. For value investing to thrive, all you really need to anticipate is that cash flows and profitability will ultimately determine stock valuations again—and that's a belief that doesn't require any magic at all. ■

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