



## VALUE INVESTING: HIGH TIME ... OR PAST ITS PRIME?

Value investing has underperformed over the last few years as investors have emphasized other stock characteristics amid shifting market conditions. We explore the reasons Value has lagged—and what might give rise to its resurgence.

Listen to the podcast [here](#).

As active equity managers, we are always assessing the risk / reward trade-offs across a range of stock characteristics, or factors, as they're commonly known in the industry. Some of these factors (Size, Quality, Beta, Value, and Growth, for example) have historically outperformed the broad markets over the long term. Partly because of that empirical evidence—and also because of the diversification benefits that each lends to the others—our flagship Bernstein equity services target a balance among such factors.

While each of the factors we target has delivered positive relative returns against the broad market over the long term, there can be times when some are out of favor—sometimes for years—as investors' preferences shift. Consider the Value factor, of late. Companies that are (arguably) inexpensive relative to their future prospects, current earnings, or assets due to a short-term controversy have been cast aside in favor of faster-growing, less controversial stocks. Does this mean that Value investing is past its prime? We don't think so. Although we see rational drivers for Value's stretch of underperformance, a number of catalysts may at some point foster a comeback.

### ADVANTAGE, GROWTH

Admittedly, Value has lagged the broader market (**Display 1**) of late while stocks with other characteristics like Income, Quality, and, particularly, Growth, have taken the lead. The question remains: Will the trend continue ... or is Value poised for a rebound? Before we can answer, we need to understand some of the reasons for Value's lackluster results.

The prevailing macroeconomic environment shoulders some of the blame. The recovery from the global financial crisis of 2008 ("GFC") has been marked by low growth and subdued inflation—conditions that favor faster-growing stocks. Why? When growth is hard to come by, investors place a premium on companies that can grow through any environment — Facebook, Amazon, and Alphabet (i.e., Google), for example, have been sought after for this reason today. It's a scarcity factor that has lured investors to idiosyncratic growers capable of above-market returns—at the expense of bargain stocks prized for their compelling value.

### WHAT DO YOU EXPECT?

Current market conditions have placed Value stocks at a disadvantage in another way, too. Consider the mechanics. Value investing seeks to exploit investors' overreaction to

#### Display 1 VALUE HAS LAGGED

CUMULATIVE TOTAL RETURN,  
JAN 2015–AUG 2017

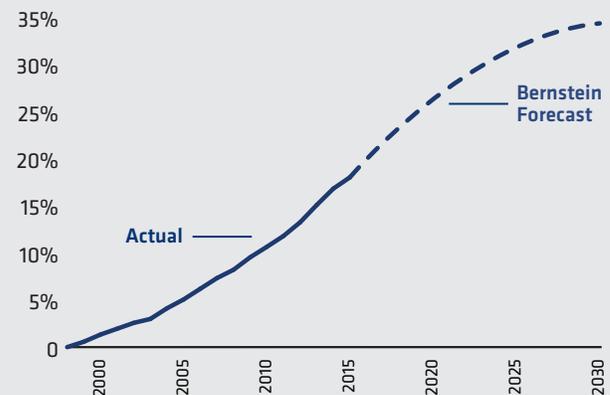


As of August 31, 2017

**Past performance does not guarantee future results.**

Return factors refer to certain characteristics that may apply to an individual security. The factor performance above represents the returns of the MSCI USA High Exposure Indexes: Value – Enhanced Value Index, Growth – USA Growth Index, Income – High Dividend Yield Index, Quality – Quality Index.  
Source: FactSet, MSCI, S&P, and AB

#### Display 2 FORECASTING THE FUTURE OF ONLINE Online Apparel Sales Market Share



As of August 31, 2017

**Past performance does not guarantee future results.**

Source: US Census and AB

short-term events in the hopes that a company's stock price will revert to fair value once management fixes the underlying problem. And yet, this so-called reversion to the mean has been called into question in an environment of slow growth and benign inflation. That's because the steady state to which the company returns must revert may be lower than historical averages. Averages established in periods of more rapid growth and higher inflation may not apply. Moreover, for many investors, the underperformance of Value stocks is justified as the lowered bar also translates to less reward. This conundrum has made Value stocks appear less attractive—especially considering the risk that some companies may not get there at all.

Further complicating matters, in several industries—such as retail, pharmaceuticals, and energy—structural shifts are upending historical patterns. Such disruption makes it even more difficult to assess what steady-state returns should look like. Take retail, for example. Department store giants like Macy's and JC Penney have been struggling, and their stocks have fallen accordingly. As their shares continue to drop, some wonder whether they're cheap enough to finally buy. Yet the challenge faced by Value investors is determining fair value for the *department store* of the future when we don't yet know what the *department store industry* should look like. For investors in these industries, the question becomes, Where will the bar be set in the new normal?

## CATALYSTS FOR RECOVERY

Anytime we face an out-of-favor factor, our goal as an active, research-driven manager is to explore potential catalysts that might signal improvement. Given what we know about why Value has lagged, what kinds of conditions might produce a turnaround?

First, any evidence that the global economy is accelerating will benefit Value stocks, since a more robust economic environment can help establish a higher floor on average returns. Fortunately, a number of signs point this way.

As we noted in our July CMO, several elements that had been a drag on global economic activity have reversed recently, including a strong US dollar, falling oil prices, and a buildup in corporate inventories. The reversal of these three trends—along with the higher capital spending that has occurred as a result—has fueled earnings growth across the globe after several years of plateauing. That said, investors haven't completely bought in to the belief that the growth is sustainable, particularly in the US. For Value to really work, investors will have to be confident that US growth can accelerate from the 2% level on GDP to something closer to 3%.

Second, normalization in both inflation and interest rates would turn the tide back toward Value. Higher, but controlled, inflation will raise returns on assets as revenue grows faster than invested capital. Higher interest rates, which follow inflation, also help Value stocks. One reason is that some of the cheapest sectors in the market—most notably, financial stocks—should see earnings rise as interest rates move up. Finally, just as they do for bonds, falling interest rates tend to benefit low-risk (noncontroversial) stocks more than (controversial) Value stocks, with the reverse being true when rates rise. Taken together, higher inflation and rates could serve as a welcome development for Value.

## COMPLETE TRANSFORMATIONS

While a more favorable macroeconomic landscape, we believe, will propel many Value stocks, it won't address the forces of disruption. Instead, affected industries need to finish their makeover and reveal their new look. Only then will investors know where to set the bar—and how to judge a company's trajectory in relation to it.

For instance, in a world where online shopping has taken greater hold, what is the optimal mix between online and brick-and-mortar sales? How large should each physical store be and what should be done with the existing real estate footprint? What does the new profit structure look like and how does a traditional retailer organize in this new world?

In terms of retail apparel, many investors are now fearing the worst and deeming the sector uninvestable until they have more clarity on the ultimate level of online penetration. Looking at other sectors like booksellers, which have ~50% online penetration, is only so helpful, since every industry contends with different dynamics. Rather than wait for the dust to settle, we conducted our own analysis, which concludes that online apparel sales will plateau at just over 35% (**Display 2**)—considerably lower than some investors fear. The implications for the apparel industry, other industries (e.g., REITs), and individual companies are meaningful. No matter what the sector, markets are bound to overshoot, and only well-thought-out analysis can help distinguish the signal from the noise.

## RESEARCH POINTS THE WAY

Unfortunately, there's no way to tell when these catalysts will come to fruition and unleash Value's potential. Until then, we remain committed to using our research to find individual stocks that show promise, irrespective of the market environment. And as we construct portfolios, we will continue to pursue balance across Value and all the other factors that have proved beneficial over time. The benefit of this approach is that a portfolio's return pattern is more consistent and predictable . . . even if, at times, you hold companies that few others are seeking out.

## MARKET UPDATE

Equities took a pause in August, while remaining in strong positive territory year-to-date (**Display 3**). Emerging-market stocks were a bright spot, returning approximately 2%, while developed-market stocks were essentially flat for the month. Geopolitical risks, among other concerns, weighed on sentiment. Year-to-date, both markets have advanced materially in US-dollar terms.

Fixed-income benchmarks were positive as interest rates continued to fall. The yield on the 10-year Treasury finished August at 2.12%, down 20 bps from the end of July.

Oil prices finished near \$47/barrel as the market grappled with the aftermath of Hurricane Harvey and the shutdown of US oil refineries in the region.

After strengthening early in the month, the US dollar reversed course, finishing flat against a basket of major currencies. Despite geopolitical tensions, lower rates of inflation caused broad selling. Year-to-date, the USD is down 9%.

### Display 3

## EMERGING MARKETS VERY STRONG IN AUGUST

### Index Returns in US Dollars

Stocks	Aug 2017	Jan–Aug 2017
US	0.3%	11.9%
Int'l Developed Markets	0.0	17.0
Emerging Markets	2.2	28.3

Bonds	Aug 2017	Jan–Aug 2017
Municipal	0.6%	3.4%
Taxable	0.9	3.6

Alternatives	Aug 2017	Jan–Aug 2017
Funds of Hedge Funds	N/A*	4.3%†
Real Assets	-0.2%	-0.2

#### Past performance is not necessarily indicative of future results.

US stocks are represented by the S&P 500 Index; international developed-market stocks by the Morgan Stanley Capital International (MSCI) EAFE Index of developed markets in Europe, Australasia, and the Far East; emerging-market stocks by the MSCI Emerging Markets Index; municipal bonds by the Lipper Short/Intermediate Blended Municipal Fund Average; taxable bonds by the Bloomberg Barclays US Aggregate Bond Index; hedge funds by the Hedge Fund Research Inc.'s (HFRI) Fund of Funds Composite Index; and real assets by the MSCI ACWI Commodity Producers Index. See "Information About MSCI" at the end of this report.

\*The data are not yet available.

†January–July 2017

Source: Bloomberg Barclays, HFRI, Lipper, MSCI, S&P, and AB

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