

Cheap and cheerful

Value investing—buying shares that look cheap compared with their fundamentals—is the oldest stock-picking strategy. And still one of the best

SINCE 1934, when Benjamin Graham and David Dodd first pointed it out in their book "Security Analysis", generations of investors have believed that buying "value" shares—those with low prices relative to, say, earnings, dividends or book assets—produces market-beating returns. Most of the time they have been right. In America, where the strategy has been most used, value stocks (those with a low ratio of market price to book assets) have far outperformed "growth" stocks (those with a high price-to-book ratio) over most periods.

Value investing has also paid off outside America since at least 1981 (see chart). Indeed, of the five countries shown, value investing helped least in America. The strategy has worked most spectacularly in France: value stocks there generated returns almost 80% higher than did growth stocks. Japanese value stocks were almost as good.

Even so, value investors are often dismissed as lucky. Pooh-pooers reckon so simple a strategy should not be able to beat the market: if investors see they can earn higher than average returns by buying certain types of shares they are likely to flock into them, bidding up prices and so reducing the chance of higher profits.

Indeed, in America between 1989 and 1991 the sceptics seemed, at last, to have been proven right. According to Barra, an investment-research firm, total returns (share-price growth plus dividends) on value stocks averaged around 10% a year less than the returns on growth stocks over this period. But in 1992 American value stocks produced total returns of 10.6%, compared with returns of 7.7% on the S&P 500 and 5.1% on growth stocks. Value

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stocks are doing even better in 1993. So does the strategy actually work?

One reason it seems to, reckon Eugene Fama and Kenneth French of the University of Chicago, might be that value stocks are actually riskier than growth stocks. The higher returns they yield could be simply a reward for investors taking on higher risks. But, as Messrs Fama and French concede, it is not entirely obvious why value shares should be riskier.

A new study* of American share returns between 1963 and 1990 by three American economists—Josef Lakonishok, Andrei Shleifer and Robert Vishny—finds few signs that value means extra risk. True, investors may face extra volatility if they hold value shares for just one year before selling, but not if they hold the shares over longer periods. Value strategies did better than growth strategies in recessions, when investors may well be more risk-averse than usual. And in the 25 worst months for America's stockmarkets during the period, value stocks held up better than growth ones every time.

Messrs Lakonishok et al suggest a different reason for the success of value strategies: value investors earn higher returns simply because they are taking a contrarian bet against naive strategies followed by other investors. Some investors over-react in favour of stocks that have done well and against those that have done badly, they suggest. Growth stocks tend to fall into the first, high-performance, category, and value stocks into the lowlier second. So value investors, who

only buy bargains, should beat growth investors who pay too much for their shares.

The three economists also try to identify the best sort of value strategy. Investing in shares with a low ratio of share price to cash flow is an even better strategy than buying shares with a low price-to-book ratio, they suggest. Best of all are shares with a low price-to-cash flow ratio and a low rate of sales growth. Such shares will probably have a low price-to-book ratio—but not all low price-to-book shares have those other, attractive, features.

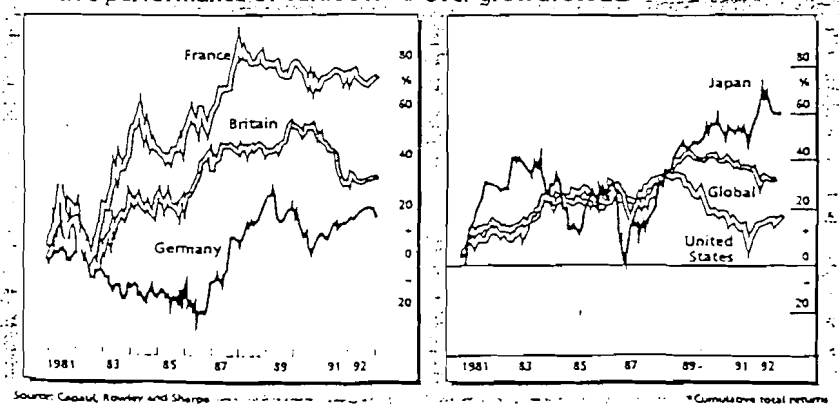
If the contrarian explanation of value investing is right, two things follow. First, the size of the extra returns earned by value investors may be a good (if crude) guide to how sophisticated investors are in any stockmarket. The bigger the returns on value investing, the more naively investors are over-reacting to success or failure. This should interest investors in the Japanese stockmarket, which since 1987 has had by far the biggest value premium.

The second consequence is that value shares will only outperform in future so long as naive investors do not wise up. The good news is that they will have to get a lot cleverer before value investors need to find a new strategy, suggests a new study† by Carlo Capaul and Ian Rowley, both of Union Bank of Switzerland, and William Sharpe, of Stanford University.

This asked a simple question. Given that a prudent investor buys different sorts of stocks to offset each stock's volatility, how much bigger did returns on value shares have to be between 1981 and mid-1992 for an investor to justify putting all his money into value stocks alone? The answer varied, but in every country the returns on value investing were far above the minimum required to eschew diversification. There was least room to spare in Britain, where value investors earned about twice the minimum. Japanese investors, by contrast, earned seven times as much, and American and French investors around three times as much.

Value investing looks even less risky if it is done globally. Messrs Capaul, Rowley and Sharpe note that, though value investing seems to have worked everywhere, it does not work to the same extent everywhere at once. In fact, the correlation between different countries is tiny. Provided value stocks outperform growth stocks in future by at least one-tenth as much as they did during the last decade or so, investing in a global value portfolio will pay off handsomely.

Relative performance of value stocks over growth stocks*



*"Contrarian Investment, Extrapolation and Risk", by Josef Lakonishok et al, University of Illinois working paper, February 1993. †"International Value and Growth Stock Returns", by Carlo Capaul et al, Financial Analysts Journal, March 1993