

IS THERE VALUE IN THE VALUE PREMIUM?

January 2016

In 1992, Eugene Fama and Kenneth French documented a value factor that helps explain equity returns. The Fama-French value factor is approximately defined as the return of stocks with low price-to-book ratios minus the return of stocks with high price-to-book ratios.¹ Other measures of value work almost as well. The average (arithmetic) annual return of the value factor since 1926 is about 5%, and this premium is statistically robust.²

The value premium has been elusive in recent years. From the beginning of 2009 through December 2015, the annualized returns of the Russell 3000 Growth and Value indexes have been 17.0% and 12.9%, respectively. This has led some investors to question whether they should retain a value tilt in their portfolios.

Factor-based investing requires a long-term view. Like any risk premium, the value premium is earned on average, but not every year. There is a fair amount of dispersion around the average annual premium, with large positive and negative swings in any given year. This is similar to investing in the market factor (the return of equities above cash), which also generates a positive excess return on average, but not every year. For example, when viewing calendar year returns from 1927 to 2014, equities outperformed cash in 69% of calendar years while value stocks outperformed growth stocks in 61% of calendar years. Exhibit 1 graphs the returns of the Fama-French value factor for each calendar year. The average annual premium of about 5% comes with a standard deviation of 14%. Volatility around the average is significant, but it is a normal part of the return-generating process for the value premium.

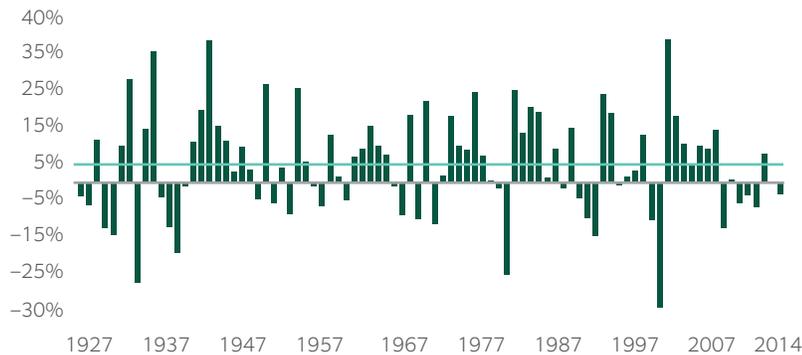
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EXHIBIT 1 – ANNUAL FAMA-FRENCH VALUE FACTOR RETURNS



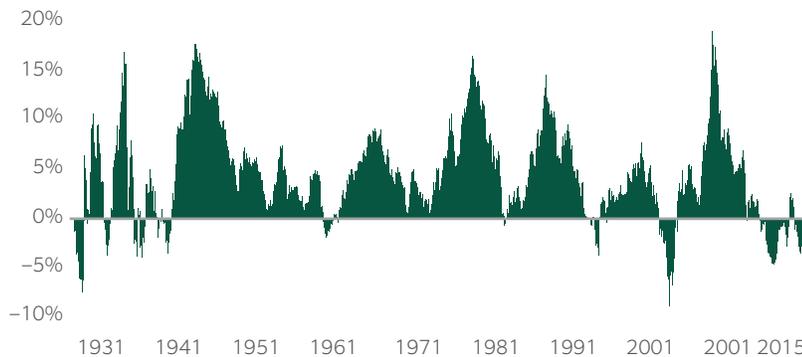
Source: Northern Trust Research, Ken French Data Library.

With a long-term view, the law of large numbers begins to work in your favor. There is a higher probability (but still no guarantee) in capturing a positive value premium with a longer time horizon. Exhibit 2 graphs rolling monthly 5-year returns of the Fama-French value factor. The large majority of rolling 5-year holding periods (83%) enjoys a positive value premium, while 5-year holding periods with a negative value premium are much less frequent (17%). Exhibit 2 shows that recent underperformance seems more drawn out – though not necessarily more acute – than prior underperforming periods.

83%

ROLLING 5-YEAR PERIODS WITH POSITIVE VALUE PREMIUM RETURNS

EXHIBIT 2 – ROLLING 5-YEAR VALUE FACTOR RETURNS



Source: Northern Trust Research, Ken French Data Library.

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When viewing rolling-return graphs, there is a tendency to see cyclical patterns. We caution against viewing the value premium as cyclical or predictable based on past returns. For example, the cyclical optics can result from a single negative-return observation that weighs on the 5-year return calculation until it eventually rolls off.

The premiums associated with the intersection of size and value (i.e., small-value stocks) are more robust than the value premium alone.

EXHIBIT 3 – RUSSELL 3000 VALUE-GROWTH SPREAD IN PRICE-TO-BOOK RATIOS

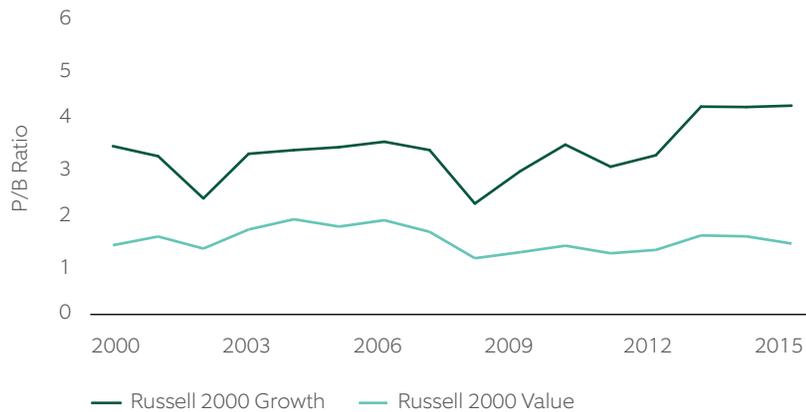


Source: Northern Trust Research, Bloomberg.

Since relative value defines the value premium, it is intuitive to compare today's spread in price-to-book ratios between value and growth stocks versus past spreads. Exhibit 3 displays price-to-book ratios of the Russell 3000 Value Index versus the Russell 3000 Growth Index since 2000.³ The graph shows a widening of the current spread, which could support a future premium for forward-looking investors who own portfolios tilted toward value stocks. Interestingly, it's not that value stocks are cheaper but that growth stocks have become more expensive. We observe the same pattern when extending the universe from U.S. equities to global equities.

Fama and French also documented a size factor that helps explain equity returns. The Fama French size factor is approximately defined as the return of small-capitalization stocks minus the return of large-capitalization stocks. Although the size premium remains positive and statistically significant since 1926, it is not as large or prevalent as the value premium. However, the premium associated with the intersection of size and value (i.e., small-value stocks) is more robust than the value premium alone.

EXHIBIT 4 – RUSSELL 2000 VALUE-GROWTH SPREAD IN PRICE-TO-BOOK RATIOS



Source: Northern Trust Research, Bloomberg.

Exhibit 4 compares the price-to-book ratios of the Russell 2000 Value Index versus the Russell 2000 Growth Index since 2000. Among small-cap stocks, we also find a widening of the current spread, which could support a future premium for forward-looking investors who own portfolios tilted toward small-value stocks.

A key question with any documented return premium is whether it will persist into the future. If a return premium is clearly risk-based like the market factor, then there is no reason to believe it will not persist if financial markets are competitive (making return and risk related). The value premium may be risk-based, behavioral or, more likely, some combination of risk and behavior. But behaviors can persist too. We are more confident in the persistence of the market premium than the value premium. But when seeking equity returns in excess of the market return, perhaps your highest probability of achieving that objective is to tilt your portfolio toward value stocks.

Timing the value premium is difficult, if not impossible. For investors already invested in a value-tilted equity strategy, stay the course. For investors considering implementing a value-tilted equity strategy, now is as good a time as any to start.

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When seeking equity returns in excess of the market, perhaps your highest probability of success is to tilt your portfolio toward value stocks.

Notes

1 In 1993, Fama and French introduced a three-factor model comprised of a market factor, size factor and value factor to explain the cross section of equity returns.

2 The timeframe covers July 1926 to October 2015.

3 Annual price-to-book ratios are available since 2000 from Bloomberg.

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