REPRINTED FROM
POINT OF VIEW

MAY 2018

THE VALUE FACTOR ISN'T DEAD, JUST MISAPPLIED

CONTRARY TO POPULAR PERCEPTION, THE VALUE FACTOR HAS OUTPERFORMED OVER THE LAST DECADE.

Investors are losing patience with value strategies. They think the value factor has lost its power, underperforming since 2008. We disagree. But there's a difference between the value factor and value strategies. The value *factor* contributed positively to performance over the past decade. In contrast, many value *strategies* suffered from inefficiencies in portfolio construction.

WHERE'S THE VALUE?

The cyclical nature of the value factor's typical return patterns demands patience. For example, the average historical cycle of underperformance of the value factor in developed markets has been approximately four years, based on our research. Nonetheless, value strategies have historically rewarded patience over the longer term.

We illustrate the past decade's apparent break from historical patterns by comparing the rolling three-year historical performance of the MSCI World Value Index to the MSCI World Growth Index (Exhibit 1). Over the 40 years preceding the global financial crisis, the MSCI World Value Index delivered fairly consistent outperformance with periodic cycles of underperformance. This pattern appeared to end abruptly in 2008. Since

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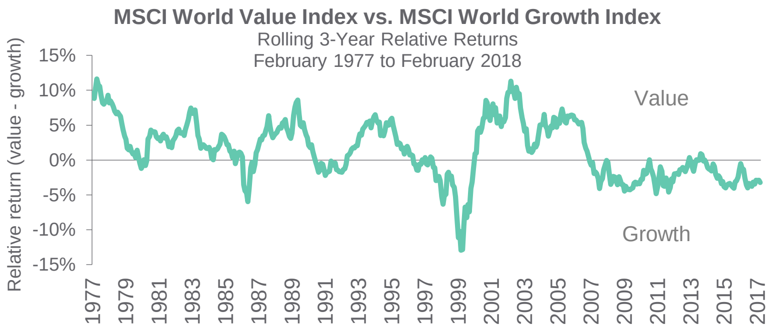
then, the MSCI World Value Index has underperformed its growth counterpart in nearly every rolling three-year period.

> *Contrary to popular belief, the value factor contributed positively to returns over the period.*

EXHIBIT 1: THE VALUE CHALLENGE

The MSCI World Value Index delivered fairly consistent outperformance with periodic cycles of underperformance. However, since 2008, the MSCI World Value Index has underperformed its growth counterpart in nearly every rolling three-year period.



SOURCE: Bloomberg. Relative returns reflect rolling 3-year net total returns of the MSCI World Value Index and MSCI World Growth Index in USD. Data February 28, 1977 to February 28, 2018.

VALUE STRATEGY VS. VALUE FACTOR

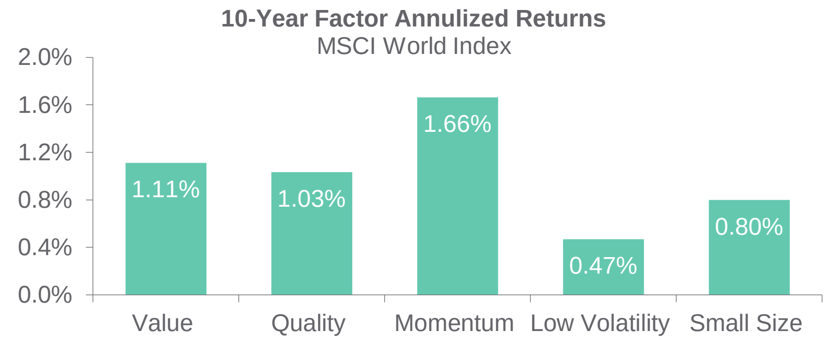
Some people may use this chart to question whether the value factor works anymore. However, this chart does not represent the performance of the value factor. Instead, it shows the performance of a value strategy. This matters because a value strategy is subject to a number of return drivers including but not limited to value.

When we isolate various factors in Exhibit 2, we get a more accurate view of factor performance. The chart shows that value actually outperformed from 2008 to 2018. In other words, and contrary to popular belief, the value factor contributed positively to returns over the period.

Many of the underperformers inefficiently targeted the value factor, resulting in undesired or unexpected exposures.

EXHIBIT 2: PURER VALUE TELLS A DIFFERENT STORY

Contrary to popular belief, the value factor, along with other compensated factors, performed positively over the period.



SOURCE: Northern Trust Asset Management quantitative research. Data 10 years through February 28, 2018. Factors shown represent groups of Barra GEMLT risk indices descriptors. Grouped performance calculated monthly as the average of the underlying indicators descriptors. Performance reflects the results of multivariate regression.

YOUR VALUE STRATEGY MAY BE CORRUPTED

So, why have value strategies underperformed? Because many of the underperforming strategies inefficiently targeted the value factor, resulting in undesired or unexpected exposures.

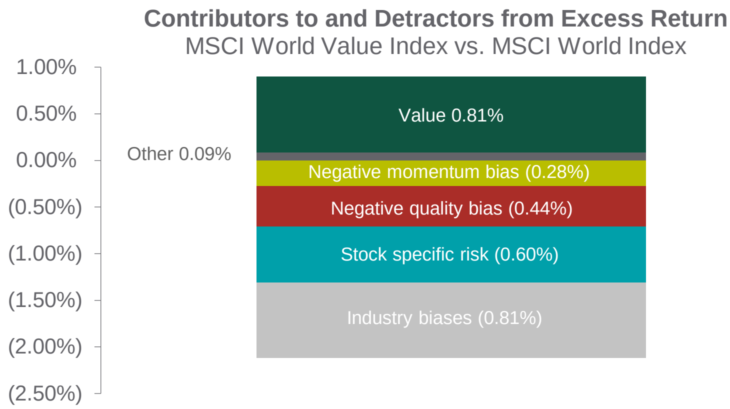
Factor efficiency is a key driver of the risk-adjusted performance of factor-based strategies. We regularly see value indices or strategies without strong risk controls that structurally underweight the information technology sector and that display other industry biases, as well as having significant stock concentration. Furthermore, as the value factor tends to be negatively correlated with the quality and momentum factors, many value strategies are biased toward unfavorable low quality and low momentum stocks.

The negative contribution of these undesired or unexpected exposures overwhelmed the value factor's outperformance over the past 10 years (Exhibit 3). This happened because, over the past decade, the information technology sector was among the best performers. A few very large information technology stocks significantly outperformed both the sector average and the broader market. As value strategies tended to avoid these stocks, this drove the negative stock-specific return contribution. Further, quality and momentum performed positively over the period, so value strategies' under-exposure to them contributed to underperformance.

It is critical to select a value strategy designed and executed to target value precisely.

EXHIBIT 3: VALUE STRATEGIES WEIGHED DOWN BY NOISE

While positive exposure to the value factor was rewarded, this benefit was offset by the other biases in the portfolio, such as low quality and industry biases.



SOURCE: Northern Trust Asset Management quantitative research, Barra. Data reflects 10 years of performance as of February 28, 2018, using monthly holdings of the MSCI World Value Index and MSCI World Index. Attribution calculated using the Barra GEMLT risk model. Value, quality and momentum contributions reflect groups of Barra GEMLT risk indices descriptors.

STRATEGY DESIGN AND IMPLEMENTATION MATTER

A robust investment process that explicitly accounts for the uncompensated risks discussed above can overcome such negative contributions. We believe that the value factor is not dead. While we expect the value premium to persist, it is critical to select a value strategy designed to target value precisely.

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The MSCI World Index captures large- and mid-cap representation across 23 developed markets countries. With 1,653 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.