IS THERE VALUE IN THE VALUE PREMIUM? (REVISITED)

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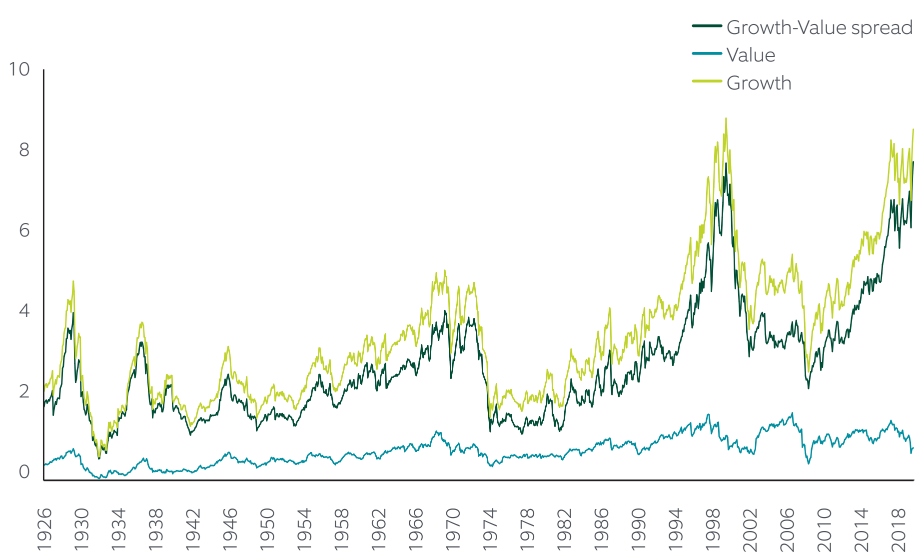
In January 2016 we published the research article "Is There Value in the Value Premium." At the time, value stocks (Russell 3000 Value index) had underperformed growth stocks (Russell 3000 Growth index) by 4.1% annualized since 2009, and investors were questioning whether a value tilt was beneficial to their portfolio. Fast forward to July of 2020 and the underperformance has fallen to 7.2%.

The main academic research on the value premium uses the price-to-book ratio to sort value and growth stocks, though other value measures produce similar results. The value premium is the return of value stocks over the return of growth stocks, so an intuitive measure of potential "value" in the value premium is the spread in price-to-book ratios between growth and value stocks. Exhibit 1 shows the price-to-book ratio for both growth and value stocks, as well as the spread from July 1926 through June 2020.

EXHIBIT 1

U.S. Price-to-Book Ratio (July 1926 - June 2020)



Source: Dimensional Fund Advisors

The spread hovers around levels not seen since the technology bubble of the late 1990s. The increased spread is fueled by a run-up in the valuation of growth stocks and to a lesser degree by the devaluation of value stocks. Market timing is unreliable, and we can't know for sure when the value premium will turn positive or even if it will persist going forward. But we can put this in the context of history, which may be informative to forward-looking investors. We calculate a Z-score[1] for the price-to-book ratio spread (number of standard deviations above the average spread) for every month back to July 1926. In Exhibit 2, for a range of Z-scores we display the average value premium and percentage of time the value premium was positive over subsequent one-year and five-year periods.

EXHIBIT 2

		Subsequent 1YR		*Subsequent 5YR*	
	Z-score Range	**Return Avg.**	**% Positive**	**Return Avg.**	**% Positive**
June 2020 Z-score: 3.7	**>3**	**2.6%**	**33%**	**8.5%**	**100%**
	2 – 3	4.5%	65%	7.2%	96%
	1 – 2	4.3%	66%	3.0%	74%
	0 – 1	2.3%	56%	2.1%	66%
	-1 – 0	5.3%	67%	5.4%	90%
	-2 – -1	12.1%	58%	5.6%	97%
	<-2	-13.1%	0%	-6.1%	0%
	All Months	**4.4%**	**61%**	**4.1%**	**80%**

Source: Northern Trust Research

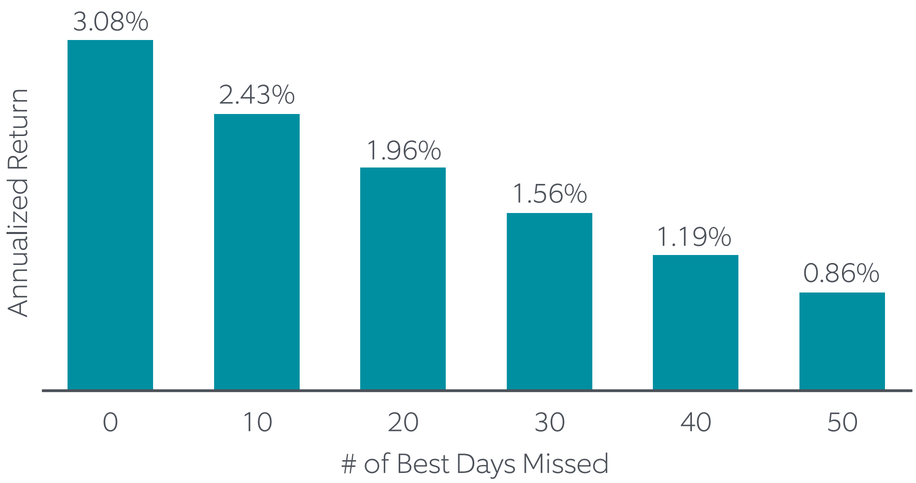
At the one-year horizon there is not much of a discernable pattern across the Z-score ranges. This reinforces the fact that short-term returns are noisy, valuations can stay extreme for a long time, and attempting to time the value factor is probably a useless endeavor. At the five-year horizon there is also not much of a pattern for the middle Z-score ranges, but we see stronger evidence at the extremes of the distribution. The Z-scores associated with the most extreme spreads have historically been associated with both the highest average 5-year subsequent value premium and the highest likelihood of a positive value premium. The current spread is in the extreme Z-score range. While history is no guarantee of future performance, this observation may inform confidence levels for long-term investors who seek additional return from a value tilt in their portfolio.

1 Calculated with respect to the since inception history at every point in time to mitigate any look-ahead bias.

Finally, Exhibit 3 displays the cost of trying to time the value premium historically. Missing just the best 30 days cuts the value premium in half over its 94-year history.

EXHIBIT 3

U.S. Value Factor (July 1926 - June 2020)



Sources: Northern Trust Research, Ken French Data Library

Factor-based investing requires a long-term view and the value premium is earned on average, but not every year. For investors already invested in a value-tilted equity strategy, it may be wise to stay the course. For investors who are considering implementing a value-tilted equity strategy, now is as good of a time as any to start.