After a challenging 2015 for contrarian value investors, we are optimistic

Shaun le Roux

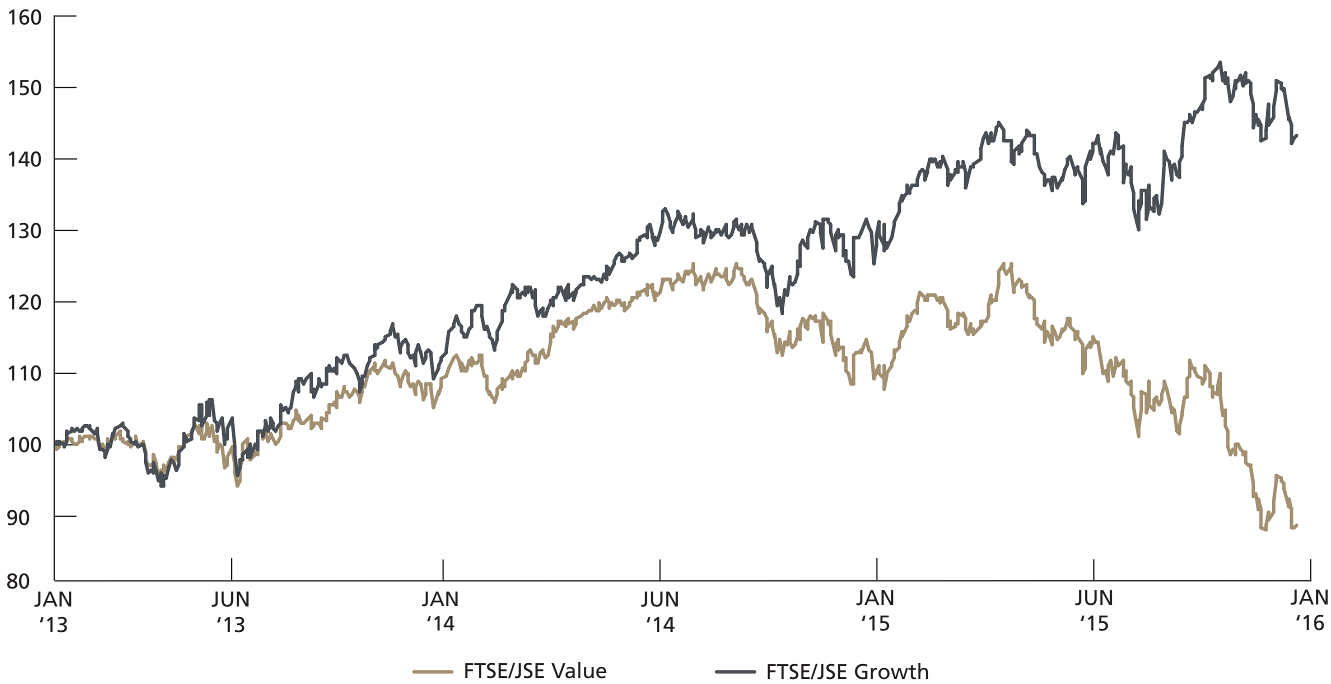
Shaun is the Fund Manager of the PSG Equity Fund.

2015 was a very challenging year for value investors
On the JSE, the Growth Index beat the Value Index by a staggering 32% in 2015 (as shown in Graph 1). This was a global phenomenon: the MSCI World Value Index lagged its growth equivalent by more than 9%. The only times when growth has beaten value by more in a single year over the past two decades were 1998, 1999 and 2007. It is therefore no wonder that value investing is getting such a bad rap.

However, value investing delivers superior results over the long term
Despite a poor run in recent years, and a particularly poor 2015, value has beaten growth by 0.5% per year over the past 41 years on the MSCI World indices (as shown in Graph 2). This is before accounting for dividends, which would further boost the relative performance by value. Investing in companies that are trading for less than they are worth has been shown to yield superior results for those investors who can consistently identify such opportunities and have the patience to wait for the discount to intrinsic value to close.

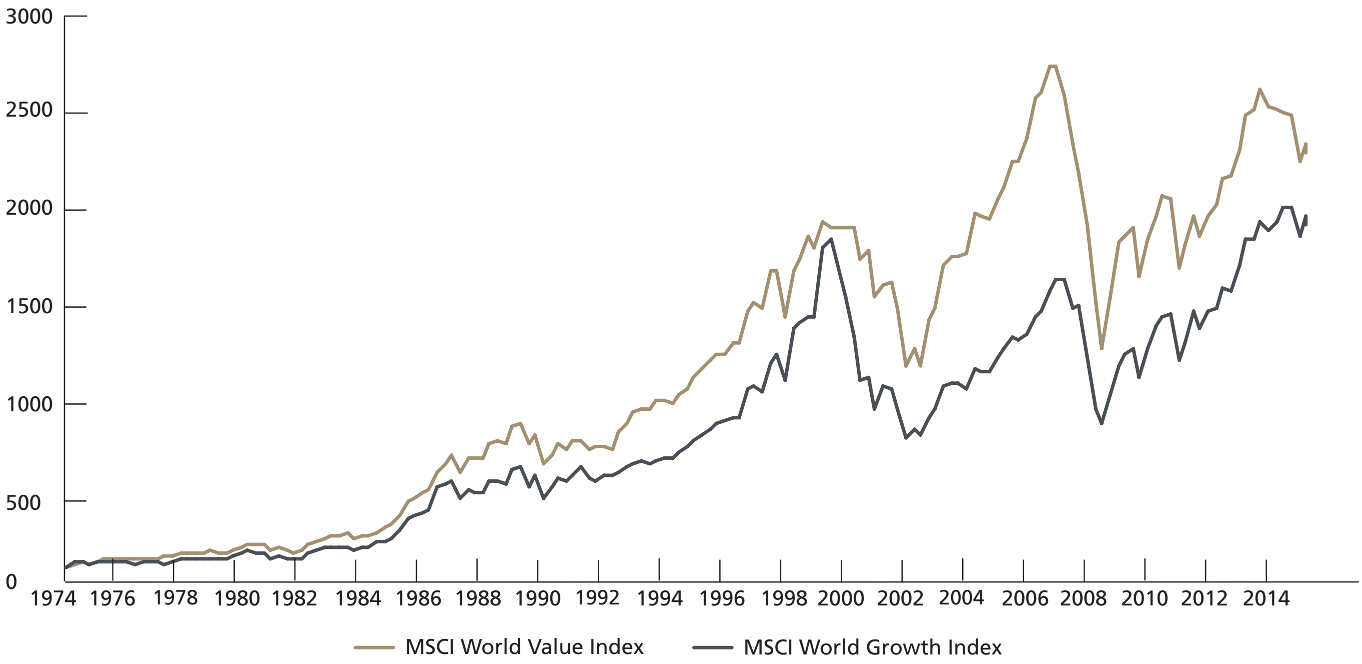
The gap between the share price and intrinsic value is what is referred to as a 'margin of safety'. Value investors like ourselves view this margin as a buffer against the reality that investing is inherently unpredictable and all participants will make mistakes in their assessment of intrinsic value.

Graph 1: The FTSE/JSE Value Index had a tough year in 2015



Sources: PSG Asset Management, Bloomberg

Graph 2: Value trumps growth investing over four decades (1974 - 2014)



Sources: PSG Asset Management, Bloomberg

Value investing is not easy

There are many measures that indicate that a business is possibly undervalued, but there is no free lunch – often companies can appear to be cheap on one of the traditional measures of valuation but end up being value traps. Value traps can arise when a business is in structural decline, has too much debt on the balance sheet or when the management team has a tendency towards shareholder value destruction. Therefore, buying a share just because the share price has declined or because it is out of favour can produce very poor investment results.

The ability to exploit value opportunities typically requires strong emotional discipline and a longer investment time horizon, both of which are in short supply in global financial markets. Value investors will typically be early, buy a stock before its price bottoms and wait for value to be unlocked. A rare breed, the true value investor relishes falling prices. This provides the opportunity to buy stocks cheaper, thereby enhancing future returns. This is contrary to human nature, as we are all conditioned to feel the pain of losses twice as much as we enjoy the pleasure of gains. As a result, the man on the street has a recurring habit of selling when prices are falling and only having the confidence to buy when prices have been rising for a while.

Stocks tend to only become cheap if they are out of favour. Buying unloved stocks on the cheap requires a contrarian investment strategy and, as we all know, it is always more comfortable in the herd. 2015 was a clear example of just how lonely contrarian value-based investing can be. The average stock portfolio naturally has a high exposure to large cap shares, and 2015 was characterised by very strong gains for a narrow group of large cap growth stocks, which flattered equity indices around the world. By contrast, the average stock was sharply down. This was particularly the case for cyclical value stocks and emerging markets. Index-tracking strategies produced favourable results, which supported the push towards passive investing over active investing.

What is the outlook for value investors?

Current sentiment in global stockmarkets is poor and in the unloved parts it is terrible. As a result, many stocks and sectors are trading at valuation levels last seen in the global financial crisis. Times are tough and economic conditions will probably get worse before they get better. However, this is largely reflected in the prices of many securities and currencies. All this has value investors such as ourselves licking our lips and buying good businesses that are priced for distress. A tendency to be early and a willingness to invest away from the crowd, take a longer-term view and exploit panic bodes well for future returns for our clients.