Value Strategies Almost Always Outperform Growth Strategies

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It's a debate that's been raging for as long as equity markets have been in existence, which is the best strategy: value or growth?

If you look to the numbers, however, value strategies almost always outperform growth strategies. And there's plenty of evidence to support this statement.

Value versus growth

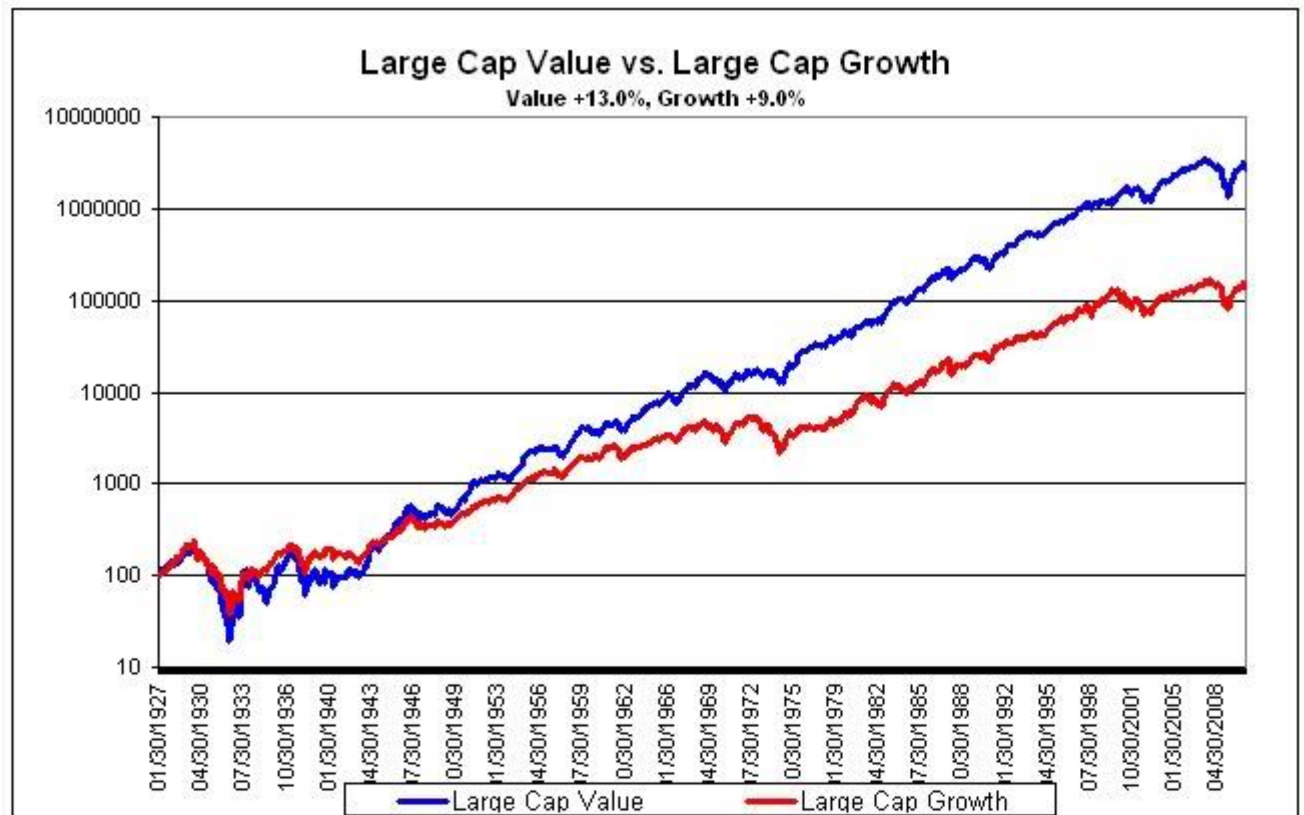
"Value Versus Growth: The International Evidence," is a key study on the topic. Published during 1997 and co-written by renowned finance professors, Eugene Fama of the University of Chicago Graduate School of Business and Kenneth R. French, a former Chicago faculty member now at the Yale School of Management supports the conclusion that on balance, value strategies continually outperform growth strategies.

The data used in this study was taken from portfolios of growth and value stocks in the US and 12 other major developed economies. Data used was captured in each December from 1974 to 1994.

French and Fama defined value stocks for the study as those with high ratios of book value to market value and growth stocks as those that have low ratios of book value to market value. In other words, value stocks had the markets low price to book ratios while growth stocks had the highest price to book ratios.

The difference between average returns on global portfolios of high and low book-to-market equity stocks was 7.60% per year. Value stocks outperform growth stocks in 12 of 13 major markets during the 1975-1995 period. What's

more, similar return premiums were also reported when sorting the stocks in order of earnings/price, cash flow/price, and dividend/price. Additionally, a strong value premium in emerging markets was also reported but to a certain extent, this should be expected. A lack of information and illiquid market could easily explain how emerging market stocks outperform in terms of value vs. growth stocks.



value vs growth

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High expectations

It was found in many cases that the market's high expectations for growth stocks held back their long-term performance. Specifically, the market often pegged a high valuation on growth stocks from the very beginning, leaving them no choice but to grow into their valuation, at which point growth would slow and the valuation would adjust accordingly.

Fama has since commented that, “people think because these are good companies, their stock returns will be high. But in fact, their prices are pegged so high by the market that their returns actually tend to be low..."The intuition is that value stocks have low prices relative to their book value, so the market feels they're relatively distressed...The intuition is the opposite for growth stocks."

In other words, value stocks may seem more risky at first glance due to their distressed valuations and growth stocks, trading at high valuations appear less risky to the average investor. The opposite is true.

This analysis reminds me of the following paragraph from Warren Buffett’s famous essay, ‘The Superinvestors of Graham and Doddsville’:

“The Washington Post Company in 1973 was selling for $80 million in the market. At the time, that day, you could have sold the assets to any one of ten buyers for not less than $400 million, probably appreciably more...Now, if the stock had declined even further to a price that made the valuation $40 million instead of $80 million, its beta would have been greater. And to people that think beta measures risk, the cheaper price would have made it look riskier. This is truly Alice in Wonderland. I have never been able to figure out why it's riskier to buy $400 million worth of properties for $40 million than $80 million..."

Contrarian investment, extrapolation, and risk

The French and Fama study is not only scientific work that points to the fact that value outperforms growth over time. Another paper, Contrarian Investment, Extrapolation, and Risk by Josef Lakonishok, Andrei Shleifer, Robert W. Vishny, published in The Journal of Finance, Vol. 49, No. 5 (Dec., 1994), looked at two factors that influence value stock returns vs. growth stocks. Firstly, the performance of a contrarian stocks in comparison to glamor stocks and the variance in returns achieved. Secondly, the paper asked

whether value stocks are indeed fundamentally riskier than glamor stocks -- To be fundamentally riskier, value stocks must underperform glamor stocks with some frequency. The sample period for this study was broader than the Fama and French research. Data used spanned the period April 1963 through April 1990 over five-year sample periods. For each of the portfolios studied, stocks were equally weighted, and returns were calculated using an annual buy-and-hold strategy for years one through five.

The results from the study showed three key trends. Firstly, a variety of investment strategies that involve buying out-of-favor stocks outperformed glamor strategies over the period April 1968 to April 1990. Secondly, the study showed that the poor performance of glamor stocks was, on balance, due to the fact that the growth rate of these companies turned out to be lower than the market was expecting, and market participants appeared to be consistently overestimating growth rates.

And thirdly, using conventional approaches to fundamental risk, value strategies appear to be no riskier than glamor strategies. Josef Lakonishok, Andrei Shleifer, Robert W. Vishny found that on average, value strategies outperformed glamor strategies by 10% to 11% per year.

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