360INSIGHTS

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When Value Underperforms

By Jared Kizer, Chief Investment Officer

Imagine you are a competitive diver in the Olympics. You will be judged on your form, your technique and the difficulty of your dives. The more complicated a dive, the higher your potential score. But also, the higher the chances of not executing the dive perfectly.

Investing is similar. The more risk you take on in your portfolio, the greater your expected return potential. Academic research has shown that different stocks have different expected returns. For example, small company and value company stocks have greater expected returns — and risks — than growth and large company stocks. As an investor, you need to decide how much of these risks you are willing to take.

Value stocks are usually associated with corporations that have experienced slower earnings growth or sales, or have recently experienced business difficulties, causing their stock prices to fall.

Still, value stocks will experience periods of relative underperformance. In the U.S. stock market over the last decade, value stocks have performed poorly relative to growth stocks. Using Dartmouth College Professor Ken French's data, value appears to have experienced its sixth-worst drawdown ever over the period of January 2007–September 2018, with a cumulative underperformance versus growth stocks of −32.2 percent. This observation contrasts with the long-term data showing that value stocks have outperformed growth stocks by 4.8 percent per year over the period of 1927–2017. For investors who have experienced poor performance in recent years, it is natural to wonder how value stocks tend to perform after periods of poor performance.

Table 1 reports the 2007–2018 drawdown, as well as the five others that were worse.

TABLE 1: VALUE PREMIUM DRAWDOWNS (7/1926–11/2018)**

	Drawdowns in Value
Largest Drawdown	-43.5
Start	Sep-1933
End	Mar-1935
2nd	-40.9
Start	Sep-1998
End	Feb-2000
3rd	-36.4
Start	Apr-1937
End	May-1940
4th	-34.3
Start	Jun-1927
End	Dec-1931
5th	-33.2
Start	Sep-1932
End	Dec-1932
6th	-32.2
Start	Jan-2007
End	Sep-2018

Source: Ken French, Dartmouth College

Looking at the five largest drawdowns — which are all from distinct, non-overlapping time periods — they all exceeded −30 percent with the largest being −43.5 percent over the period of September 1933 through March 1935. The −30 percent threshold means that in each of the five drawdowns, value stocks underperformed growth by at least −30 percent over some period of time, with the shortest encompassing less than a year(!) and the longest covering more than four years.

In three of the periods, value essentially went straight down while in two there was a significant recovery that was then followed by a reversal into an extension of the drawdown. Some of the drawdowns occurred over relatively long periods of time while others did not.

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Performance After Value Disappoints

Historically, value has done very well after periods of poor performance relative to growth. Table 2 presents the same drawdown statistic for each of the five-largest drawdowns cataloged in Table 1, but also presents the total returns to the value premium for the five-and 10-year periods after each drawdown period concluded.

TABLE 2: TOTAL RETURNS AFTER VALUE DRAWDOWNS (7/1926–11/2018)**

	Returns
Largest Drawdown	-43.5
Total Return Next 5 Yrs	23.0
Total Return Next 10 Yrs	159.7
2nd	-40.9
Total Return Next 5 Yrs	124.7
Total Return Next 10 Yrs	128.9
3rd	-36.4
Total Return Next 5 Yrs	127.4
Total Return Next 10 Yrs	161.5
4th	-34.3
Total Return Next 5 Yrs	93.5
Total Return Next 10 Yrs	71.6
5th	-33.2
Total Return Next 5 Yrs	41.5
Total Return Next 10 Yrs	54.9

Source: Ken French, Dartmouth College

If we take averages across all five of the five- and 10-year horizons, total returns have averaged +82 percent for the five-year horizon and +115 percent for the 10-year horizon. In annualized returns, these are 12.7 and 8.0 percent per year, respectively. The bigger point here is not that we should expect an exact repeat of these averages, but rather understand that the data clearly shows that value has historically done well after extended periods of poor performance.

The 2007–2018 Value Drought

As Table 1 shows, value struggled mightily from 2007 to 2018. In the U.S. market, value underperformed growth by 32.2 percent over the stretch of January 2007–September 2018. One interesting aspect of this period relative to the five that were worse is how long the most recent stretch covered: almost 12 years total. So how might value perform from here? It's impossible to know for sure, but the results from Table 2 indicate it's very reasonable to expect value to do well following the difficult period of 2007–2018. This long-term potential for strong performance is why we believe most investors should have an allocation to value in their portfolios.

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Markets (And Some Premiums) Bounce Back

By Jonathan Scheid, CFA, AIF®, VP, Portfolio Strategy & Education, Loring Ward

What a difference a few months can make! A few months at the end of 2018 turned U.S. stock returns negative and made international stocks to decline further for the year. Now, just a few months after that recent low, stocks in the U.S. and abroad have staged a significant recovery.

U.S. stocks (represented by the S&P 500 Index) declined -13.5% in the fourth quarter of 2018. After the first two months in 2019, they were up 11.5%. This pattern of losses followed by gains is not a new one and has historically occurred quite often. A review of the following table can help shed some light on this historical pattern.

In the table we list, by order of magnitude, the largest calendar quarter declines in the U.S. stock market since the end of World War II. (The end of World War II is often used as a starting point because the Federal Reserve had its current mandate and tool kit in place by then.) Next to each return we show the subsequent market returns for the following quarter, 1-, 3- and 5-year periods. You can see that the worst quarterly decline of -25.2% occurred in the third quarter of 1974, and the Q4 2018 decline was the 11th worst since 1945.

When we look at how markets performed following those large quarterly declines, we can see that returns were positive in the following quarter in all cases but one. The same is true for the one-year period. In the three- and five-year periods, all the subsequent returns were positive, and the average return was much higher than the long-term historical U.S. market average.

WHAT HAPPENS AFTER A DOWN QUARTER?
A Review of the worst Quarters from the S&P 500 (1945-2018)

			Return following the Down Quarter			
Rank	**Quarter Ending**	**Quarterly Return**	**3 Months**	**1 Year**	**3 Years**	**5 Years**
1	9/30/74	-25.2%	9.4%	38.1%	20.0%	16.8%
2	12/31/87	-22.6%	5.9%	16.8%	14.2%	15.9%
3	12/31/08	-21.9%	-11.0%	26.5%	14.1%	17.9%
4	6/30/62	-20.6%	3.7%	31.2%	19.2%	14.3%
5	9/30/46	-18.0%	3.7%	6.4%	7.6%	16.6%
6	6/30/70	-18.0%	16.9%	41.9%	16.3%	9.3%
7	9/30/02	-17.3%	8.4%	24.4%	16.7%	15.5%
8	9/30/01	-14.7%	10.7%	-20.5%	4.0%	7.0%
9	9/30/11	-13.9%	11.8%	30.2%	23.0%	16.4%
10	9/30/90	-13.7%	9.0%	31.2%	18.1%	17.2%
11	12/31/18	-13.5%	n/a*	n/a*	n/a*	n/a*
Average		-18.6%	6.8%	22.6%	15.3%	14.7%
Median		-18.0%	8.7%	28.3%	16.5%	16.1%

*Not available at publication deadline

While this historical evidence is quite compelling, it is important to remember that there is still risk when it comes to investing. Just because we bounced back from this recent decline, doesn't mean that we will bounce back from the next one. Yet, our expectation for stocks to post long-term, positive results still holds, and the reality is that those results don't occur in a straight line.

Small-Cap Premium Bounces Back

While we saw U.S. and non-U.S. stocks recover following the fourth quarter sell off, we also saw a promising trend for our investment strategy. Our academic, evidence-based approach to investing has us focused on factors of return that we feel help drive overall market results. Those factors of return suggest we tilt our investments toward stocks that are smaller than the broad market, cheaper than the broad market, and more profitable than comparable companies.

The historical evidence strongly favors these factors of return, yet they are not guaranteed. Over the past five years, the premiums were not realized. Consider the small company factor of return where we expect small companies to outperform large companies. Over the past five years ending December 31, 2018, small company stocks (measured by the Russell 2000 Index) returned 4.4%, and large company stocks (measured by the Russell 1000 Index) returned 8.2% on an annualized basis. Our expectations for outperformance were not met.

Despite underperforming over the past five years, we still feel small companies should outperform large companies over the long term. That outperformance can occur over very brief time periods and with substantial magnitude. During the first two months of the first quarter, U.S. small company stocks outpaced U.S. large company stocks by a wide margin. U.S. small stocks returned 17.0%, and U.S. large stocks returned 12.0%. Premium can be received in a short period of time, so we feel it is best to stay exposed to small company stocks. If we miss the brief time period premiums appear, it could be detrimental to our wealth.
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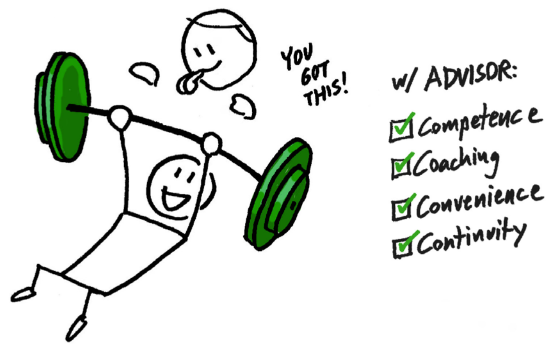
Investing Is Hard — Get Help from a Trusted Advisor

IT IS NOT ENOUGH FOR A PROFESSIONAL TO BE RIGHT: AN ADVISOR'S JOB IS TO BE HELPFUL.
— David H. Maister, Professor



Some things are just too difficult or stressful to do on your own. Like a dietitian or a personal trainer, a financial advisor can help set up the right plan for you, then monitor and motivate you so you end up with the results you want.

There are four key benefits to working with an advisor:

Competence: Financial advisors provide the critical actions that help drive successful long-term outcomes, including planning, asset allocation, rebalancing and working with other financial professionals.

Coaching: An advisor offers education and guidance through the emotional cycles of investing, which can cause us to compromise long-term goals.

Convenience: You delegate the complex and time-consuming work of investing and planning to your advisor.

Continuity: It's nice to have someone who knows your wishes and goals and can help preserve your legacy and protect those you care most about if anything happens to you.

Remember, choosing a financial advisor is one of the most important decisions you can make.

This article is an excerpt from a new book, "27 Principles Every Investor Should Know," with sketches by well-known illustrator Dan Roam, coming out in early 2019.

Markets (And Some Premiums) Bounce Back, continued from page 3)

Takeaways

Our first takeaway is that, uncertainty is a normal part of investing. We don't know when the stock or bond market may fall, how long it may decline and when it may recover, if at all. Second, despite not knowing when declines may happen and if we will recover from those declines, history has shown us that we should not lose faith in stocks when they decline. Positive results have historically followed most past declines.

Finally, there are risks associated with pursuing the factors of return offered by small-cap companies, value companies and higher profitability companies. These factors may not deliver on our expectations of outperformance over short and medium time frames, but when factor returns do deliver, they can deliver in a big way. Therefore, it is important to stay the course with an evidence-based investment strategy. We don't want to miss out on the times when the premiums are present.

Data source: Morningstar Direct, 2019. All investing involves risk, principal loss is possible. Implementing an asset class investing strategy cannot guarantee a gain or protect against a loss. Indexes are unmanaged baskets of securities in which investors cannot directly invest; they do not reflect the payment of advisory fees or other expenses associated with specific investments or the management of an actual portfolio.