OUTSIDE THE FLAGS

Patience Pays Off for Value Investors

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"Sure enough, even waiting will end…if you can just wait long enough." That quote from the great American novelist William Faulkner may be striking a chord with value investors right now after the value premium turned positive in recent months.

It's no secret that the value premium – the additional expected return of low relative price over high relative price or 'growth' stocks– has struggled in the past decade, testing the patience and resilience of many investors.

But we also know from history that stock returns are unpredictable and that there is a precedent for the value premium turning around quickly after a prolonged poor run. After the end of the 'dot-com' era in early 2000, for instance, a long period of outperformance by growth stocks ended abruptly and value came to prominence.

And even within the drought of the past decade, value has experienced strong run-ups in some years. In 2016, for example, value was the standout premium, particularly in Australia where value beat growth by about seven percentage points.

In fact, most of the underperformance of value in the past decade was concentrated in the three years of 2018-2020. Last year, amid the pandemic, growth was boosted by rallies in technology giants Apple, Microsoft, Amazon and others.

In the final quarter of 2020 and first quarter of 2021, however, stocks that had been beaten down during the pandemic – retailers, oil and gas explorers, airlines, media and financial stocks – have started to shine.

In the 12 months to 31 March, for instance, large value stocks in Australia have delivered a premium above growth of about 22 percentage points. Among small caps, the premium has been even more impressive at about 34 percentage points.

Some of the big name value outperformers have been big banks Westpac, ANZ and NAB, oil and gas producers Santos and Woodside Petroleum, and materials stocks Fletcher Building and South32.

Outside Australia, the value premium over the year to the end of March has been about

10 percentage points among both large caps and small caps.

To be fair, value still lags growth over the past 10 years, but it has made up significant ground. And while we don't know whether this revival will continue, we do know there is solid empirical evidence for a long-term value premium.

That evidence is based on the theory that paying a lower price for a security relative to fundamentals means a higher expected return. However, as with the equity market itself, we know that *realised* returns are volatile. A 10-year negative premium, while not expected, is not unusual.

But history also tells us that changing course after a disappointing run for known premiums can lead to you missing opportunities. When those drivers of outperformance have turned around in the past, investors who stuck to their plan have been rewarded.

Sometimes, the waiting is the hardest part.