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Revisiting Value Investing: A Behavioral Finance Perspective

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Snapshot

- Irrational expectations that recent market trends will last forever can create opportunities for individuals willing to break with the consensus view.
- Investors can fight behavioral biases by remembering that long-term relationships usually hold up for good reason.
- At SEI, we believe that value investing continues to represent an historical opportunity for long-term investors.

It's easy to overlook long-term potential benefits when faced with shorter-term drawbacks. In fact, we're all cognitively hardwired to think this way. There's a direct relationship between the behaviors that arise from this line of thinking and value investing opportunities.

The market factors that drive factor investment strategies are all rooted in behavioral biases. At the overall market level, biased behavior can accumulate into inefficiencies that persist over time. Factors can go through periods in and out of favor, but their payoffs have been clearly visible with a long-term perspective.

Value: A Well-Known Quantity

Numerous studies have examined the historical outperformance of value investing. Benjamin Graham and David Dodd—widely considered the fathers of this approach—published a book in 1934 (well before the invention of big data) that documented the benefits of investing in the value asset class.

Years later, armed with computing power, academics Eugene Fama and Kenneth French (in 1992), as well as Josef Lakonishok, Andrei Shleifer and Robert Vishny (in 1994) documented strong long-term returns for value securities in the U.S. and many other countries around the world. Still, this data did little to deter most investors in the late 1990s from piling into internet stocks with no earnings and zero book values.

Behavioral biases can punish investors

Behavioral finance is a field of study that examines the impact of emotions on investing decisions. We believe that emotion-based investing can ultimately lead to weakened performance. In our view, exposure to the value asset class can help investors avoid mistakes driven by behavioral biases that include (but are not limited to):

Recency bias: Investors' tendency to remember items that appear at the end of a long list of complex data rather than recalling those that appeared earlier. Of the many examples demonstrated throughout the history of financial markets, the last prominent episode of recency bias took place in early 2000. After four years of U.S. equities reaching new highs on a raging bull market in technology, media and telecommunications stocks, investors (professional and amateur alike) continued to invest as if the stocks that soared during the tech bubble would continue to rise unabated despite the experiences of past boom and bust cycles. As we know now, this was not the case. Instead, the tech bubble deflated in a tragic spectacle.

Loss aversion: Investors' tendency to overreact to stressful market events with excessive caution—putting a higher priority on avoiding losses than on seeking gains (or avoiding losses altogether)—thereby giving up on the opportunity to benefit from an eventual market rebound. During the COVID-19 pandemic, for example, investors who fled the plummeting retail or transportation sectors out of loss aversion also abandoned potential earnings once these deeply discounted securities recover.

Over-extrapolation: Investors' tendency to arrive at a long-term conclusion based on limited or select data points. Historical examples include investors presuming in the 1980s that dominant oil producers would remain among the world's biggest companies forever, and believing in the 2000s that large banks would remain strong for the foreseeable future. More recently, mega-cap technology stocks have appeared to expand without competition, regulation, or the need to deliver earnings.

Behavioral science tells us that these biases are generally amplified in times of greater market uncertainty, particularly when it comes to deciding whether to invest in stocks that may be hard to value. When the outlook is uncertain, as in the COVID-19 pandemic environment, investors are more likely to act on emotion and lock into those behavioral mistakes.

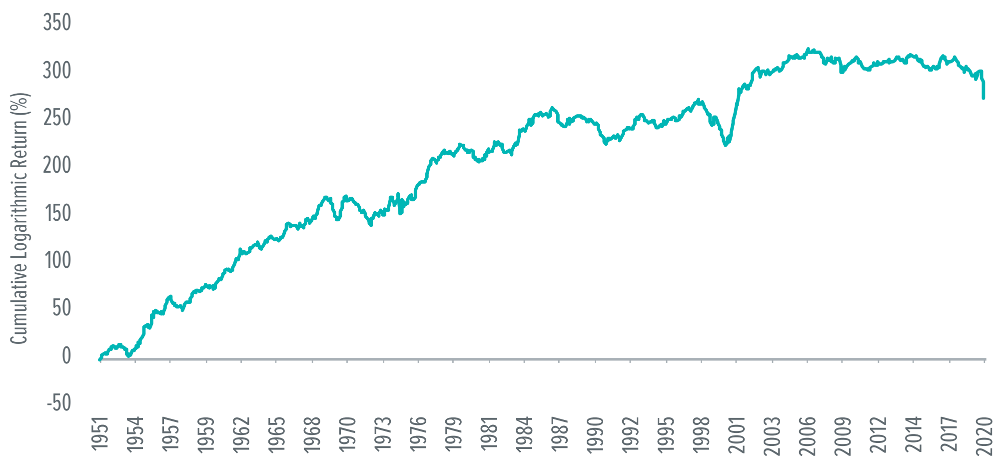
A time-tested strategy

Value investing is a time-tested, viable strategy that history has shown can help investors avoid some of these behavioral biases, using an objective approach. Value investors don't have to rely on unique, unknown or unrecognizable metrics and can intuitively understand why buying cheap can be better than buying expensive. The methodology can be verified with conviction that is not overly influenced by behavioral bias.

Exhibit 1 illustrates the long-term history of value investing. The blue line represents the relative performance of a hypothetical portfolio that holds the cheapest 30% of U.S. equities compared to a portfolio of the most expensive 30% of U.S. equities. Over a period of nearly 70 years, the value investor's portfolio of least-expensive stocks was the clear winner.

This is not to say the value portfolio outperformed every year, or even every three or five years. Its drawdowns are quite obvious when looking at the chart, particularly the more dramatic dips of the 1986-87 period and the 1999-2000 tech bubble. Thus far, 2020 has also been a clear standout from what has been a long-term benefit of buying cheap.

Exhibit 1: Long-Run Return to Value in the U.S.



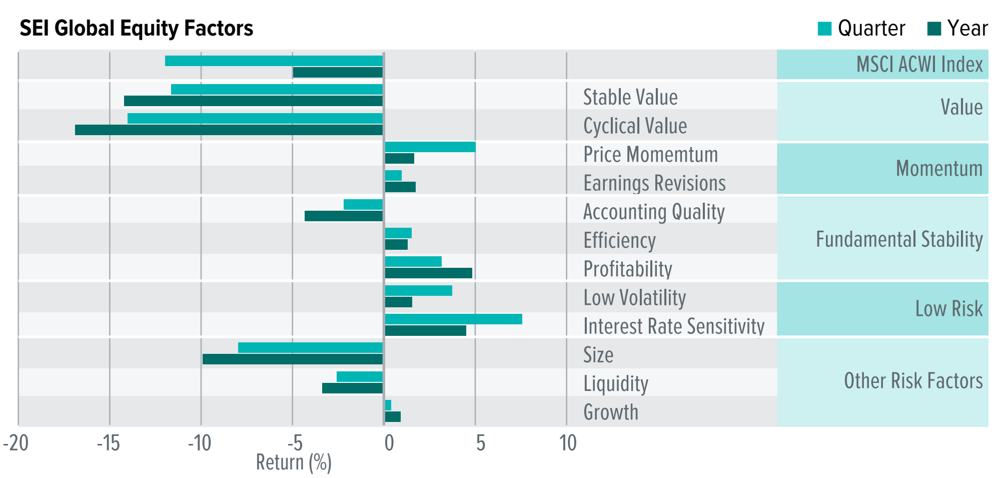
Source: Ken French's cap-weighted U.S. equity data from 7/1/1951-3/31/2020, showing the return of the cheapest 30% of the market over the return of the most expensive 30% of the market. (https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html). Past performance is not a guarantee of future results.

current environment, zeroing in on
returns. It's clear that value has
overall market, as measured by the

Of course, there are biases at play as pandemic-related uncertainty mounts and questions multiply: What if airlines or small businesses do not get bailed out or receive enough stimulus funding from the government? What if the lockdown continues for longer than expected? Even the possibility of such events creates enormous opportunity in the long run; in the short term, though, price declines in these sectors are self-fulfilling.

Just as fear drove consumers to stockpile certain goods like toilet paper and flour, stripping the supermarket shelves bare, we have seen investors rapidly run from risk and toward the comfort of securities that have outperformed over the last year—over-extrapolating—causing cheaper names with lower price-to-earnings to lag.

Exhibit 2: Short-Run Departure From Value



Source: SEI, based on data from MSCI and FactSet. Data as of 4/30/2020. MSCI ACWI Index performance is net returns. The metrics are composites of underlying ratios that SEI has determined are appropriate measures of each factor. Global equities are represented by the MSCI ACWI Index. Data refers to past performance of liquidity-weighted top-quartile portfolios vs the capitalization-weighted benchmark and rebalanced quarterly. Past performance is not a guarantee of future results.

Such a pullback in value stocks does not mean that investors should abandon the asset class. Imagine an apple orchard that just had a fruitless season brought by frost or drought; the orchard would not be thereby deemed useless for future seasons. Similarly, we think it's important to remain invested in value stocks even as they experience a fruitless period amid unstable market conditions. Economic life, like the life of an apple orchard, is measured in decades rather than months or even years. As value investors, we see periods of decline as rife with opportunity to invest in the steeply discounted stocks that were discarded by fearful investors, with the aim to harvest them in the years to come.

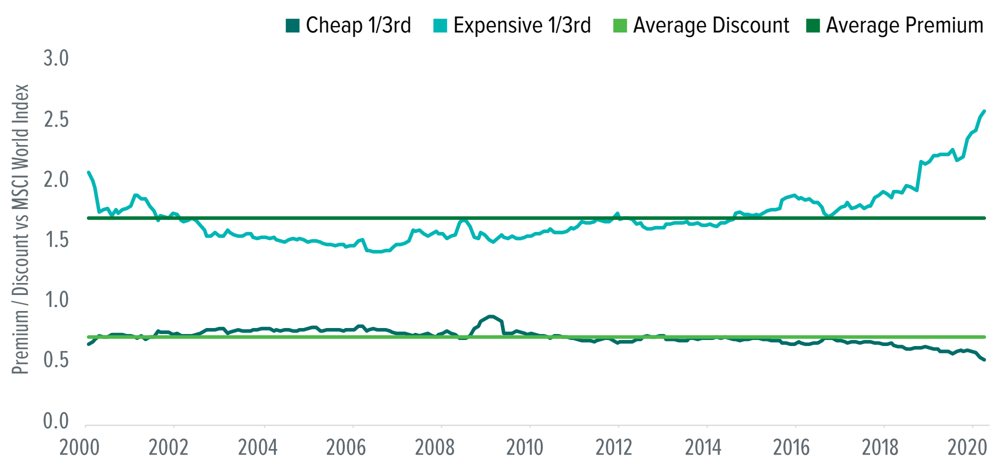
How cheap is cheap?

While we believe value investing represents a solid long-term approach, we also believe the current environment presents a short-term opportunity to purchase historically cheap securities.

As illustrated in Exhibit 3, the most expensive third of the MSCI World Index is about 2.6 times more expensive than the rest of the market as of April 30, 2020; however, this group is also trading at about a 90% premium to its historical expensiveness (the average of the most expensive third over the last 20 years).

On other hand, value stocks—represented here by the cheapest third of the market—are trading at about a 20% discount to historical cheapness (the average of the cheapest third of the market over the last 20 years) and a 46% discount to the rest of the market as of April 30, 2020. In our view, this is an example of short-term uncertainty amplifying behavioral biases.

Exhibit 3: Irrational bubble?



Source: SEI, FactSet. Data spans 1/1/2000-4/30/20 0 based on MSCI World constituents. Valuation discount and premium calculated using an equal-weighted composite of price to historical earnings, price to forecasted earnings, price to cash flow, and price to book value.

We believe that investors can fight behavioral biases by remembering that long-term relationships usually hold up for good reason. For example, the relationship between a firm's cash flow and stock price should not vary by large degrees for long periods of time. Eventually, history shows it will more likely revert toward the mean. It's up to investors to decide whether the market turmoil we face today is truly different this time. We don't believe that is the case.

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