Many investors opt for "value-light" strategies that sacrifice key value principles. This essay demonstrates value investing's superior returns compared to growth and value-light strategies, dispels risk misconceptions, and exposes the flaws of indexing value.

Despite a wealth of empirical evidence highlighting the superior returns[1] associated with value investing, many investors are still hesitant to fully embrace it. This reluctance to fully commit to value investing has led many investors to turn to "value-light" strategies, which sidestep the most contentious and volatile stocks, often sacrificing the core tenets of the value philosophy. In this essay, we will do the following:

- Show how the returns of value investing have been superior to all styles, including value-light
- Dispel misconceptions about the risk profile of value stocks
- Evaluate the damage indexing value has done to asset allocation over the past 20+ years

SUPERIOR RETURNS FOR VALUE

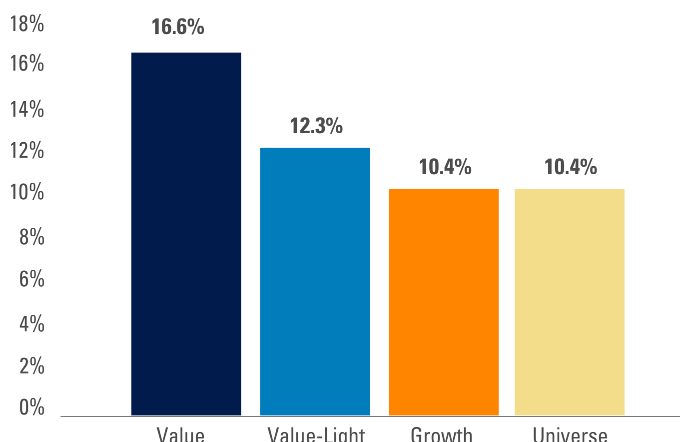
Superior returns from value investing have passed the scrutiny of a myriad of studies since Graham and Dodd first printed Security Analysis nearly a century ago. In addition, the data clearly make the case for selling stocks that perform well and reinvesting in the cheapest quintile, instead of holding value-light stocks which, on average, doesn't add as much value (Exhibit 1).

Despite the preponderance of evidence, investors have always been slow to embrace value stocks, which we believe occurs for two reasons:

1) There can be pain and discomfort when purchasing out-of-favor stocks.

2) There is a perception that value stocks are riskier.

Exhibit 1: Superior Returns for Value



Source: FactSet, Sanford C. Bernstein & Co., Pzena analysis
1H 2023 data uses the Russell 1000 Index.
Since 1980 data is Bernstein's analysis that uses the largest 1500 US stock universe.
Since 1980 data = averages of all half year periods since 1980.Past performance is not indicative of future returns.

To deal with these issues and still capture the value premium, some investors have pursued value-light strategies. These strategies go by several different names, usually with some adjective appended to value, and generally avoid the most controversial and out-of-favor stocks. Since these strategies purchase stocks beyond the cheapest quintile, and historically have much lower returns, we believe they sacrifice too much of the rewards of the value philosophy to generate significant long-term outperformance.

THE "VALUE IS RISKIER" MYTH

Value investing works because most investors shy away from the near-term uncertainty and potential pain of holding out-of-favor stocks. Ben Graham's parable of Mr. Market selling out-of-favor stocks to purchase stocks that are in favor is as true today as it was when he first wrote it in 1949.

While value investing works due to behavioral reasons, academics have tried to explain its superior returns by theorizing they are generated by taking additional risk. The measure of "risk" they use is generally volatility of short-term returns, which we believe is a poor measure of risk. Using a more appropriate (yet imperfect) proxy for risk, such as five-year volatility, value investing is superior when considered in the context of the returns generated relative to volatility.

Equities in general are a relatively volatile asset class, particularly in the near term. While value stocks can be more volatile in shorter periods, we would not recommend any style of equity investing over less than a five-year time horizon, as the volatility is too high to justify the potential return. However, over longer periods, the incremental volatility of value stocks is less material versus other styles and the market (Exhibit 2).

Exhibit 2: Volatility Converges Long Term
ACWI Average Rolling Standard Deviation

	1-Year	3-Year	5-Year
Value (Q1)	29.6%	13.7%	11.0%
Value-Light (Q2)	20.3%	11.0%	9.1%
Growth (Q5)	21.1%	11.1%	8.4%
Universe	17.3%	9.7%	7.5%

Source: Sanford C. Bernstein & Co., Pzena analysis. Value = stocks within the cheapest quintile based on price/book of the MSCI ACWI universe. Value-Light = 2nd cheapest quintile. Growth = most expensive quintile. The quintiles are measured on an equally weighted basis. Universe = cap-weighted returns of MSCI ACWI universe. Total return US dollar data from January 1, 1975 – September 30, 2023. Does not represent any specific Pzena product or service. Past performance is not indicative of future returns.

1 See for example: Eugene L. Fama and Kenneth R. French "The Cross-Section of Expected Stock Returns", Working Paper 333, Graduate School of Business, University of Chicago, January 1992; Josef Lakonishok, Robert W. Vishny, and Andrei Shleifer "Contrarian Investment, Extrapolation and Risk", Working Paper No. 4360, National Bureau of Economic Research, May 1993; and Sanjoy Basu, "Investment Performance of Common Stocks in Relation to Their Price/Earnings Ratios: A Test of the Efficient Market Hypothesis", Journal of Finance, June, 1977.

Looking at volatility in isolation ignores the significant reward an investor may earn for bearing the potential near-term volatility. Comparing the reward to the volatility over the same period, value is in line with the market over one-year periods and outshines all other strategies over longer periods (Exhibit 3). Interestingly, for value-light stocks, the return/risk ratio, is more or less in line with the market as a whole, meaning value-light strategies are sacrificing the return of value strategies while paying higher fees for the same return/risk profile as the market.

Exhibit 3: Return/Risk Favors Value

ACWI Average Risk/Return

	1-Year	3-Year	5-Year
Value (Q1)	0.65	1.23	1.51
Value-Light (Q2)	0.67	1.14	1.35
Growth (Q5)	0.55	0.97	1.24
Universe	0.66	1.09	1.38

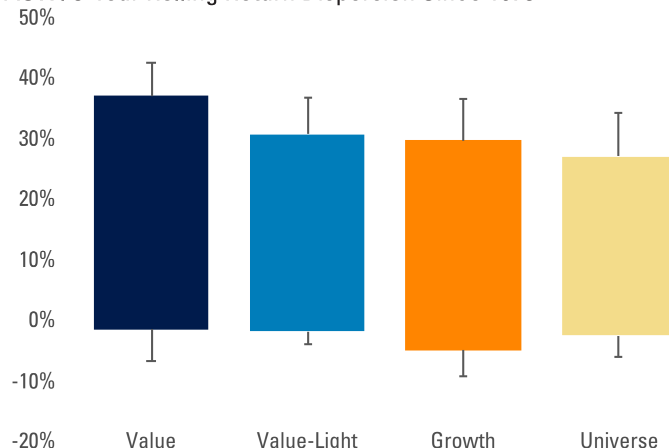
Source: Sanford C. Bernstein & Co., Pzena analysis.
Return/Risk = Average rolling return divided by the standard deviation of the rolling returns.
Value = stocks within the cheapest quintile based on price/book of the MSCI ACWI universe. Value-Light = 2nd cheapest quintile. Growth = most expensive quintile. The quintiles are measured on an equally weighted basis. Universe = cap-weighted returns of MSCI ACWI universe.
Total return US dollar data from January 1, 1975 – September 30, 2023.
Does not represent any specific Pzena product or service. Past performance is not indicative of future returns.

THE VALUE DISPERSION MYTH

Value's wider dispersion of returns is a related criticism of value investing. Over rolling 5-year holding periods, value returns are 18% more dispersed than value-light and 31% more dispersed than the universe. However, more dispersed does not mean worse, and in this case, it is good dispersion. The top-performing 5-year periods are significantly higher than the market's top returns and all other styles, while the worst performance is comparable or better (Exhibit 4—top and bottom of the boxes). Even for the extreme downside periods (Exhibit 4—whiskers), value is in line or better, on average, while performing significantly better in the extreme upside performance periods.

Exhibit 4: Value Dispersion of Returns is Favorable

ACWI 5-Year Rolling Return Dispersion Since 1975



Source: Sanford C. Bernstein & Co., Pzena analysis. Value = stocks within the cheapest quintile based on price/book of the MSCI ACWI universe. Value-Light = 2nd cheapest quintile. Growth = most expensive quintile. The quintiles are measured on an equally weighted basis. Universe = cap-weighted returns of MSCI ACWI universe. The solid box areas represent 95% of the rolling 5-year return observations. The vertical whisker bars represent the remaining 5% of observations. Total return US dollar data from January 1, 1975 – September 30, 2023. Does not represent any specific Pzena product or service. Past performance is not indicative of future returns.

While value is also criticized for performance in down markets, it does better than value-light portfolios in both up and down markets, even excluding the dot-com era, which was the period of value's best alpha generation (Exhibit 5). Finally, value portfolios generated negative five-year absolute returns just 3.8% of the time, versus 5.4% for value-light and 8.8% for the universe.

Exhibit 5: Value in Down Markets

ACWI Average 5-Year Rolling Return

	All Periods		Ex. Dot Com Bubble	
	Up Markets	Down Markets	Up Markets	Down Markets
Value (Q1)	17.0%	12.2%	17.0%	0.1%
Value-Light (Q2)	13.0%	4.9%	13.7%	-1.1%
Growth (Q5)	11.6%	-2.3%	12.8%	1.4%

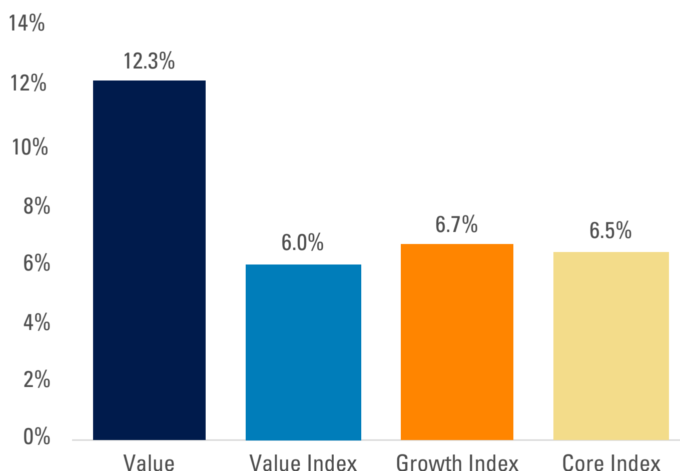
Source: Sanford C. Bernstein & Co., Pzena analysis. Value = stocks within the cheapest quintile based on price/book of the MSCI ACWI universe. Value-Light = 2nd cheapest quintile. Growth = most expensive quintile. The quintiles are measured on an equally weighted basis. Universe = cap-weighted returns of MSCI ACWI universe. Total return US dollar data from January 1, 1975 – September 30, 2023. Ex Dot Com Bubble data excludes rolling returns from August 31, 1995 to August 31, 2007. Does not represent any specific Pzena product or service. Past performance is not indicative of future returns.

INDEXING VALUE —A FLAWED APPROACH

As we mentioned in last quarter's newsletter, the vagaries of index formation have led to value indices that are filled with stocks that we would not consider bargains. Since value and growth indices match cumulative market caps, expensive mega-caps have caused many growth stocks to fall into the value index. Bizarrely, some stocks wind up with a portion of their weighting in both the value and the growth series. We are firm believers that a stock is either cheap or not.

This has caused investors who chose to index their value allocation, presumably to lower volatility, to significantly underperform. While ACWI Value has significantly underperformed MSCI ACWI and MSCI ACWI Growth since MSCI constituted the indices in 1997, true ACWI value, as measured by the cheapest quintile of stocks, was the top-performing style (Exhibit 6).

Exhibit 6: Value Indexing Has Underperformed



Source: Sanford C. Bernstein & Co., MSCI, Pzena analysis.
Value = stocks within the cheapest quintile based on price/book of the MSCI ACWI universe. The quintiles are measured on an equally weighted basis. Value Index = MSCI ACWI Value Index, Growth Index = MSCI ACWI Growth Index. Core Index = MSCI ACWI Index.
Total return U.S. dollar data from January 1, 1997 - September 30, 2023. All indices use gross returns.
Does not represent any specific Pzena product or service. Past performance is not indicative of future returns.

CONCLUSION – PATIENCE PAYS

As most performance studies have shown, value investing has generated superior returns, and we've shown that those returns have outpaced those of value-light portfolios. In addition, over reasonable investment horizons value stocks:

- are superior on a return/risk basis
- exhibit volatility levels that converge with other styles and the universe over longer time periods
- while more dispersed, have better dispersion characteristics
- do better in up or down markets on average

Finally, indexing a value allocation has historically not been a good strategy, likely due to index formation vagaries.

NOTE: This is the first in our Why We Are Active Value Investors series. In future quarters, we will further explore other topics, including the importance of patience over long time horizons and why deep value works.

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