Pzena Investment Management
Fourth Quarter 2016 Commentary

Pro-value cycles are long and durable. Spreads are still wide, setting the current cycle on a path remarkably similar to past cycles.

As The Cycle Turns

The U.S. presidential election jolted global financial markets, pushing U.S. equities to new records and setting off a rout in fixed income securities and bond proxies. Just a few short months ago, investors accepted the paradigm of low interest rates and sluggish economic growth forever; that has now been turned on its head, with expectations of fiscal stimulus and higher interest rates in the U.S. driving asset prices. Value indices handily outpaced growth in every region globally in 2016.

These developments have left investors asking:

- Is this the long-awaited turn in the value cycle?
- Given the recent sharp outperformance of value, have I missed the opportunity?

It appears that the value cycle[1] in the U.S. turned up in February 2016, with deep value stocks[2] outperforming the broader market by 19.9% since then (Figure 1). Given the length and durability of previous value cycles, along with the current environment where valuation spreads continue to be wide, our response to the second question is an emphatic "no" – we believe there is still significant opportunity and longevity to this value cycle.

Deep value has also outperformed across regions outside the U.S. for the past six months. While it is too soon to say if the value cycle has turned in those regions, we believe the wide spreads we are seeing in markets outside the U.S. are similar to what we have seen in the U.S., which has usually preceded extended periods of deep value outperformance.

Figure 1: Early Days In The Current Pro-Value Cycle

Cycle	Dates	Relative Returns: First 11 month	Relative Returns: Full Value Cycle	Length of Cycle: # of Months
1	Jul '73 - Mar '78	12.7%	127.2%	57
2	Dec '80 - Aug '88	23.0%	264.4%	93
3	Nov '90 - Aug '95	29.4%	131.3%	58
4	Mar '00 - Feb '07	55.1%	176.9%	84
5	Dec '08 - Jun '14	35.4%	107.5%	67
Average		**31.1%**	**161.5%**	**72**
Current	Feb '16 - Dec '16	19.9%	-	11

Source: Sanford C. Bernstein & Co., Pzena Analysis

Recovery Phase Appears Far From Over

Only hindsight will allow us to make a pronouncement on the ultimate length and magnitude of the current value cycle. However, history over the last 50 years has shown that pro-value cycles are typically far longer in duration and greater in cumulative value outperformance than what we've seen from the current cycle to date (Figure 2). We can also observe that outperformance was earned over the course of the entire cycle, not just in its early phases.

The data are compelling. Pro-value cycles in the U.S. have lasted 72 months on average and generated 162% cumulative excess returns versus 11 months and 20%, respectively, in the current cycle-to-date. Notably, while deep value has seen strong outperformance since February, it has been a fairly typical start to a pro-value cycle, if not somewhat muted, 20% versus the 31% average outperformance for the first 11 months of the previous five cycles.

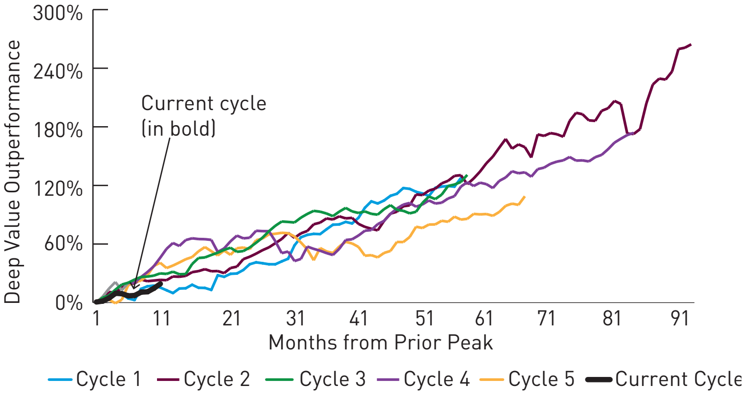
The Pattern Of Value Cycles

Value cycles have historically been characterized by sharp underperformance for a relatively shorter period, about 32 months on average in the U.S., followed by a substantially longer of period of outperformance. This period of outperformance usually more than makes up for underperformance during the anti-value portion of the cycle, leading to outperformance for deep value over the full cycle.

The past nine years, however, have been a tough period for value. The last full value cycle (March 2007 – June 2014) never reached its full potential, and the subsequent period of sluggish growth and quantitative easing resulted in an early resumption of the anti-value cycle.

Value peaked in early 2007, as cracks in the U.S. housing market appeared. This ultimately triggered the

Figure 2: Cumulative Outperformance of Deep Value From Beginning of Pro-Value Cycle in the U.S.



Source: Sanford C. Bernstein & Co., Pzena Analysis

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global financial crisis and deep recession that lasted from late 2007 through March 2009. As is typical in the early phase of recessions, value strategies suffered. But as the U.S. bank stress tests and subsequent capital raises started to stabilize the market, value was poised for a strong rebound. This in fact occurred, starting right after the U.S. presidential election in November 2008. From that point through June 2014, a period of five and a half years, deep value outperformed the broad market by a cumulative 107%.

That upcycle showed the smallest cumulative gain of the five cycles we have observed since the early '70s, leading to the only full cycle in which deep value underperformed. We believe this was due to permanent loss of capital during the global financial crisis due to bankruptcy or massive equity dilution in the financial sector which impacted many developed world financial institutions. Additionally, the slowdown in China and the subsequent collapse in commodity prices undermined global cyclicals. The response by governments to these developments, namely a dramatic tightening of regulation in the financial sector around the world and the use of quantitative easing to force down interest rates in an effort to stimulate economic growth, has led investors to seek yield and earnings stability to the detriment of financial service stocks and other economically sensitive issues. Stock prices of these deeply undervalued businesses languished, surging only recently on the dramatic shift in investor sentiment.

Figure 3: U.S. Value Cycles
Performance of Deep Value[3] vs. U.S. Universe[4]

	Deep Value	U.S. Universe	Relative Performance	# Months
Mar '71 - June '73	-4.4%	13.1%	-17.5%	28
Jul '73 - Mar '78	134.8%	7.6%	127.2%	57
Full Cycle	124.5%	21.7%	102.9%	85
Apr '78 - Nov '80	53.2%	87.7%	-34.5%	32
Dec '80 - Aug '88	414.7%	150.3%	264.4%	93
Full Cycle	688.4%	369.7%	318.6%	125
Sep '88 - Oct '90	-16.2%	22.2%	-38.4%	26
Nov '90 - Aug 95	248.4%	117.1%	131.3%	58
Full Cycle	192.1%	165.3%	26.8%	84
Sep '95 - Feb '00	72.3%	171.9%	-99.6%	54
Mar '00 - Feb '07	190.6%	13.7%	176.9%	84
Full Cycle	400.7%	209.1%	191.6%	138
Mar '07 - Nov '08	-56.2%	-33.3%	-23.0%	21
Dec '08 - Jun '14	250.3%	142.8%	107.5%	67
Full Cycle	53.3%	62.1%	-8.7%	88
Mar '71 - Jun '14 (Annualized)	14.8%	10.5%	4.3%	520
Current Cycle-To-Date				
Jul '14 - Jan '16	-18.6%	-1.4%	-17.2%	19
Feb '16[5]-Dec '16	35.8%	15.9%	19.9%	11

Source: Sanford C. Bernstein & Co.; Pzena Analysis

Conclusion

When posed with the question, "is the value cycle over?" we look to history to see if we can find similarities in investor reaction to both fear and greed. There is no shortage of evidence that these primal instincts continue to drive the markets; perhaps technology has aided and abetted market participants in their ability to react even more quickly to these forces.

Valuation spreads remain wide throughout the world, leaving us with portfolios that are generally characterized by deeply discounted, cyclical businesses with sustainable business franchises, strong balance sheets, and a demonstrated ability to adapt to a wide range of economic scenarios. Coupled with a history of relatively long value cycles, we believe the environment for deep value stocks remains attractive and the cycles of value investing appear to be firmly intact, with the current up-cycle likely to resemble prior cycles. ■

[1] To define value cycles, we compare the performance of an equally weighted portfolio of the cheapest quintile of price-to-book stocks to the performance of the market cap weighted universe. For the purpose of our analysis, we define turning points in value cycles as occurring when 1) the relative performance is at a peak or trough and 2) the relative performance since the last peak or trough is +/- 1500 basis points and has persisted for 12 months. (By this strict definition the U.S. remains one month short of an official turn in the value cycle). We then define a full value cycle as consisting first of a period when the cheapest quintile underperforms, followed by a period of outperformance.

[2] Deep value stocks are defined as the cheapest quintile of stocks on a price-to-book basis of the 1000 largest U.S. stocks using equally weighted data. Does not represent specific performance of any Pzena service.

[3] Cheapest quintile price-to-book of the 1,000 largest U.S. stocks (equal-weighted data). Does not represent specific performance of any Pzena service.

[4] Cap-weighted data.

[5] Does not yet qualify as a turn in the cycle under our methodology.

DISCLOSURES

Past performance is no guarantee of future results. The historical returns of the specific portfolio securities mentioned in this commentary are not necessarily indicative of their future performance or the performance of any of our current or future investment strategies. The investment return and principal value of an investment will fluctuate over time.

The specific portfolio securities discussed in this commentary were selected for inclusion based on their ability to help you understand our investment process. They do not represent all of the securities purchased, sold or recommended for our client accounts during any particular period, and it should not be assumed that investments in such securities were, or will be, profitable.

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