Pzena Investment Management
Third Quarter 2015 Commentary

Successful Value Investing Provides More than Passive Exposure to a Value "Factor"

The recent underperformance of many value investors has raised questions about whether value investing works the way it once did. The proliferation of ETF's and other passive/ low fee strategies also begs the question of whether active investing is "worth" the fees. In last quarter's newsletter we addressed this issue by highlighting the long run advantage of active strategies in general. In this piece, we discuss the drivers of long term outperformance for a value manager such as Pzena Investment Management. Specifically, we want to address the difference between having a generic exposure to a value cycle (or factor) versus an active exposure to company-specific research.

A Value Cycle Interrupted

Value cycles over the last fifty years have unfolded in a pattern closely related to the macroeconomic cycle. Value investing strategies typically struggle as economies slow and the fear of earnings declines becomes the preoccupation of investors. Then, as valuations bottom and expectations for an improvement in the economy and corporate earnings replace the fear, value strategies tend to outperform during and coming out of a recession. The strongest relative returns are earned as the economy picks up steam and stocks that had embodied the fear outperform, benefitting from both earnings normalization and re-rating by investors. The late stages of expansion are the most challenging period, as stresses have ebbed, and investors chase momentum with little regard to valuation. Then excesses in the economy build, counterforces act to cool the economy, and the cycle starts again. For forty years through February 2007, value cycles have lasted on average about ten years and resulted in value stocks outperforming the broad market by 480 basis points per annum[1].

The current cycle, which started in February 2007 in the U.S., has not fit this pattern. The rebound off the bottom occurred in 2009 in the U.S. following the financial crisis, and in 2012 in Europe following Mario Draghi's "whatever it takes" speech signaling the European Central Bank's determination to protect the monetary union. Those sharp recoveries were very much consistent with value cycle history. But this time, there has been no follow through after the initial ebbing of fear. Following each period of outperformance value stalled, as another set of fears interrupted the value cycle, most recently over the slowdown in emerging markets. Persistently low interest rates are another reflection of the environment of fear from which we have yet to emerge.

Value Has Underperformed

While value strategies have struggled, growth and momentum have done exceedingly well, with this trend accelerating over the last twelve months (Figure 1). Investors flocked to companies with either demonstrated or prospective growth prospects, resulting in growth indices trouncing value. This is a global phenomenon. As a result, this value cycle – so far – has skipped the "sweet spot" of strong relative performance following the recovery off the bottom and moved on to a period that looks a lot like the momentum-driven late stages of the cycle. The middle stage – characterized by strong growth and improving earnings – seemingly has yet to take place.

Adding Value Through Individual Company Research

One conclusion from the foregoing discussion is that in this cycle, value as a factor has disappointed. The environment has been a significant headwind to value investing and a difficult one to overcome. As we observe in Figure 2, a simple factor that describes value (low price-to-book in this case) has mostly underperformed. Yet the DNA of value investing going back to Benjamin Graham has always been rooted in bottom-up research and human psychology. We believe viewing value investing as a discipline, not a factor, offers the opportunity for a more favorable outcome than a simple quantitative approach

[1] Value stock defined as the cheapest price-to-book quintile of the 1,000 largest U.S. listed companies. Similar patterns have been observed in global markets. Does not represent specific performance of any Pzena service.

Figure 1: Value Has Underperformed Growth
USD Returns Through September 30, 2015

	MSCI World		Russell 1000		MSCI EAFE		MSCI Europe		MSCI Emerging Markets	
	1 yr.	**5 yr.**	**1 yr.**	**5 yr.**	**1 yr.**	**5 yr.**	**1 yr.**	**5 yr.**	**1 yr.**	**5 yr.**
Value Index	-9.3%	7.0%	-4.4%	12.3%	-12.6%	3.1%	-15.9%	2.4%	-22.7%	-5.1%
Growth Index	-0.8%	9.5%	3.2%	14.5%	-4.7%	4.8%	-2.6%	6.1%	-15.9%	-2.1%
Value Underpeformance	**-8.5%**	**-2.5%**	**-7.6%**	**-2.2%**	**-7.9%**	**-1.7%**	**-13.3%**	**-3.7%**	**-6.8%**	**-3.0%**

Source: MSCI, Inc., Russell Investments

provides. In spite of recent headwinds, our research-driven portfolios have outperformed low price-to-book stocks over the last five years (Figure 2). Given our disciplined approach, it is hard for us to escape correlation with naïve value benchmarks, but our goal is to add value through understanding the specifics of every individual company we buy. Our aim is to buy good businesses with temporary impediments, rather than simply buying "cheap" stocks. Put another way, our long-term performance is a function of two drivers:

Long term Outperformance = Exposure to Value Factor + Alpha from Proprietary Research

In this cycle, the benefits of exposure to a naïve value strategy have been dubious, but our proprietary research has continued to provide alpha.

What Lies Ahead?

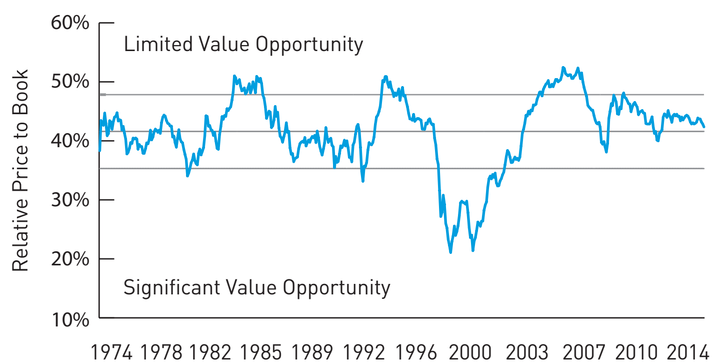
Although it is impossible to predict whether value as an investment style will ultimately outperform this cycle, it is reasonable to believe that it will when the pain of the Global Financial Crisis ("GFC") has run its course. China's current slowdown (possibly the delayed effect of the GFC and accompanying fiscal interventions) is certainly impacting many "value" stocks negatively today. Is this the start of another global value cycle, or is it simply emerging markets being the last region to fall in a long global unwind, setting us up for a sustained outperformance phase of the value cycle? It's hard to know. What we do know is that valuation spreads today support the prospect for an outperformance phase of the value cycle (Figure 3).

Conclusion

Regardless of the outcome of this cycle, we believe the odds are in favor of an active value investor, and that company-specific research is the key to achieving investment success. Value investing is not a simplistic factor, but rather a philosophy that requires research to outperform over the long-term. We are in an environment where poor earnings performance of companies tied to the global economic cycle provides us with what we believe are some very attractive buying opportunities. We are focused on identifying a select number of these companies using our disciplined, rigorous research process to uncover the best in terms of risk and reward. ■

Figure 3: Valuation Spreads Indicate Opportunity

Price/Book: Cheapest Quintile of 1600 Stock Universe* to World Universe



*1600 largest World stocks; data through September 30, 2015

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

Figure 2: Research Adds Value
USD Returns Through September 30, 2015

	5 Years				Pzena Portfolio vs.			
	Style Neutral Index	Value Index	Low P/B*	Pzena Portfolio	Style Neutral Index	Value Index	Low P/B*	Index
Global Focused Value	8.3%	7.0%	4.8%	7.6%	-0.7%	0.6%	2.8%	MSCI World / World Value
Large Cap Focused Value	13.4%	12.3%	7.5%	11.1%	-2.3%	-1.2%	3.6%	Russell 1000 / Russell 1000 Value
International (ex-U.S.) Focused Value	4.0%	3.1%	5.1%	6.0%	2.0%	2.9%	0.9%	MSCI EAFE / EAFE Value
European Focused Value	4.3%	2.4%	0.7%	6.2%	1.9%	3.8%	5.6%	MSCI Europe / Europe Value
Emerging Markets Focused Value	-3.6%	-5.1%	-4.2%	-2.5%	1.1%	2.6%	1.7%	MSCI EM / MSCI EM Value

*Equal weighted

Source: Pzena Investment Management; Sanford C. Bernstein & Co.; MSCI, Inc.; Russell Investments; Pzena Portfolio Returns are Gross of Fees.

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.