

Equities in general and value spreads in particular remain attractive, and history would suggest that we are in the early innings of the value cycle. The next leg up is likely to be driven by earnings increases in the context of a modest economic recovery.

The Cycles of Value Investing Redux

The more things change, the more they stay the same. Eleven years ago in our newsletter we published an article titled "Perspective on Value Investing." In it, we observed that over the course of the prior 30 years and last three recessionary cycles, value investing underperformed the broad market leading up to a recession, and then took over leadership as the economy entered recession. We noted:

"In fact, we can look back to the last three recessions and find market behavior which is essentially identical to that which we face today. Investors flock to the companies which are having current success, and shun the companies that are threatened by the consequences of a downturn. ... In all three cases over the past 30 years, fear of a pending recession reduced the demand for value stocks and caused a flight into the supposed "good names." In all three cases, the under-performance ended at approximately the time when the recession began. In other words, once we are in a recession, or it is almost certain one is imminent, investors can and do focus on the light at the end of the tunnel."

Figure 1: The Cycles of Value Investing

Period	S&P 500	Value Benchmark*	Value Advantage
Jan '69 - Jun '73	19.3%	-8.3%	-27.6%
Jun '73 - Jul '79	30.4%	206.9%	176.4%
Full Cycle	4.3%	10.3%	6.0%
Jul '79 - Nov '80	45.6%	17.4%	-28.3%
Nov '80 - Aug '88	160.7%	414.7%	254.1%
Full Cycle	16.0%	22.1%	6.1%
Aug '88 - Oct '80	25.1%	-16.2%	-41.3%
Oct '90 - Aug '95	113.2%	247.9%	134.6%
Full Cycle	14.9%	16.3%	1.4%
Aug '95 - Feb '00	163.0%	71.8%	-91.2%
Feb '00 - Feb '07	15.6%	187.5%	171.9%
Full Cycle	10.2%	14.9%	4.7%
Feb '07 - Feb '09	-44.6%	-63.3%	-18.7%
Feb '09 - Sep '09	45.1%	96.4%	51.3%
Current Cycle	-7.8%	-11.5%	-3.7%
Cumulative Annualized	10.1%	15.2%	5.1%

Source: Sanford C. Bernstein, Pzena Analysis
*Cheapest quintile of 1000 company universe

As can be seen in Figure 1, value stocks ultimately regained leadership heading into the recession of 2000, starting a value run that lasted through early 2007. We believe we are experiencing a similar cycle now, where value stocks lagged heading into the most recent recession, and regained leadership early this year. The S&P 500 gained 45.8% from March 9th through September 30th 2009, with the Russell 1000 Value index up 49.8% during the same period, and our deep value portfolios up substantially more. Surprisingly, value underperformance relative to the market during this down cycle was not nearly as bad as compared to others (e.g., down a relative 18.7% this cycle versus 91.2% during the internet bubble); it just felt much worse, as it occurred in an environment where the broad market was down 45%.

Absolute returns have been dramatic since the turn, not to mention the level of value out-performance. But this begs the question: is this value cycle over?

Deep Undervaluation Led to Sharp Bounce

Both Figure 1 and the following table highlight how dramatic the "down" part of the cycle was for both the market and the value benchmark. The ensuing sharp rebound has brought us back to a "normal" range of valuation spreads in a broad market that is still undervalued. As a result, our portfolios continue to be attractively valued.

	Feb. 09	Sept. 09	Average
Cheapest Quintile* Discount to S&P500	65%	54%	56%
% S&P 500 Over/(Under) Valued***	(52%)	(29%)	0%
Pzena Value Portfolio - Price/Normal	5.0x	7.0x	8.5x**

*Universe of the 1000 largest U.S. listed stocks

**1996 - 2007 average

***Versus bond market

Price-to-normal based on harmonic average

Source: Sanford C. Bernstein, Pzena Analysis

Figure 2: Value Rebounds Globally

Nominal and Relative USD Returns to the Best Quintiles of Valuation¹
December 2008 Through August 2009



Source: Empirical Research Partners Analysis

¹Monthly returns compounded

²Developed world (ex-U.S.) returns are USD-hedged

Figure 2 tells the global recovery story; global equity markets have rebounded in unison, with the level of value outperformance remarkably consistent around the world. Further, despite recent recovery, history suggests that the current value cycle has a long way to go; the average length of value outperformance over the last four cycles is 77 months (compared to 7 months so far in the current cycle) and the average level of value outperformance is 184.2% versus 51.3% so far in this cycle. In no case did more than 20% of value's outperformance occur during the first seven months of the last four value cycles.

Value Cycles Persist

Cumulative Outperformance Value vs. S&P 500

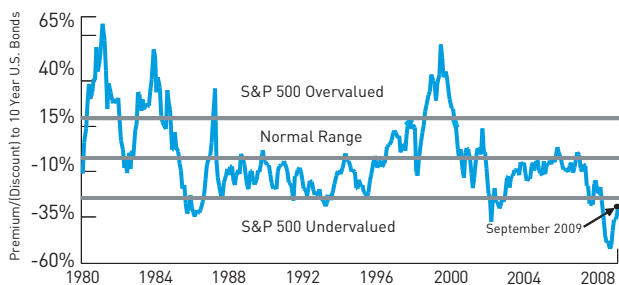
Period	Relative Returns		Length of Value Cycle
	First 7 Months	Full Value Cycle	# of Months
Jun '73 - Jul '79	15.3%	176.4%	73
Nov '80 - Aug '88	24.1%	254.1%	93
Oct '90 - Aug '95	26.8%	134.6%	57
Feb '00 - Feb '07	22.0%	171.9%	84
Average	22.0%	184.2%	77
Feb '09 - Sep '09	51.3%	TBD	7 (so far)

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

Equities Still Undervalued; Valuation Spreads Attractive

Broadly speaking, equities continue to appear undervalued globally, although certainly not at the generation-low levels we reached back in March. Our dividend discount model for the U.S. equity market – Figure 3 – indicates that we are still at a 29% discount to fair value. This model is sensitive to the current

Figure 3: S&P 500® Valuation Relative to Bond Market



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

interest rate on treasuries. Interest rates would have to rise by over 200 basis points to 5.75% (a level not seen since 2000) for our model to indicate equities are fairly valued.

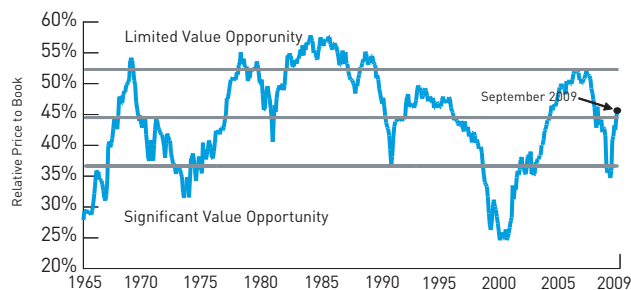
In addition, value spreads continue to be attractive. Figure 4 shows the spread between the valuation of the market's cheapest quintile and the market average for the U.S. Figure 5 on page 12 shows that the price-to-book of the MSCI EAFE cheapest quintile is also attractive. The combination of broad market undervaluation and attractive value spreads give us reason to believe that there is still a significant opportunity for value to continue its run of outperformance.

The Next Step: Earnings

The recovery in stock prices over the last seven months can, to a great extent, be attributed to the depth of undervaluation reached during the market meltdown. In late 2008 and early 2009 investors valued companies as if the depression case was a near certainty. The depression case is now off the table, and valuations have been driven up by expectations of an economic recovery.

Although earnings are down significantly from year-ago levels for most companies, actual results have beaten analyst expectations in many cases. The First Call positive earnings revision index hit 66.8% at the end of September, up from 22% in January, as managements adjusted their cost structures and capital spending aggressively in light of the downturn. It would therefore not be unreasonable to expect that even a modest increase in revenues would translate into a meaningful increase in earnings. Margins typically surprise on the upside (as they have so far these last two quarters), as managements adapt to the lower level of revenues, and margins are significantly more

Figure 4: Cheapest Quintile of 1000 Stock Universe to S&P 500



*1000 largest U.S. stocks; equally-weighted data
Source: Sanford C. Bernstein & Co., Pzena Analysis

of a determinant of profits than sales growth. We have not assumed robust top-line growth in our financial modeling; in many cases, our long term (e.g.: five year) revenue estimates only get back to 2007 levels.

Figure 6 suggests that returns on equity also return to long-term averages regardless of the economic environment. For example, ROE's averaged 13.7% from 1975 – 1982 (which included both inflation and a deep recession), slightly above the thirty year average of 13.5%. A return to this level would imply current S&P 500 earnings of \$67, and a normalized (e.g.: five-year out) earnings level of \$90, roughly back to their 2007 peak. In the post-war era, once earnings have troughed, it has never take more than three years for earnings to recover to their pre-recession peak.

Sector Rotation in Cheapest Quintile

Our research is always focused on companies that are experiencing stress, or have been left behind as investors pile into what is “working.” The current environment is no exception. If we look back to the last quarter of 2008 and first half of 2009, stress was prevalent throughout the economy, giving us a broad range of high quality investment opportunities at bargain-basement prices. Sectors such as consumer discretionary and technology stood out, as fears surrounding consumer and corporate spending drove their valuations down so that they appeared in the cheapest quintile of the market. As fears subsided and hopes of economic stabilization took root, it was these sectors (along with financials) that led the sharp market rebound. As a result, the consumer discretionary, technology and financial sectors are less prevalent in our current opportunity set than at the beginning of the year, having been replaced by companies experiencing near-term stress such as health care, where reform legislation works its way through Congress.

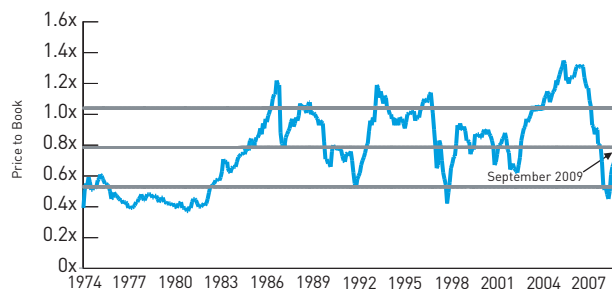
Quality continues to be a significant theme in our portfolios, as many companies with strong balance sheets that are leaders in their industries are available to us in the cheapest quintile of valuation. This is particularly prevalent in (but not limited to) the technology sector, where companies have low or no debt, and cash balances that would see them through the most extreme business downturn. These businesses typically attract premium valuations, but are now some of the cheapest in our investment universe. We have taken advantage of this unusual opportunity.

Conclusion

While market pundits are counseling “de-risking” as their advice du jour, equities in general and value spreads in particular remain attractive despite the sharp run up of the last seven

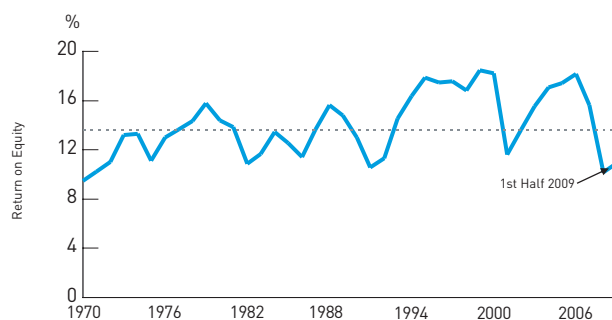
months. History suggests that we are still in the early innings of this value cycle, with the next leg up likely to be driven by earnings increases in the context of a modest economic recovery. We continue to find high quality companies in sectors experiencing near term stress where we believe research and patience are the ingredients for long term outperformance. ■

Figure 5: MSCI EAFE Price-to-Book of Cheapest Quintile 1974 - September 2009



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

Figure 6: S&P 500 Return on Equity at Cyclical Trough S&P 500 Return on Equity* 1970 - 1st Half 2009



Source: Standard & Poor's, Empirical Research Partners Analysis