

Pzena Investment Management

Fourth Quarter 2011 Commentary

Although no two cycles are exactly alike, the current cycle is remarkably consistent with the four prior. If history is a guide, there should continue to be significant opportunity in the deep value space.

Is Value Investing Dead?

Equity investors have been shaken to the core.

The cumulative pain of the last five years is palpable, and has been compounded by the market decline and incessant volatility of the last six months. Add to that the proliferation of high-frequency trading, ETFs and other new market participants, and investors are questioning the very foundation of value investing: the notion that, over the long term, the value of a good, but undervalued, business will ultimately be recognized by the market. We are hearing echoes of 1999, the last time the death knell of value investing gained currency. Investors are asking whether there is a new paradigm, one in which the long term view is overwhelmed by short term traders reacting to macro events half way around the world. Will value investing ever work again?

There is no denying that an obsession with macroeconomic events dominated market activity during 2011. The correlation of stock returns is the highest it has ever been, an indication that markets are being driven by broad, unspecified fears. Volatility has also spiked, with the MSCI ACWI moving by more than 1% on 28 trading days in the July – December period. The “risk-on, risk-off” trade has come to dominate market activity, driving cash flows into sectors considered safe on days when fears spike, merely to reverse back into economically sensitive sectors when fears abate.

Taking a step back from the day-to-day market noise, how-

ever, provides a useful perspective in which to assess recent market activity, and possibly even identify hidden opportunities otherwise obscured. We studied the performance of a naïve deep value benchmark (referred to as “value” in this article and defined as the cheapest quintile of the 1000 largest U.S. listed companies on a price-to-book basis) versus the S&P 500 index over the last 42 years, and have a number of key observations:

- Recent experience is highly consistent with the historical ebbs and flows of the cycles of value investing;
- The most recent period of value outperformance, which started in December 2008, was interrupted in mid-2011 for six months, as investor sentiment shifted from optimism to uncertainty on concerns over sovereign debt, Eurozone stability, and slowing global economic growth;
- We experienced similar interruptions in almost all value cycles over the last 42 years, and both the magnitude and duration of the mid-2011 interruption are consistent with prior cycles (Figure 1);
- The last peak in the value cycle was 58 months ago – a seeming eternity in the investment world. Since then, value has underperformed the S&P 500 by a cumulative 11.8%. As it turns out, this cycle-to-date relative performance for value versus the broad market is almost exactly the average of the last four full value cycles (Figure 2);
- If history is a guide, there is significant pent-up opportunity in the value category (Figure 2);
- The flight to safety and across-the-board, indiscriminate selling of cyclical businesses has left a wealth of deeply undervalued, industry leading companies with solid business franchises, high free cash flows, and solid balance sheets. Conversely, businesses considered safe (i.e., stable earnings or high dividend paying such as utilities and consumer staples) are at record high valuations rela-

Figure 1: Interruptions Are Common During Cycles of Value Outperformance*

	# of Months of Value Outperformance	Cumulative Outperformance	Interruptions of Greater than 5% in Relative Underperformance During Value Outperformance Cycle					
			Number	Magnitude		Duration (# of months)		
Jul 73 - Jul 79	73	176.4%	4	-7.2%	-7.8%	-8.2%	-5.8%	3, 3, 3, 9
Dec 80 - Aug 88	93	254.1%	2	-6.0%		-5.9%		6, 6
Nov 90 - Aug 95	58	134.6%	0	N/A**		N/A**		
Mar 00 - Feb 07	84	171.9%	2	-6.2%		-10.4%		1, 5
Average Prior Cycles	77	184.3%	2	-7.2%				4.5
Dec 08 - Present	37 (so far)	51.5% so far	1	-8.8%				6

*Cheapest quintile price-to-book of 1,000 largest U.S. stocks; Measured from the start of value outperformance vs. S&P 500. Data through 12/31/11

**The Nov 90 - Aug 95 cycle had three relatively short, mild interruptions of 2.7%, 2.7% and 2.0% lasting two months each

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

tive to cyclical businesses.

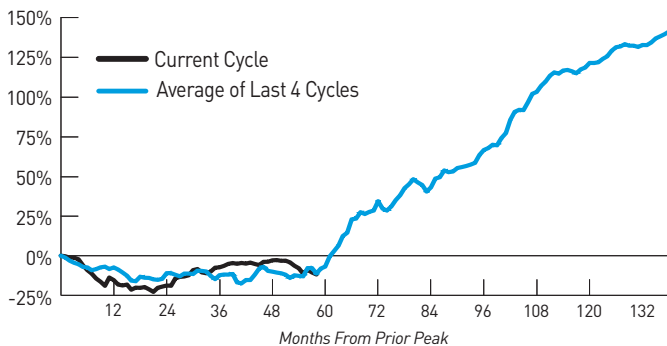
- Because these undervalued companies have the financial strength and market position to make it through a range of economic scenarios, share price volatility provides opportunity without outsized risk of permanent loss relative to the market.
- To a large extent, the macro outcomes are not knowable, so it is prudent to place significant emphasis on balance sheets and competitive position, with a conservative view of future growth. Even with these conservative assumptions, many attractively valued opportunities exist.

Value Cycles Repeat

As Mark Twain once said, "History does not repeat itself, but it rhymes." We can see this in Figure 3, where we detail the cycles of value investing over the last 42 years. Although each cycle is different, there is a distinct pattern, driven by the common denominators of economic cycles and investor behavior. The value cycle tends to peak at the end of an economic cycle, as investors see impending signs of economic slowdown or recession. It may be the bursting of a bubble that is the precursor (commercial real estate in the late 80's, internet in the 90's, housing in 2007). Regardless of the trigger, expectations of an economic slowdown cause investors to re-price equities downward, as they flee to safer havens. Although this is a time where value tends to underperform the broad market, it sets the stage for a long run of outperformance, as valuations become compelling when investors give up on equities, providing a wealth of undervalued businesses. It is usually during recessions where value starts to outperform, when valuations fully reflect recessionary expectations, and investors start looking forward to an eventual recovery.

Value outperformance tends to abate as the economy is

Figure 2: The Current Value Cycle Looks Very Familiar
Cumulative Relative Performance of Value* vs. S&P 500



Source: Sanford C. Bernstein & Co., Pzena Analysis
*Cheapest quintile price-to-book of 1000 largest U.S. stocks

peaking and investors throw valuation to the wind to chase the momentum of "hot" areas. The refrain "but this time it's different" gains widespread currency. Remember the internet in 1999? But eventually, traditional forces that drive the economic cycles reappear, and the cycle starts all over again.

Periods of value outperformance in these cycles have been long and rewarding. Since 1969 these periods lasted 7 1/2 years on average, and delivered 184% of cumulative out-performance versus the broad market (Figure 1). As a result, over four entire cycles lasting a total of 38 years, value outperformed the broad market by 4.8% per annum. All of these periods of value outperformance, however, have experienced, on average, two temporary interruptions, each lasting 4 1/2 months, with value underperforming the broad market by 7.2%. The 2011 interruption was quite similar, lasting six months and producing relative performance of -8.8%.

The last value cycle peaked in early 2007, as cracks in the housing market appeared. This ultimately triggered the global financial crisis, and deep recession that lasted 18 months from late 2007 through March, 2009. As is typical, value strategies suffered as the market underwent a massive re-valuation. But as the U.S. bank stress tests and subsequent capital raises started to stabilize the market in March 2009, value was poised for a strong rebound. This in fact occurred, actually starting right after the U.S. presidential election in November, 2008. From that point through December, 2011, deep value outperformed the broad market by a cumulative 51.5%.

Although we have been buffeted by massive volatility during the last half of 2011, the downward re-valuation of global

Figure 3: Value Investing Cycles over the Last 42 Years

	Performance			# Months
	Low P/B*	S&P 500**	Low P/B vs. S&P 500	
Feb 69 - Jun 73	-8.3%	19.3%	-27.6%	53
Jul 73 - Jul 79	206.9%	30.4%	176.4%	73
Full Cycle (Annualized)	10.4%	4.3%	6.1%	126
Aug 79 - Nov 80	17.4%	45.6%	-28.3%	16
Dec 80 - Aug 88	414.7%	160.7%	254.1%	93
Full Cycle (Annualized)	21.9%	15.8%	6.1%	109
Sep 88 - Oct 90	-16.2%	25.1%	-41.3%	26
Nov 90 - Aug 95	247.9%	113.2%	134.6%	58
Full Cycle (Annualized)	16.5%	15.1%	1.5%	84
Sep 95 - Feb 00	71.8%	163.0%	-91.2%	54
Mar 00 - Feb 07	187.5%	15.5%	171.9%	84
Full Cycle (Annualized)	14.9%	10.1%	4.8%	138
Feb 69 - Feb 07	15.5%	10.7%	4.8%	457
Mar 07 - Nov 08	-56.3%	-33.4%	-22.8%	21
Dec 08 -	102.2%	50.6%	51.5%	37
Cycle-to-Date (Annualized)	-2.5%	0.1%	-2.6%	58

Source: Sanford C. Bernstein & Co., Pzena Analysis
*Value cumulative **Capitalization weighted

equities occurred mainly during the third quarter. Investors fled cyclical stocks, seeking the safe havens in the likes of U.S. Treasuries and German Bunds, as well as dividend paying equities and companies with more stable earnings profiles. This has driven the valuation of cyclical (or high beta) stocks to record lows versus stable, or low beta, stocks (Figure 4).

Solid Value Opportunities

Only hindsight will allow us to make a pronouncement on the ultimate length and magnitude of the current value cycle. But one thing is clear: as a result of investor uncertainties, we have been left with a wealth of deeply discounted, cyclical businesses with sustainable business franchises, strong balance sheets, and a demonstrated ability to adapt to a wide range of economic scenarios. Many of these businesses have global footprints, are industry leaders, and have demonstrated their ability to restore profitability quickly during the severe recession of 07-09. Investors are not rewarding the strong cash flow being generated by these businesses, driving cash flow yields to near peak levels (Figure 5).

What we find unusual in today's environment is that valuations reflect a deep sense of pessimism, yet earnings have continued to hold up well and corporate cash flows are robust. In addition, consensus global GDP forecasts remain a healthy 3%. It would not be unreasonable to see high profit margins and cash flow yields lasting until much later in this economic cycle, as managements take a wait-and-see approach to hiring, investing and making acquisitions until the prospects for sustained growth become much more visible.

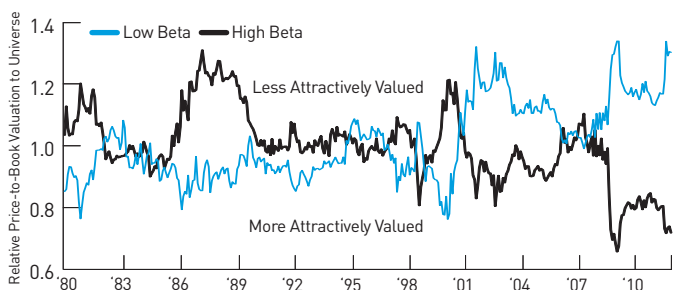
A question on every investor's mind, however, is how sustainable is the current level of profitability? The honest answer is no one really knows. If the economy enters a recession and demand weakens, profitability would likely fall from current lev-

els over the short term. However, since this recovery has been relatively short, companies are generally not experiencing the robust demand that they would after a long period of economic expansion. In other words, they would not be coming off of a peak, as is typical heading into a recession, mitigating the downside. In addition, managements learned in this latest cycle how to restore profitability in a very weak demand environment, and have not had the opportunity to forget those lessons quite yet. So if faced with a deteriorating environment, they will likely react quickly once again to cut costs and restructure their processes to gain efficiencies. And in the event a downturn is avoided and growth ticks up even modestly, we are likely to experience continued strong profits and cash flows.

Conclusion

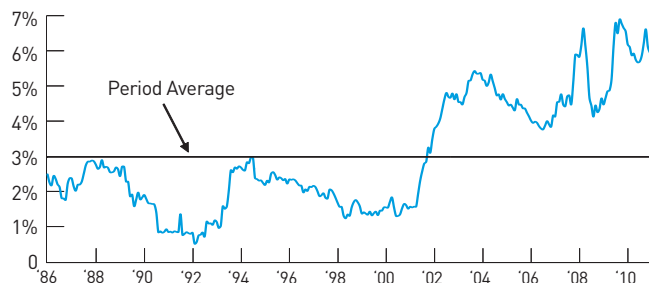
When posed the question, "will value ever work again?" we look to history as our guide, and make a judgment as to whether economic cycles are still relevant, and if we can find similarities in investor reaction to both fear and greed. There is no shortage of evidence that these primal instincts continue to drive the markets; perhaps technology has aided and abetted market participants in their ability to react even more quickly to these forces. But despite massive stock price volatility and what feels like five years of uninterrupted pain, the cycles of value investing appear to be firmly intact, with this cycle "rhyming" with the others. ■

Figure 4: Extreme Opportunity Globally for High Beta Stocks



Source: Sanford C. Bernstein & Co., FactSet

Figure 5: Free Cash Flow Yields Near Peak Levels Developed Markets Nominal Free Cash Flow Yields* 1986 Through Early-January 2012



*Capitalization-weighted data; Data excludes financials
Source: Empirical Research Partners Analysis, Pzena Analysis

DISCLOSURES

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