THIRD QUARTER 2020 COMMENTARY

Value: If Not Now, When?

Value has endured its longest anti-value cycle in history. Over the last 12 months alone, value underperformed growth by a record 44 percentage points,[1] leaving value investors with two key questions:

1. Is value investing dead?

2. If value's not dead, when will the market turn towards value?

To us, value is simply arithmetic that entails buying something cheap relative to the present value of its future cash flows, which we measure using normal earnings. Value is not a factor. It is a timeless and logical approach to estimating the long-term value of a business and determining whether there is a dislocation between the fundamentals and how the market perceives that value. Since there are no reliable datasets for future cash flows, other proxies, including price to book, price to earnings, or price to cash flow, are often used for historical comparisons. We don't believe any of these metrics are true measures of value, but they are satisfactory in studying past value cycles.

Of course, nobody knows precisely when the cycle will turn. But history has shown that once market sentiment starts to anticipate the end of a recession, value tends to stage a powerful and long-lasting rally. With the recent growth rally driven primarily by multiple expansion — as opposed to operating performance — this recession is set up nicely to follow history.

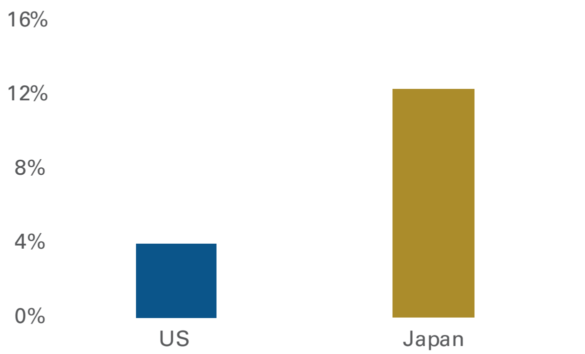
RECESSIONS ARE CATALYSTS FOR VALUE

Our philosophy toward value investing is to buy stocks when their share prices have dropped for reasons we believe are temporary. By focusing on business fundamentals and ignoring temporary issues, we seek superior long-term returns. Therefore, it's hardly surprising to us that value cycles are closely related to economic cycles. In a recession, investors focus on current trends and assume the downturn will be deeper and longer-lasting than it typically is. When this happens, we believe waiting for clarity is imprudent. Whether one's looking to individual stocks or the market as a whole, by the time a catalyst comes, it's often too late.

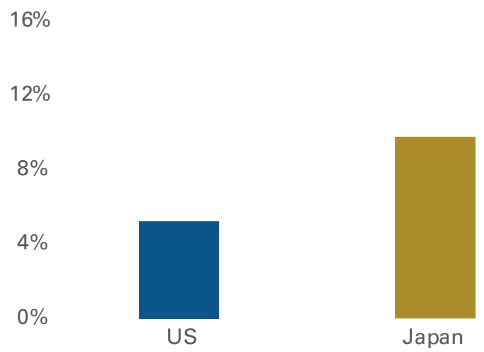
With this thesis in mind, we studied 14 US recessions dating back to the Great Depression, and the 8 recessions in Japan since 1975, to see how value has performed versus the market in and around recessions. We chose the US and Japan because their data sets are the longest and most reliable. The bonus of using Japan is that the country's macroeconomic situation over much of the study period bears a close resemblance to today's environment, i.e., slow growth and low-interest rates. Figure 1 shows that the results have been solidly in value's favor. In the US, recessions have lasted about 13 months, and, on average, value beat the broad market by about 400 basis points (bps). Value even outperformed during the recession that accompanied the global financial crisis and did not meaningfully lag the market in any of the past nine recessions, spanning nearly 70 years.

Figure 1: Recessions Have Favored Value

AVERAGE ALPHA OF DEEP VALUE DURING A RECESSION



AVERAGE ANNUAL ALPHA OF DEEP VALUE FIVE YEARS AFTER A RECESSION BEGINS



Source: Cabinet Office of Japan, Federal Reserve Bank of St. Louis, data Kenneth R. French data library, MSCI, Sanford C. Bernstein & Co., Pzena analysis
Charts use 14 US recessions from 1929 through 2009 and eight Japan recessions from 1977–2012. The overall US universe is based on the top 70% of companies based on market capitalization (ex- small- and micro-cap companies). The Japan universe is based on the MSCI Japan Index. Deep value stocks are represented above by the cheapest quintile of stocks on a price-to-book (P/B) basis. We do not believe P/B is ideal for assessing valuations, but it's a useful proxy for comparing value stocks because of its availability across markets and history. At Pzena, our preferred valuation metric is price-to-normalized earnings. All returns are equally weighted in US dollars. Past performance is not indicative of future returns. Figure 1 does not represent any specific Pzena product or service.

[1] Based on respective Russell 1000 growth and value indices.

In Japan, the average length of a recession has been 19 months, and value has delivered 1,200 bps of alpha.

Value's excess return hasn't only been evident *during* the recession but also over the 5 years from its onset (Figure 1). During these periods, value in the US has surpassed the market by 530 bps annually, generating alpha in 12 out of 14 recessions. While long-term returns are most important for value investors, history shows that value's initial performance during the recession beats the broad index over one year (260 bps) and three years (300 bps). In Japan, value's five-year results have been remarkable. On average, value provided 980 bps of *annual alpha* during such timeframes. Regional and global markets showed similar results, though there are few data points available due to the rarity of synchronized recessions across multiple geographies.

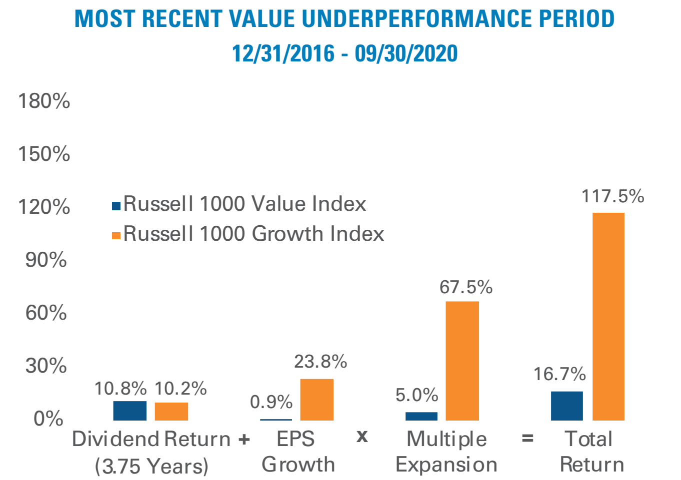
Given value's strong performance during and subsequent to recessions, it is clear that value cycles are tightly linked to economic cycles. Arguably, the length of this anti-value cycle *has been driven by the lack of a recession*. Today's recession, sparked by COVID-19, has ended the longest and most shallow expansion on record in the US.

DISTORTED MULTIPLE EXPANSIONS ARE UNSUSTAINABLE

In The Intelligent Investor, Ben Graham famously said, "In the short run, the market is a voting machine, but in the long run, it is a weighing machine." This is an apt quote given the recent extremes in growth's multiple expansion. Graham's "weighing machine" referenced earnings growth and dividends, which are the fundamentals of valuation enhancement. The voting machine describes the investors' reaction to market sentiment that drives up valuation. Proving Graham's point, growth's won the popular vote among investors as demonstrated by the excessive multiple expansion that has driven the vast majority of it's return since 2017. Figure 2 illustrates the large contrast to value's multiple that has barely budged over the last few years.

This dynamic explains much of the (101 percentage point) return differential, as well. Results like these have left even the most enthusiastic value investors fatigued and indicate that Graham's voting machine is hard at work.

Figure 2: Growth's Multiple Expansion Has Been Extreme



Source: FactSet, Pzena analysis
Total Return = Dividend Return + ((1 + EPS Growth) x (1 + Multiple Expansion Growth)) - 1. Dividend Return value includes reinvestment of dividends and compounding effects. Earnings per share growth is calculated using forward 12-month consensus estimates per FactSet for both starting and ending dates. All data is cumulative in US dollars. Past performance is not indicative of future returns.

Although there's no telling when this dynamic will reverse, it's hard to imagine that such a bifurcation can continue much longer. After all, rising multiples have added just 6 bps (0.06%) to stocks' historical long-term performance.

The last time we saw such a contrast in multiples and performance was during the dot-com era. Figure 3 (on the following page) shows that throughout the bubble, the performance differential was slightly less than 100 percentage points. Growth's valuation was responsible

Figure 3: Déjà Vu All Over Again

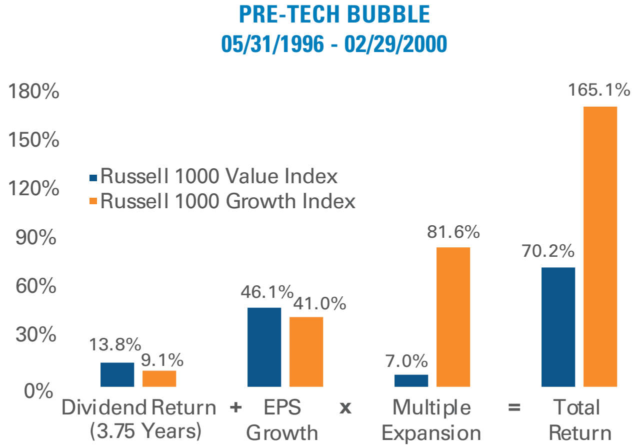
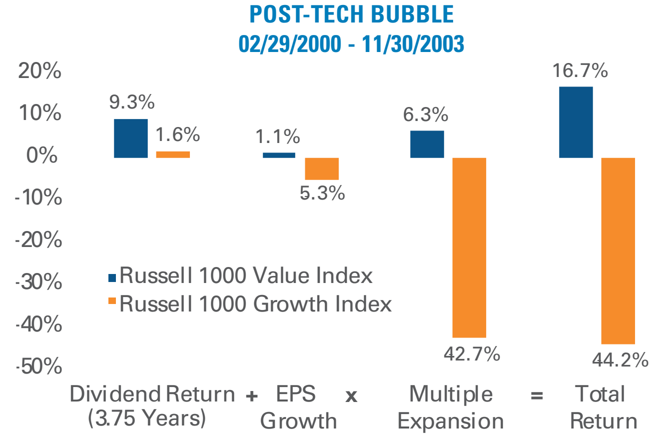


Figure 4: The Dramatic Snapback



Source: FactSet, Pzena analysis
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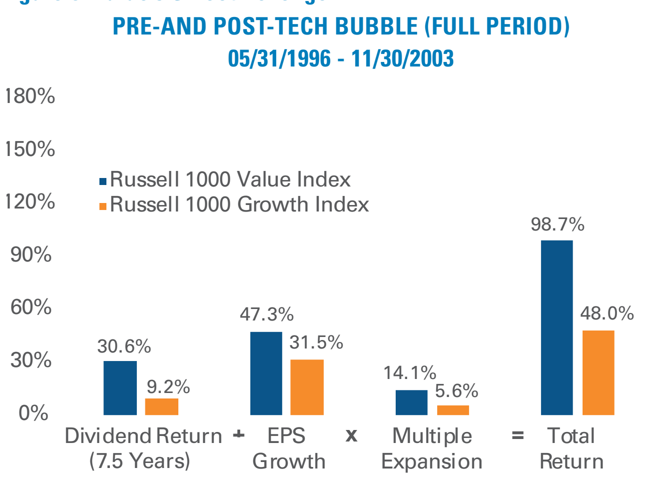
for the majority of its return, with the difference in multiple expansion between growth and value similar to that of the past few years. What happened next was dramatic: growth's valuations normalized in violent fashion, and its returns fell to earth. (See Figure 4.) *Upon the reversal, value gained a sizable advantage — and then some.* These businesses were able to generate earnings and return capital to shareholders even during the recession, leading to value's stunning outperformance.

Figure 5: Value's Sweet Revenge



Source: FactSet, Pzena analysis
Total Return = Dividend Return + ((1 + EPS Growth) x (1 + Multiple Expansion Growth)) - 1. Dividend Return value includes reinvestment of dividends and compounding effects. Earnings per share growth is calculated using forward 12-month consensus estimates per FactSet for both starting and ending dates. All data is cumulative in US dollars. Past performance is not indicative of future returns.

Over the full cycle, value prevailed as it almost always has, despite the severe dislocation during the bubble period. After growth's exaggerated performance reversed, its annualized return trailed the broader market's long-term average for the full period. As growth's multiple expansion normalized, value's gains were twice as high — largely reflecting value's superior earnings improvement through the entire period.

CONCLUSION

Once again, the long anti-value period is culminating in growth's extreme outperformance, raising questions over the viability of value investing. This is at least the third period in the history of our firm that we have heard this argument. Our reaction is no different than it always has been. We remain true to our value discipline. We pick from the cheapest stocks and carefully select what we view as the best opportunities in the market.

To us, value investing is far from dead. The arithmetic of purchasing assets that are significantly discounted to the present value of their future cash flows can't die. However, endless multiple expansion, which has never been a sustainable source of excess return, can die. We don't know when such a reversal will happen, but the link between economic and value cycles seems clear. Value's track record during and after recessions has been impressive and begs the obvious question, "If you don't like value now, when will you?"

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