Rich Pzena

The storied investor argues that value is not a factor but a philosophy

JOHN COUMARIANOS

Why be a value investor? It's a question many portfolio managers may have asked themselves over the last decade as the style had endured a long run of underperformance versus growth.

According to a paper from Research Affiliates founder Rob Arnott and three other authors, growth stocks have beaten their value counterparts by 55% over the 13-and-a-half years to the end of June. This, they said, was the longest period of underperformance since 1963.

An October article in the *Financial Times* went further. Citing research by Two Centuries Investments, the paper reported that value was experiencing its worst run since at least 1826.

But the question 'why be a value investor?' assumes two things: first, that you accept it is a choice, and second, that you accept 'value' to be a factor based on stocks with low price-to-book (P/B) or price-to-earnings (P/E) ratios.

Rich Pzena rejects both assumptions.

'Value investing is more upbringing and personality,' he says. 'Growing up, we learned that the same stuff you pay full price for, you can get at half price sometimes. It gets ingrained in you.'

The founder and co-CIO of Pzena Investment Management adds: 'Value is not low P/B and P/E and factors. It's a philosophy of trying to buy things when prices make sense in relation to the possible outcomes for the business.'

He is not alone in these views. The former is a position also espoused by First Pacific Advisors' Steven Romick. The latter view was shared by Pzena's former classmate Joel Greenblatt in a September interview with Citywire.

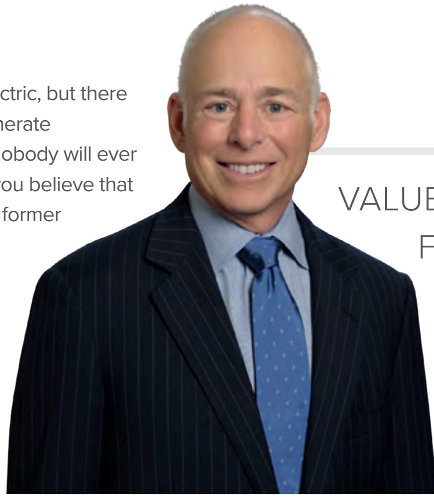
POWER PLAY

To demonstrate his point about value being a philosophy rather than a factor, Pzena gives the example of General Electric (GE), the embattled industrial conglomerate and top holding of the $1.6bn John Hancock Classic Value fund, which he and his team have subadvised for nearly a quarter of a century.

At one point, GE was the most valuable company in America, but its shares declined some 60% from 2016 to 2019 as the company struggled amid issues in its financial division exposed by the financial crisis, management changes, and layoffs, among other challenges. The share price, at the time of our interview was $8 (it took place in October prior to value's November rally), which Pzena believes undervalues the company's potential, despite its troubled recent history.

Today, GE has three main businesses: medical appliances, power systems, and jet engines. With its jet engine business, it forms a duopoly for wide-body passenger planes with Rolls Royce.

Pzena argues that the power business has a future even as energy sources and usages change – and that the jet engine business is dominant and will be resurgent when travel resumes in a post-Covid-19 world.



VALUE IS NOT LOW P/B AND P/E AND FACTORS. IT'S A PHILOSOPHY OF TRYING TO BUY THINGS WHEN PRICES MAKE SENSE IN RELATION TO THE POSSIBLE OUTCOMES FOR THE BUSINESS

'We believe cars will be electric, but there can't only be windmills [to generate electricity]. It's low odds that nobody will ever build another power plant. If you believe that this business goes back to its former luster – and GE has the dominant franchise in jet engines – the stock is very cheap,' Pzena says.

'I could buy GE today and lock in big returns if things go back to the way they were pre-Covid. Something is wrong with this arithmetic.'

He acknowledges the trouble in GE's financial business, GE Capital, including mispriced long-term care policies. As part of his process when picking stocks, Pzena gets outsiders in to present the bear case on a company, and in this instance, the individual said GE would need giant reserves to cover the potential liabilities in its financial unit.

But from other conversations and investigations, Pzena decided bad news was already baked into the stock price and backed GE to withstand considerable stress.

'Our conclusion was that if you make up the worst possible assumptions – negative cash flow could be $7bn – they have $50bn in cash. So, we thought they had seven years [to hang on],' he says.

'They have $2bn in cash flow this year, and the stock is moving back up. It's $8… in a business that in a normal environment earns over $1 per share.'

BANK ON IT

While GE was burned badly during the financial crisis, Pzena has not been put off owning other financials, with the sector occupying 30% of John Hancock Classic Value. Holdings include AIG, Capital One, Wells Fargo, and Citigroup.

'There's no comparison between losses today and a decade ago. [Banks have] more capital than they did a decade ago,' says Pzena, who adds that these companies will not be disrupted by the rise of fintech firms.

'I had a conversation with a bank CEO in 2016, and he said he had an endless line of 28-year-old CEOs of fintech companies saying they were going to eat his lunch,' he explains. 'The CEO would say to them, "You seem smart and industrious, so why do you want to be in the banking business?" He was convinced they didn't. They knew technology, but not banking, which is highly regulated and capital intensive. Today, the CEO says, "I have a new crop of 28-year-old CEOs who are lined up to sell me their technology because they've figured out they don't want to be a bank."'

Whether backing GE or unloved financials such as Wells Fargo, Pzena does not lack the courage to be contrarian, a trait he exhibited in his student days.

He studied at Wharton in the late 1970s, a time when the efficient markets hypothesis was in its ascendancy. However, Pzena, Greenblatt and fellow classmate Bruce Newberg wrote a paper in the *Journal of Portfolio Management* on how investors could beat the market with 'net-nets,' stocks trading at below the value of current assets minus all liabilities, a valuation method used by Benjamin Graham.

Despite being at odds with the orthodoxy of the time, 'we all went into the investment business anyway,' Pzena jokes.

He concedes that back then, there was less information and more inefficiency in the markets, giving the methodology more of an edge than it might have today, when computers can easily run net-net screens.

But Pzena doesn't think computers have wrung all the inefficiencies out of markets.

'People turn value into some esoteric concept, but it's arithmetic,' he says. And sometimes emotions get in the way of making simple calculations. ■

PZENA HAS LAGGED THE BENCHMARK BUT A PROLONGED VALUE RALLY COULD CHANGE THAT

SOURCE: MORNINGSTAR DIRECT / DATA TO OCTOBER 31, 2020