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Investment perspectives

The Sustained Underperformance of Value – Part 2

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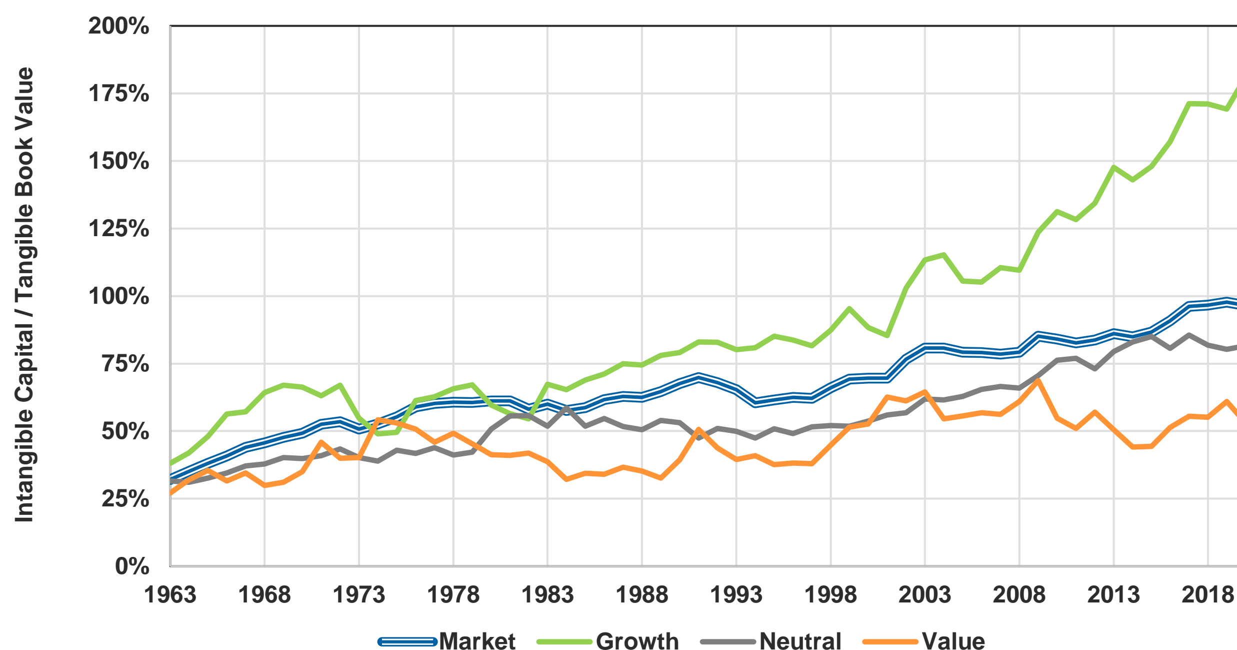
This is the second part of the Investment Perspectives series on the sustained underperformance of value style since the Global Financial Crisis (GFC). This paper will focus primarily on two other important aspects when considering the value style. These are the growing importance of intangibles and the increased focus on sustainable investing, which both have long-term implications for value style investing. We will then conclude how the value style fits within an equity portfolio for long-term investors.

The growing importance of intangible assets

From an accounting perspective, intangible assets are defined as those assets which are not physical in nature and are long-term in nature i.e. non-current. This includes goodwill, brand recognition, innovation, and capitalized research & development expenditure. Companies invest in technology, innovation, human capital, branding, and infrastructure to improve their product and services, and hence improve profitability, so by not accounting for these it does underestimate the value of a company. However, accounting for intangible assets, especially for the internally generated intangible assets, is different and varies depending on which accounting treatment is being used, whether US GAAP or IFRS accounting standards. For example, R&D expenditures are reported in a firm's financial statements as a cost rather than as an investment i.e. capitalised.

Given that the value placed on intangibles as a proportion of a company's value has increased significantly over the last four decades it is becoming more important to consider them when valuing companies. For example, Research & Development expenditure (R&D) of some of the largest corporations now comprise approximately 11% of the firm's valuation (Research Affiliates, April 2021). This has happened at the same time as economies have been moving from manufacturing to more service-based industries. The increased role of intangibles is particularly dominant in technology led industries, especially in some of the largest stocks within FAANGs (Facebook, Amazon, Netflix, Google) as they are very capital light businesses with few tangible assets. Below is the ratio of intangible capital vs. tangible book values of the US equity market. As it can be seen, the trend has been increasing, especially for growth-oriented companies.

Chart 1: Ratio of Intangible Capital vs. Tangible Book Value for US equities.



Source: Research Affiliates as at June 2020.

As discussed in the first article, the original value factor, as defined by price to book ("P/B") multiples, does not account for intangibles. For traditional value investors, high P/B valuations for technology stocks has led them to avoid such investments in their portfolios further contributing to the negative value factor performance of these active managers. But is the traditional P/B multiple appropriate across all industries? It is certainly still relevant in more capital-intensive business models in industries such as real estate, financials, energy, and materials, but perhaps less so in service and technology-based ones. More importantly, how does the original P/B valuation metric and overall company valuation change when incorporating intangible assets?

Over the past few years many quantitative managers have significantly underperformed, which has been mainly attributed to the underperformance of value tilt within their quantitative models, which often relies on P/B as a key input metric. Would the underperformance have been less pronounced if intangibles were accounted for?

There are many quantitative studies that show that when accounting for intangibles the valuation metrics do improve. More recently, analysis conducted by Research Affiliates[1], which focused on capitalized R&D costs and capitalized partial selling, general & administrative expenditures (SG&A expenditures) found similar results. Their quantitative research concluded that when adding intangibles, the value factor improved as a result for both growth and value stocks and found that the traditional P/B metric can lead to misclassification of value and growth companies. Furthermore, capitalized R&D costs have a more important role in improving the value factor than the capitalized SG&A expenditures. The findings showed that for growth companies, intangible assets represented two third of the company's value, while for value-oriented companies one third of the value. The results were similar across the market cap spectrum and by region although the value premium improvement was more pronounced in small market capitalization stocks.

Sustainable investing

From a valuation perspective, there have been additional headwinds as we have seen an increase in demand for both passive and active investments focusing on sustainable investing. The energy sector has been one of the most challenged sectors within the value universe, further impacted by climate change and low carbon initiatives. On the other end of the spectrum, solution type businesses that fall primarily within information technology, and companies within the industrial sector which provide

[1] Research Affiliates. Intangibles; The missing ingredient in Book Value, April 2021

alternative energy, such as wind or solar, have benefitted from the *greenium*[2] premium due to the increased focus on sustainable investing further widening the valuations between what are deemed as value and growth stocks.

As part of this discussion, considering how value investing is implemented also matters. There are many different approaches; deep value, rule-based, fundamental, and factor-based approaches. In addition, the duration of the value opportunity being targeted can differ as it can be shorter-duration or long-term which focuses more on the assessment of evolving business models. Also, the set of stocks that represent good value should change over time as companies adapt to changes that come with disintermediation, evolving business models and ESG considerations.

Therefore, by using more flexible approaches in assessing what constitutes value, and what measures to apply to identify value, may be required to keep value investing relevant. For example, those approaches which are longer-term focused and place greater importance on cash generative businesses that have more quality style attributes, are better placed in identifying the value opportunities. To that extent systematic investors are also now wishing to take a longer-term framework in their investment approach, using longer-term valuations, including intangible-adjusted value metrics, is a natural evolution of value investing.

Summary

In summary, the traditional value factor has had many headwinds over the past few years. The valuation gap between value and growth is quite stretched by historical standards and there are periods (even if quite short lived) when traditional value stocks can rally. Most recently, markets experienced a comeback post vaccine announcement late in 2020, and as the cyclical rebound commenced the value style did well in early 2021.

Whether or not a period of sustained performance by value stocks will continue is difficult to predict. However, the longer-term secular trends towards digitalization and focus on sustainable investing are driving changes to business models and the increasing importance of intangibles in company valuations.

These trends affect both value and growth companies alike; as a result, how company management are embracing these changes, considering and addressing environmental, corporate and social risks and opportunities, should be embedded features of how managers assess all companies. Taking that as a 'new' given, crucially, timing style is hard to do, therefore for long-term investors we conclude that the value style still deserves an allocation alongside other investing styles in an equity portfolio.

[2] Risk premium related to the greenness of a firm, based on companies' greenhouse gas emissions and the quality of their environmental disclosures.

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