

LGC&D Wealth Management, LLC
Educated Investor Feature Articles: 2008, Vol. 1
January

If You Can't Stand the Heat

Overview: The stock market's recent activity continues to make headlines. The following article reviews several important concepts, including why investors should expect periods of underperformance by value stocks and why they should not allow this to convince them to abandon their long-term investment strategy.

A good friend has been a two-line sport kite flier for several years. While not a pro, he has learned a few tricks by observing the flying behavior of these kites. He said that one of the most difficult skills for beginners to master is what to do when their kite starts to plunge toward Earth. The natural, panicky impulse is to yank backward on the lines. However, this action only accelerates the kite's death spiral. The simple kite-saving technique is to calmly step forward and thrust your arms out. This causes the kite's downward acceleration to stop, allowing you to regain control of the kite and end its plunge.

What does this have to do with investing? Just as yanking backward on the lines is the natural, panicky reaction when a kite starts to plunge toward Earth, the natural, panicky reaction to a dive in a portfolio's value is to pull back (sell). In both cases, pulling back is the wrong strategy. The right strategy is the less-intuitive one of remaining calm and stepping forward (buying stocks to rebalance the portfolio to the desired asset allocation).

Investors who are questioning their strategy should ask themselves the following question: "What has changed that would cause me to abandon my strategy?" Those asking the question should consider the following: The most basic tenet of investment theory is that risk and *expected* return are related. Value stocks have historically provided higher returns than growth stocks, and stocks have provided higher returns than Treasury bills for the same reason — they are riskier. Because there is incremental risk, investors require a risk premium (higher *expected* return) as compensation.

Thus, the answer to the question "What has changed?" is "Nothing." Does the fact that value stocks provided lower returns than growth stocks in 2007 mean that they now have lower expected returns than growth stocks? For that to be true, value stocks would have to be safer than growth stocks, or risk and expected return would be unrelated.

The Value Premium

The value premium is one of the most well-documented facts in finance. To calculate the value premium, financial economists take the return of value stocks (defined as stocks within the top 30 percent of stocks ranked by book-to-market (BtM) value) and subtract the return of growth stocks (defined as stocks within the bottom 30 percent when so ranked). The term HmL — the return of high (H) BtM stocks minus (m) the return of low (L) BtM stocks — is the term used for the value premium. For the 80-year period 1927–2006, HmL was 5.2 percent on an annual average basis. The annualized (compound) HmL was 4.4 percent.

With this knowledge, many investors deviated from pure market-cap weighted portfolios. Instead, they seek to capture the value premium by tilting their portfolios toward value stocks. Investors who did so were rewarded with large premiums from 2000 through 2006. The premiums were 37.8, 14.5, 12.2, 3.0, 8.3, 8.3 and 12.7 percent, respectively. This produced an annualized premium of 13.4 percent. However, in 2007, the value premium turned sharply negative.

Still, there are some important statistics to keep in mind regarding the value premium:

- The value premium has appeared with a high degree of persistence. HmL was positive in 51 of the 80 years from 1927–2006, or 64 percent of the time. Of course, that means it was negative 36 percent of the time. That is the nature of risk.
- The standard deviation of HmL was more than 2.5 times the annual premium at 12.8 percent, which shows the risky nature of investing in value stocks. The highest HmL occurred in 2000, when it reached 37.8 percent. Ironically, the lowest occurred the prior year when HmL was a negative 26.4 percent (probably causing many investors to panic and sell).
- As shown by the tables below, there have been numerous times when HmL has had runs of positive years and negative years.

Year	HmL
1927	-2.12
1928	-4.20
1929	15.87
1930	-18.72
1931	-19.71
1966	-1.04
1967	-4.76
1968	15.39
1969	-10.98
1970	22.92
1971	-8.88
1985	-0.41
1986	7.71
1987	-3.55
1988	12.49
1989	-3.69

1990	-11.29
1991	-10.48

Source: Dimensional Fund Advisors

Year	HmL
1961	5.28
1962	9.84
1963	14.84
1964	9.55
1965	6.56
1972	2.17
1973	24.20
1974	10.95
1975	7.16
1976	20.82
1977	7.54
2000	37.81
2001	14.49

2002	12.24
2003	3.01
2004	8.30
2005	8.30

2006	12.67
------	-------

While HmL has been fairly persistent, there has been no predictable pattern to the premium. The only way investors could have reliably earned the value premium is if they had the discipline to maintain their exposure. This means investors would have to have ignored the clarion calls from Wall Street and the media that are often made after a few years of value outperformance. Calls such as “This is the year of growth stocks” had been heard almost continually since 2002.

Keep in mind what would have happened if investors who listened to such calls sold their value holdings after the first three years of the new century (2000–02), when HmL was 37.8, 14.5 and 12.2 percent, respectively. They would have missed the next four years when HmL was 3.0, 8.3, 8.3 and 12.7 percent, respectively.

After years like 2007, when portfolios experience negative tracking error (when a portfolio underperforms a broad market index like the S&P 500 Index), many investors question their strategy of tilting to value stocks to capture the value premium (the higher expected returns historically generated by value stocks). Few investors question their strategy when it generates positive tracking error. However, investors who tilt their investment strategy to value stocks to capture the value premium must accept the fact that there will be periods of underperformance. Investors who are not prepared for that should not tilt their portfolios in the first place.

Timing the Value Premium

Evidence from academic studies shows that there has been no persistent ability to time the market by increasing equity allocations ahead of the bull emerging into the arena, by lowering them ahead of the bear emerging from its hibernation or by shifting allocations between asset classes.

There are two reasons that trying to time the market is unlikely to be successful:

- As we have discussed, there should always be an equity risk premium because stocks are always riskier than one-month Treasury bills. All that high valuations predict is relatively low future expected returns; but those returns should still be higher than the returns on a riskless security.
- Second, the equity risk premium is so high that timing efforts would have to be right almost all the time to be successful. The same is true of the value premium.

Just as there is no evidence supporting the view that investors are likely to succeed in their efforts to time the market, there is no evidence that they can time the value premium with persistence. If there were, we would see evidence of active managers outperforming passive benchmarks with persistence greater than randomly expected. Yet, we do not see such persistence.

There is an important fact about value stocks and their returns that investors should understand because it will help them ignore the media (and their friends). Most of the HmL premium comes from a small percentage of value stocks that produce very high returns. Their outperformance often leads to them migrating out of the value asset class, leaving a different group of value stocks than the prior year. The same thing is true of small-cap stocks.

Even with this knowledge, there are those that believe the value premium can be timed based on the relative spreads between the valuations of value and growth stocks. In other words, when the spread between the BtM (or price-to-earnings) ratios of value and growth stocks is wider than the historical average, investors should load up on value stocks.

On the other hand, when the ratio is relatively low, they should abandon value stocks and move to growth stocks. This would seem to make sense since studies have found that when the spread in BtM ratios between value stocks and growth stocks is high, the subsequent value premium tends to be high. The reverse is also true.

Evidence on Timing the Value Premium

Based on that information, if next year's value premium is expected to be high, it would seem logical to own value stocks. If it were expected to be low, then growth stocks would seem to become the logical choice. Is it really that simple to earn abnormal returns? Does a statistical relation always translate into a viable portfolio strategy? These are the questions Jim Davis asked and answered in his 2007 study "Does Predicting the Value Premium Earn Abnormal Returns?"¹ The study covered the period July 1926–June 2005.

Davis found that style-timing rules did not generate high average returns despite having future information about BtM spreads. In fact, he concluded that the expected excess return of style timing is probably negative for the same reasons that efforts to try to time the overall market are likely to fail. Just as there should always be an equity risk premium, there should always be a value risk premium. And as is the case with the equity risk premium, the value premium is so large that any trading strategy would have to be right almost all of the time to deliver successful results.

It would be like switching from the high-speed carpool lane to the center lane on a crowded freeway based on an equation. This "freeway algorithm" might help predict when the carpool lane or center lane will move faster or slower than normal. But will it be accurate enough to justify switching into the slower lane in an effort to get there quicker? The lesson for investors is that the existence of a statistical relationship does not necessarily imply that a profitable trading strategy based on that relationship exists, especially after accounting for trading and other costs.

Summary

Warren Buffett is probably the most highly regarded investor of our era. Listen carefully to his statements regarding efforts to time the market.

- σ “Inactivity strikes us as intelligent behavior.”²
- σ “The only value of stock forecasters is to make fortune tellers look good.”³
- σ “We continue to make more money when snoring than when active.”⁴
- σ “Our stay-put behavior reflects our view that the stock market serves as a relocation center at which money is moved from the active to the patient.”⁵

Perhaps his views on market-timing efforts are best summed up by the following from the 2004 Annual Shareholder Letter of Berkshire Hathaway:

Over the 35 years, American business has delivered terrific results. It should therefore have been easy for investors to earn juicy returns: All they had to do was piggyback Corporate America in a diversified, low-expense way. An index fund that they never touched would have done the job. Instead many investors have had experiences ranging from mediocre to disastrous. There have been three primary causes: first, high costs, usually because investors traded excessively or spent far too much on investment management; second, portfolio decisions based on tips and fads rather than on thoughtful, quantified evaluation of businesses; and third, a start-and-stop approach to the market marked by untimely entries (after an advance has been long underway) and exits (after periods of stagnation or decline). Investors should remember that excitement and expenses are their enemies.⁶

The above observation is perhaps why Buffett has stated that investing is simple, but not easy.⁷ One of the important keys to financial success is having knowledge of how markets really work. Those that do not know that there will inevitably be periods of underperformance may fall prey to tracking error risk and abandon their plan. But investors who “know their history” are forewarned. Thus, they will be more likely to have the discipline to stay the course. In fact, disciplined investors look at periods of underperformance as opportunities to buy stocks when they are “on sale.” In other words, the market is a mechanism that transfers wealth from those without a strategy and with weak hands to those with a strategy and strong hands.

The bottom line for investors is that the prudent strategy is to ignore the calls to alter their long-term investment strategy, be they from their stomach, Wall Street or the financial media. The appropriate actions include portfolio rebalancing and harvesting any losses for tax purposes. Those who have the discipline to stay the course will avoid the fate of investors who underperform the very mutual funds they invest in by a significant margin (because they alter their strategy and chase past returns).⁸

¹ James L. Davis, **Does Predicting the Value Premium Earn Abnormal Returns?** January 2007.

² Warren Buffett, **Chairman’s Letter**, February 28, 1997.

³ Warren Buffett, **Chairman’s Letter**, March 1, 1993.

⁴ Warren Buffett, **Chairman’s Letter**, February 28, 1997.

⁵ Warren Buffett, **Chairman’s Letter**, February 28, 1992.

⁶ Warren Buffett, **Chairman’s Letter**, February 28, 2005.

⁷ Clifford Asness, **Rubble Logic: What Did We Learn From the Great Stock Market Bubble?** *Financial Analysts Journal*,

(November/December 2005).

⁸ Russel Kinnel, **Mind the Gap: How Good Funds Can Yield Bad Results.** *Morningstar FundInvestor* (July 2005).

This material is derived from sources believed to be reliable, but its accuracy and the opinions based thereon are not guaranteed. The content of this publication is for general information only and is not intended to serve as specific financial, accounting or tax advice. To be distributed only by a Registered Investment Advisor firm. Copyright © 2008, Buckingham Family of Financial Services.

To unsubscribe, please reply to this email with the subject line "unsubscribe."