(Still) Waiting for Mean Reversion

"Let's go." "We can't." "Why not?" "We're waiting for Godot."
— Sam Beckett, 'Waiting for Godot'

In Sam Beckett's 1953 absurdist play, *Waiting for Godot*, two characters, Vladimir and Estrogan, spend the entirety of the play waiting around for the mysterious Godot (spoiler: Godot never shows).[1] Despite having no clue what they are waiting for, and waxing philosophical for hours over what they should be looking for, they could not bring themselves to leave the scene for fear of missing out on the mysterious Godot.

We do not think that Beckett had the asset management industry in mind when he wrote his play, but he might as well have. In our view, many investors are playing the role of Vladimir and Estrogan — waiting around for Godot, played by the ever elusive value factor whose past outperformance refuses to show. For value investors, generally it has been a tough row to hoe over the last decade, on both the active and the passive side of things. As quality growth investors, we recognize that in polite society it is a well-observed tradition that one should not kick another while they are down. However, in the spirit of disruption, we are going to break with tradition. Our "kicking" will not be physical, but confined to the realm of data and it will not be directed at someone, but something – value's continued underperformance, in good and bad times.

THE LOST DECADE

As we sit here in March 2020, February and early March were certainly painful to investors, with global equity markets experiencing their largest drawdowns since the fourth quarter of 2018. For the S&P 500, it was the fastest 10% decline from an all-time high, *in history.*

While we can debate the highly uncertain global impact of COVID-19, what is not up for debate is the performance of the traditionally defined value factor which, to be blunt, has been abysmal. Certainly, it appears that some market participants were panicking during the recent market sell off (we were not). In our view the folks who should be in a panic, are those investors suffering from value's relative underperformance. In that regard value style investing has now underperformed on a monthly, YTD, one, three, five and ten year basis, as measured by the performance of the Russell 1000® Value Index versus both the Russell 1000® Growth Index and the Russell 1000® Momentum Focused Factor Index (which many would think should be the worst performer).

EXHIBIT 1: STILL WAITING FOR MEAN REVERSION

	1 MONTH	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR
Russell 1000 Value Index	-16.44	-15.92	-2.77	2.14	5.08	9.40
Russell 1000 Index	-14.13	-10.66	6.44	8.58	8.98	11.88
Russell 1000 Momentum Focused Factor Index	-13.80	-9.05	8.77	9.72	9.04	12.02
Russell 1000 Growth Index	-12.10	-5.72	15.62	14.97	12.75	14.25

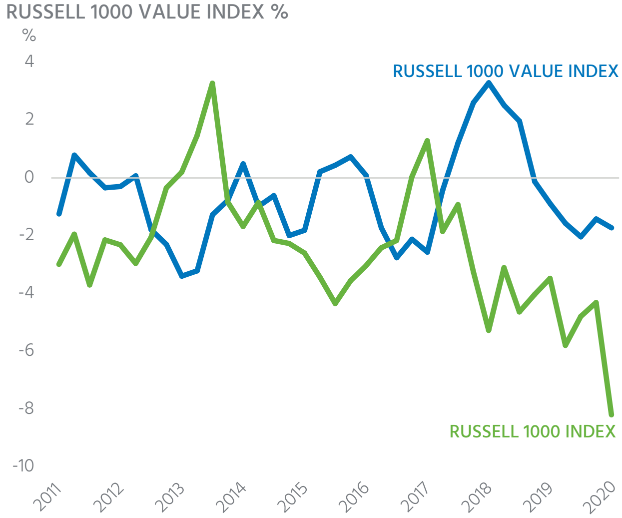
Source: Morningstar Direct. As of March 10, 2020.

If your exposures did not provide relative upside in good times and did not reduce the relative downside in the bad times, much like war, what are they good for? Adding insult to injury, for value investors, the pain has not been confined to passive space, as highlighted in Exhibit 2.

Using the Morningstar US Large Cap Value Manager Active Universe (consisting of 230 institutional value funds), rolling one-year return differentials for the median large cap value manager versus the Russell 1000® Index and the Russell 1000 Value Index, respectively, value uniformly has struggled. With the exception of a few brief time periods in 2013 or 2018, the median US Large Cap value manager has underperformed the Russell 1000 Index more than 85 per cent of the time on a one-year basis and the Russell 1000 Value (its own style) 65 per cent of the time! Beyond that, the average performance of such funds versus each respective index over the time series is negative 57 basis points (bps) versus their own style and negative 246 bps versus the Russell 1000. Now from time to time, we would expect various styles to come in and out of favor, so clearly the blue bar illustrates that value as a style, has lagged for quite some time. However, for the median manager to add no value vis-à-vis to its own style index for a decade, that seems like a tough sell.

EXHIBIT 2: YOU'VE GOT TO KNOW WHEN TO HOLD 'EM, KNOW WHEN TO FOLD 'EM

MEDIAN US LARGE CAP VALUE MANAGER VERSUS ROLLING ONE-YEAR RETURN DIFFERENTIALS OF RUSSELL 1000 INDEX AND RUSSELL 1000 VALUE INDEX %



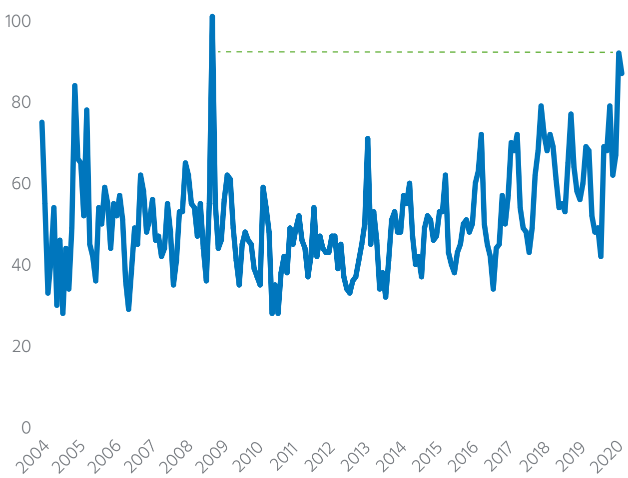
Sources: Morningstar Direct and GQG Partners analysis as of February 27, 2020 for rolling one year return differentials from February 1, 2010 to January 31, 2020. Analysis includes 230 institutional large cap value funds. These funds seek capital appreciation by investing in large cap stocks that are value-oriented. Value is defined based on low price/book and price/cash-flow ratios, relative to the MSCI EAFE Index.

WHY HASN'T GODOT EVER SHOWED?

Now we fully recognize that as of March 2020, "everyone" knows that traditional value has had a rough go of it since the global financial crisis (GFC). However, few investors seem to have figured out the "why" of this underperformance. Despite the poor returns and lack of apparent rationale for those poor returns, the popularity of value stocks, as evidenced by recent Google Trends data, is approaching an all-time high since Google started collecting the data back in 2004, as noted in Exhibit 3. Unfortunately, the all-time high in popularity on the chart, September 2008, was not exactly the best time to become a value investor. But let us give credit where credit is due, and while value has underperformed for a decade at this point, as highlighted in Exhibit's 1 and 2, one of the cases for buying cheap assets is that they hold up better in a drawdown, something that has not occurred very often in a post GFC world. To the extent that drawdowns were to occur, proponents of the 'buy cheap assets' philosophy should see their moment in the sun. In Exhibit 4, we have highlighted the since inception period of the Russell 1000 Value Index starting in January 1979 and ending in December 2019. Over the full 41-year period, the Russell 1000 Value Index was at its (relative) best when the Russell 1000 Index fell, posting a median excess return of 60 bps on a quarterly basis. Contrast this with the Russell 1000 Value's 40 bps of negative excess return when the Russell 1000 Index displayed a positive print on a quarterly basis. So far so good for cheap stuff holding up in down markets. However, and this is consistent with the data in Exhibit's 1 and 2, this relationship has completely flipped over the last 10 years, where the Russell 1000 Value Index, while performing incrementally worse in up markets relative to its history, now posted a median negative excess return in both up and down markets!

EXHIBIT 3: BACK BY POPULAR DEMAND

GOOGLE TRENDS INTEREST OVER TIME: "VALUE STOCKS"

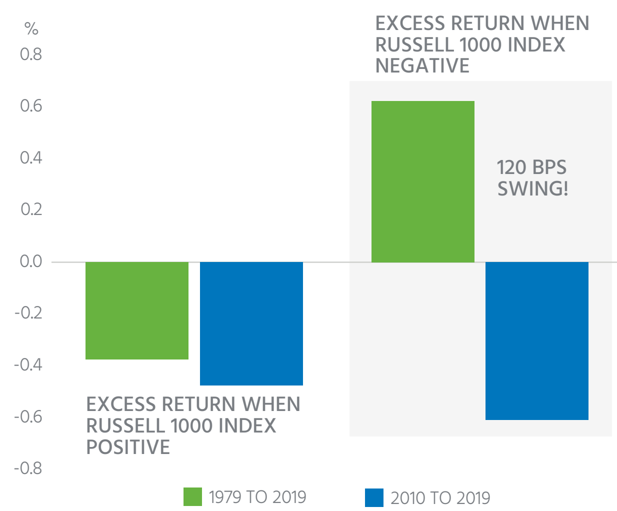


Sources: Google Trends. As of March 4, 2020. Data from January 1, 2004 to March 1, 2020. Interest over time: numbers represent search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular. A score of 0 means there was not enough data for this term.

Again, if you cannot outperform on the upside, and cannot hold up on the downside, what is the purpose of the exposure? In our view, this seems like something is fundamentally broken. However, hope springs eternal, and just as time heals all wounds, maybe if enough time passes, value will reassert itself. After all, it is not as if mean reversion is an unknown phenomenon. For context, many people are sports fans and sports are notorious for the presence of mean reversion. From the team with a 20 game win streak, to a goal scorer that just cannot miss, or the infamous "Sports Illustrated Cover Curse", when a statistic proceeds too far above or below the "mean" in a particular domain, it's more likely than not that the next set of data will see the statistic revert to the statistical mean. Baruch Lev, professor of accounting at New York University, in his 2019 paper, "The Demise of Value", provides us with an insightful description of mean reversion by contrasting value (cheap) and glamour (expensive) stocks:[2]

EXHIBIT 4: NO LONGER THERE WHEN YOU NEED IT MOST

MEDIAN QUARTERLY EXCESS RETURN %
RUSSELL 1000 VALUE INDEX VERSUS RUSSELL 1000 INDEX



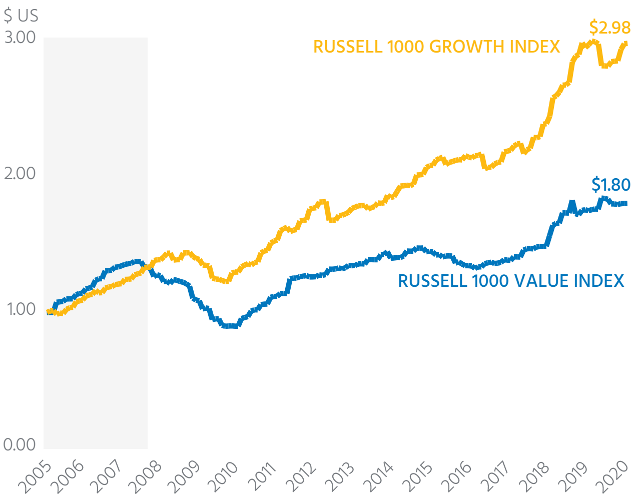
Sources: eVestment. As of February 29, 2020. Median quarterly return since inception of the Russell 1000 Index from January 1, 1979 to December 31, 2019.

> "The reason for mean reversion is that the specific ranking of a subject at a point in time, say a football team, is due to systematic (fundamental) factors, such as players' talent and size of fan base, as well as to random (transitory) factors, such as injuries. Over time, the transitory factors

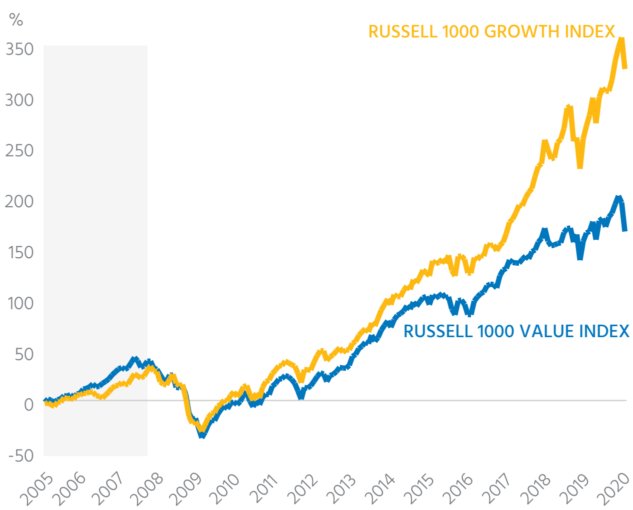
average out, and the subjects ranked at the top and bottom revert to the mean. Similarly, value and glamour stocks are ranked at the bottom and top due to systematic factors, like a strong patent portfolio or a weak product mix, as well as to random (transitory) factors, such as a contract cancellation, or an SEC inquiry. The random (transitory) factors will average out over time, leading to mean reversion of both value and glamour stocks. *The extent and speed of mean reversion is determined by the relative size of the random to fundamental factors — the larger the relative size of random to fundamentals, the stronger and quicker the mean reversion [emphasis added].*"[2]

EXHIBIT 5: EARNINGS ARE LIKE GRAVITY

CUMULATIVE EARNINGS GROWTH
RUSSELL 1000 VALUE INDEX VERSUS RUSSELL 1000 GROWTH INDEX



CUMULATIVE RETURN
RUSSELL 1000 VALUE INDEX VERSUS RUSSELL 1000 GROWTH INDEX



Sources: Bloomberg and GQG Partners analysis as of February 29, 2020. Data from March 31, 2005 to February 29, 2020.

Proceeding through Lev's paper, he proceeds to highlight that for the time period of 2007 to 2018 (the analysis period), both value and glamour stocks were remaining in their categories for longer periods of time than was the case historically. For example, for the time period of 1989 to 1999, value stocks remained "value stocks" for two-and-a-half years while glamour stocks remained "glamour stocks" for approximately two-and-a-half years. However, for the 2007 to 2018 time period, value stocks remained value stocks for three-and-a-half years while glamour stocks remained glamour stocks for four-and-a-half years. Going back to our description of mean reversion, in our view this would suggest that the *fundamental* differences, rather than the *transitory* differences of our buckets have changed. We believe that is exactly what we see in Exhibit's 5 and 6. Notice in Exhibit 5, that when value *did work* prior to 2008, it appears to be due to the fact earnings growth for the Russell 1000 Value Index was *better* than the Russell 1000 Growth Index. As earnings growth began to rollover for the Russell 1000 Value Index, relative performance began to suffer.

Additionally, as highlighted in Exhibit 6, cheap stocks really are not all that cheap when looking at the prices paid for future expected growth. In fact, much of the relative underperformance, in our view, stems from the fact that estimated earnings growth for the Russell 1000 Value Index today is lower than it was in 2006, while forward prices paid are actually higher! So while the Russell 1000 Growth Index, is and was, at a premium, the ratio of prices paid for future growth actually improved relative to the value cohort, despite strong returns for the growth Index over the prior decade.

SHALL WE GO?

While many investors are still waiting and hoping for mean reversion, we think few have looked at the data closely enough to understand why "value" has underperformed. Like many things in life, sometimes it might be best to "cut your losses". If you are a taxable investor, and have experienced not only relative underperformance but absolute losses as well, harvesting losses in the underperforming part of the portfolio can actually be a good thing. But this need not apply solely to a taxable base, as even tax exempt investors could benefit from "taking your money and running" in order to keep the portfolio fresh! After all, we believe buying companies solely because they are cheap on a traditional price to earnings or price to book basis is a fool's errand. Additionally, selling a stock solely based on a company being deemed "too expensive" on that same basis is also a fool's errand. Great ideas are hard to come by. Constantly churning your winners can be problematic because great companies are rare. We are active investors through and through, but one thing an Index, say the S&P 500, does not do is sell its winners. Maybe that is why so few managers can outperform!

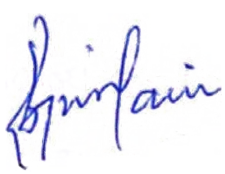
EXHIBIT 6: WHAT ARE YOU GETTING FOR WHAT YOU'RE PAYING

	RUSSELL 1000® VALUE INDEX	RUSSELL 1000® GROWTH INDEX
ESTIMATED LONG TERM EARNINGS GROWTH		
January 2006	8%	14%
February 2020	5%	12%
FORWARD VALUATIONS		
January 2006	13x	19x
February 2020	14x	21x
FORWARD PRICE/EARNINGS TO GROWTH RATIO (PEG)		
January 2006	1.6x	1.4x
February 2020	3.0x	1.8x

Source: Bloomberg. As of February 28, 2020.

Even the father of value investing, Benjamin Graham, never advocated for such a narrow approach to investing, stating "the stock of a growing company, if purchasable at a suitable price, is obviously preferable to others". No one wants to overpay for assets, so in that sense, we are all value investors, it is just some of us are more dogmatic about it than others. Our approach is to look for quality first and then growth, all through the lens of compounding. We believe this approach allows us to transcend the 3x5 card of allowable style box opinion, and focus on the fundamental, rather than transitory elements of a company over the next three to five years.

If there are any statute of limitations on mean reversion, we have not found them, but more than a decade seems like it may be approaching the limit. Sam Beckett never gave us a sequel to his play, but now that we are beyond 65 years since it hit the public, maybe there is an unpublished draft somewhere called "(Still) Waiting for Godot". For value investors, Godot cannot come soon enough; unfortunately for the remaining holdouts, if history is any guide, Godot never shows.



Rajiv Jain
Chairman & Chief Investment Officer
GQG Partners LLC

ENDNOTES

1. Beckett, Samuel. *Waiting for Godot*. New York: Grove Press, 1954.

2. Lev, Baruch Itamar and Srivastava, Anup, Explaining the Recent Failure of Value Investing. *SSRN*. October 25, 2019. https://ssrn.com/abstract=3442539

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