IS THERE A FUTURE FOR VALUE INVESTING?

Avi Lavi
Chief Investment Officer—Global and International Value Equities

The last few years have been frustrating for value investors. Ultralow interest rates have created big obstacles to success for investors in attractively valued stocks with riskier earnings profiles. Technological innovation has generated structural changes in market dynamics and investor preferences. Classic measures used by value investors, such as the price/book (P/B) ratio, have proved ineffective. Growth stocks have outperformed value stocks for most of the last decade.

Against this backdrop, many investors are asking whether there is a future for value investing. Perhaps the basic tenets of value investing just don't work anymore in the new macroeconomic and market environment. Maybe investors should no longer assume that the forces that have underpinned the returns of value stocks in the past will support returns in the future. These are questions that we cannot ignore.

Yet in the past, value investing has prevailed through many cycles and changes in global markets. With this in mind, instead of drawing rash conclusions about the demise of value investing, we think it's important to take a fresh look at the fundamentals of value today. In this article, we aim to show that behavioral biases that drove value investing in the past are still pervasive, but they require new frames of reference for investors to exploit in a rapidly changing world.

CORE PRINCIPLES OF VALUE INVESTING

For decades, the core principles of value investing were a reliable guide to generating equity outperformance. While many volumes have been written about value, the tenets can be summed up in two core principles:

+ **Uncertainty about earnings is pervasive**: the normal level of company earnings is volatile because of cyclical trends and competitive dynamics
+ **Investors are prone to emotional biases**: human emotions cause overreaction to this uncertainty, which can be exploited by investors who have conviction in a company's outlook

Applying these principles to a disciplined stock-picking process was a recipe for success in the past. And the P/B ratio was a good guide to finding value opportunities. That's because the profitability of cheaper stocks based on P/B ratios typically regressed to the mean. Since 1980, the cheapest quintile of P/B stocks (Q1) in a global developed equity universe improved profitability (as measured by return on equity, or ROE) over a five-year cycle while ROEs of expensive P/B companies (Q5) deteriorated (*Display 1, page 2*).

These trends are not surprising. When profitability is low, weaker competitors often fail and management teams take actions to improve profitability, which drives the regression-to-the-mean pattern we see in *Display 1*. And high levels of profitability decline over time because high returns on capital invite competition seeking to earn those high returns; the added competition ultimately drives returns lower.

But in recent years, the trend has weakened. Since 2015, the ROE improvement of Q1 stocks has been muted, while the ROE of expensive Q5 stocks has hardly declined (*Display 2*).

Why have these performance patterns deteriorated? We think the explanations are rooted in transformational shifts to the global economy over the past decade. Since the global financial crisis (GFC), companies have operated in a world of modest macroeconomic growth, low interest rates and surplus capital, driven by historically relaxed monetary policies. And a technological revolution is disrupting many industries while creating powerful new global monopolies.

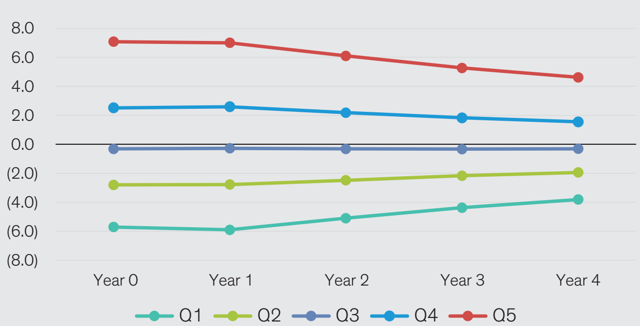
At the same time, the behavioral biases that underpinned classic value investing haven't really changed. Loss aversion still causes risk-averse investors to sell off stocks doing poorly, driving prices down lower than deserved. And anchoring makes investors underestimate the strength of the potential rebound of a stock price, when underperforming companies improve their profitability.

So, on balance, is value investing irrelevant? We don't think so. But we do need to consider what has changed in the world—and what hasn't—in order to refine a disciplined, stock-picking approach and to generate alpha once again in a world of technology-driven industry disruption.

DISPLAY 1: IN THE PAST, MEAN REVERSION WAS A RELIABLE FOUNDATION FOR VALUE INVESTORS

Global Stocks: Price/Book Quintiles

Return on Equity vs. Market, 1980–2019 (Percent)



Past performance and current analysis do not guarantee future results.

Through April 30, 2019

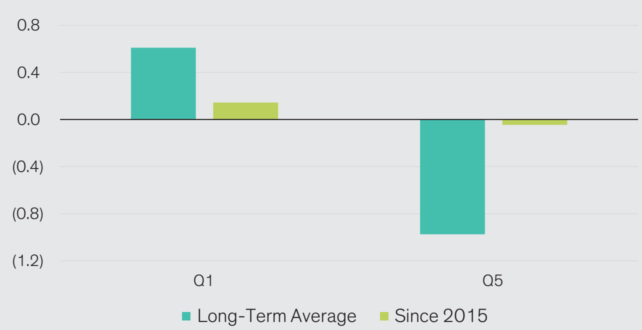
Global stocks based on MSCI ACWI. Analysis of five-year cycles. Since 2015, year 0 is 2015 and year 4 is 2019.

Source: Compustat, MSCI, Thomson Reuters Datastream, Worldscope and AllianceBernstein (AB)

DISPLAY 2: MEAN REVERSION HASN'T WORKED IN RECENT YEARS

Global Stocks: Price/Book Quintiles

Two-Year Change in ROE of P/B Quintiles (Percent)



Past performance and current analysis do not guarantee future results.

As of April 30, 2019

Global stocks based on MSCI ACWI. Long-term average is from 1980 through April 30, 2019.

Source: Compustat, MSCI, Thomson Reuters Datastream, Worldscope and AB

REFRAMING THE VALUE PERSPECTIVE

Let's start by looking more closely at why value worked in the past. In the 1980s, 1990s and 2000s, growth and value were defined by index providers like MSCI in terms of a few simple metrics such as earnings growth, P/B ratios and dividend yield. Leadership between these styles oscillated, but value outperformed over the longer term. In our view, this is because value investors were better equipped to harvest returns from taking advantage of investors' loss aversion.

Loss aversion deserves closer attention. When stock prices fluctuate, investors are alternately exposed to short-term gains and losses. In the emotional human brain, the pain of losses is greater than the pleasure derived from gains. This idea was advanced by the Nobel Prize–winning behavioral economists Daniel Kahneman and Amos Tversky, and it explains why investors often gamble to avoid losses.

When faced with a downturn, rather than riding it out (and risking an even greater loss), investors typically switch to something that seems more certain and, as a result, may end up selling low and buying high. This selling pressure creates value opportunities: steep short-term declines lead to a stock being oversold, from which value investors can profit by taking a longer-term view. To work effectively, a value investor must be willing to absorb some short-term downside risk and to have conviction in a thoroughly researched view on a company's long-term outlook that supports an eventual recovery.

During big market sell-offs in the past, this approach worked well. In 1990–1991, 2000–2002 and 2007–2009, we experienced classic big-swing cycles. In each case, many investors believed that pervasive changes in the global economy would turn classic investing principles upside down. For example, before the dot-com bubble burst in 2000, it was widely believed that the new internet economy meant unprofitable companies were worth exceptional valuations. During the global financial crisis in 2008, investors feared a depression and a prolonged bear market that would inflict catastrophic damage to sectors and companies across the board.

In both cases, some things changed, and some didn't. Each sharp downturn created tremendous value opportunities. Patient investors who bought into the right underpriced stocks were rewarded. Of course, at the time, it was hard to identify the bottom of the market, which was clearer in hindsight.

Are things different today? To answer that question, we need to consider whether the changes sweeping through the world economy have permanently impaired the ability of value investors to generate returns by identifying mispriced stocks with recovery potential.

WHAT'S CHANGED AND WHAT HASN'T? THREE BIG TRENDS

It has become increasingly fashionable to argue that value investing will never work again because market conditions have changed dramatically and irrevocably. We think that is a simplistic way of looking at the world. Instead, we believe there are three areas that require a balanced analysis of what has changed and what hasn't changed: the interest-rate environment, industry concentration and asset intensity.

1. Ultralow Interest Rates: Why Doesn't Value Work Well in a Low-Rate Environment?

Interest rates have been stuck at historically low levels since the GFC. In early 2018, expectations grew that rates would start to rise amid signs of a strengthening global economy. However, by mid-2019, renewed signs of weakness led the US Federal Reserve and the European Central Bank to project that rates would stay low for the foreseeable future.

IT HAS BECOME INCREASINGLY FASHIONABLE TO ARGUE THAT VALUE INVESTING WILL NEVER WORK AGAIN. WE THINK THAT IS A SIMPLISTIC WAY OF LOOKING AT THE WORLD.

Low rates have created all sorts of distortions in the real economy and markets. For example, exceptionally low rates have fueled the rise of "zombie companies," as reported in the *New York Times*, citing Bank for International Settlements data. Many of these companies aren't generating enough earnings to cover their debt payments but manage to survive by refinancing loans.

What does this have to do with value? In the past, companies like these would have disappeared long ago, which would support a recovery of undervalued companies with stronger fundamentals. When more zombie companies stay alive for longer, it suppresses the reversion to the mean of profitability for value companies.

More broadly, as rates came down, the discount rate fell dramatically, which fuels the performance of longer-duration stocks. In other words, many growth stocks that are only expected to deliver cash flows in the very long term, have benefited disproportionately from lower rates. In many cases, investors have also been willing to provide growth companies with cheap capital by pushing up their stock prices despite a lack of current profitability. In contrast, value stocks have underperformed.

The direct and indirect effects of low interest rates on value stocks are real. And rates may stay low for much longer than we expected. That said, in many respects, the impact of low rates on growth versus value stocks has already happened. Rates have little room to fall further and, at current levels, low rates are priced into the market; it would be highly unlikely for rates to force value stocks down further versus growth stocks. Nobody can predict when the rate environment may turn, but when it eventually does, we believe value stocks will benefit disproportionately.

2. Concentration: Does Declining Competition Undermine Value?

In just a few years, several global corporate powers have emerged as dominant forces in their industries including Amazon in retail, Google in internet searches and advertising, and Facebook in social media. In each case, the dominant power has adopted a "winner takes all" approach and has been willing to sacrifice short-term returns and profits for the prize of controlling their industries.

Investors have provided cheap capital in anticipation that domination will pay off in the future. Many companies simply cannot cope with the competitive power of the dominant players. Their industries have changed for good. In this environment, the profitability mean has probably fallen permanently in many industries, and as a result, the depressed earnings of many companies will never revert to the historic mean. Perhaps shares of many companies are cheap because they simply can't compete with powerful global players?

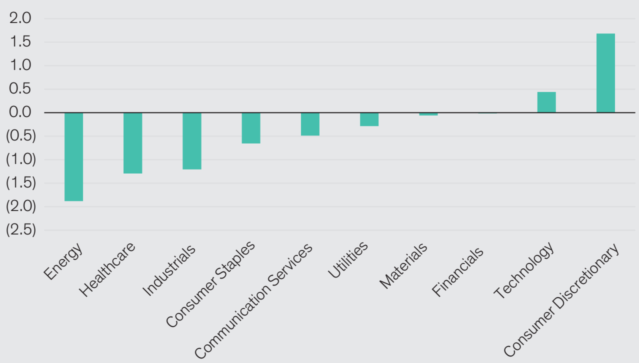
Here, too, the world hasn't changed as much as you might think. The Herfindahl-Hirschman Index, a measure of competition, reveals a mixed picture for different sectors (*Display 3, page 5*). While concentration in consumer discretionary and technology has increased—driven by Amazon, Google, and other technology and new media giants—most other sectors are in fact less concentrated than in the past.

LOW INTEREST RATES HAVE CREATED ALL SORTS OF DISTORTIONS IN THE REAL ECONOMY AND MARKETS.

DISPLAY 3: NOT ALL INDUSTRIES ARE BECOMING MORE CONCENTRATED

Herfindahl-Hirschman Index Change by Global Sector

Current vs. Long-Term Average (Percent Change)



Past performance and current analysis do not guarantee future results.

As of April 30, 2019

Based on Bernstein global universe of large-cap developed-market stocks.

Long-term average is from January 1995 through April 30, 2019.

Source: IDC, MSCI, Thomson Reuters Datastream and AB

What does this have to do with value investing? In our view, countless stories about the unstoppable rise of FANG-like companies has led many investors to think that all industries and firms are being equally shaken up by Amazons and Googles. That, in our opinion, simply isn't true. Vibrant competition remains the norm in many industries that are beyond the realm of the quasi monopolies. In these areas, we think value investors can find ample opportunities to identify mispriced companies with strong future cash-flow potential.

Even in concentrated industries, the picture is more complex than media reports suggest. For example, US competition regulators are paying closer attention to Google, Facebook, Amazon and Apple, which indicates that their paths to future earnings growth may not be as smooth as widely perceived. In addition, even in sectors that are affected by the quasi monopolies, some competitors—such as select retailers—have shown that they can adapt their business models to compete effectively with the dominant powers. Don't underestimate the ability of companies to adapt and innovate under pressure (remember how Apple reinvented itself by inventing the iPhone?). We believe investors who look for these types of companies can find value opportunities that will, over time, defy the effects of concentration and deliver long-term outperformance.

3. Asset Intensity: Are There Value Opportunities in a World of Asset-Light Business Models?

In the new world order, it's never been easier for new companies to shake up established business models, incumbent firms and entire industries. Why? Capital is cheap, as indicated by high flows into venture capital funds and low financing costs. Information technology is cheap, as the emergence of the cloud means that companies don't need to own IT infrastructure. And manufacturing can easily be outsourced to regions with less expensive labor. These days, an eager team with a good idea can disrupt an industry and turn a start-up into a world-class contender very quickly. Companies like these typically have capital-light business models, which makes the path to profitability easier.

Many technology and new media groups are asset-light companies. In some other industries, a shift to asset-light business models is also unfolding. Companies with these models have very different profitability dynamics than asset-heavy companies. But what does this mean for investors? Will these companies categorically become winners in their industries?

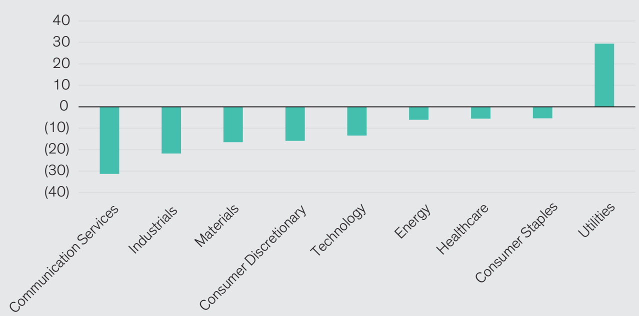
Not necessarily. *Display 4* shows the change in asset intensity of different sectors based on the ratio of capital expenditures to sales. In the communications industry, asset intensity has declined sharply, driven by the rise of Google and Facebook. In other sectors, asset intensity has declined modestly, suggesting that change is taking place at a much slower pace. So not all sectors are changing in the same ways, which means we should not look at the world through one simple lens.

Some investors think that the shift toward more capital-light business models implies that value companies will underperform. Not necessarily. In fact, as this shift unfolds at different paces in different industries, it prompts all companies to become more efficient. For example, the move to cloud computing isn't helping only growth companies. In fact, it enables many firms in diverse sectors—including value companies—to improve operating efficiency and profitability.

At the same time, generalizations about the virtues of asset-light business models can be misleading. Consider the mining industry as a case in point. In this asset-heavy sector, capital invested wisely can generate hefty returns for shareholders—and value opportunities can be found in companies whose shares have been penalized by investor preferences for asset-light businesses.

DISPLAY 4: ASSET INTENSITY IS GENERALLY DECLINING—BUT THE PACE OF CHANGE VARIES

Capital Expenditures vs. Sales (Global Stocks)
Current vs. Long-Term Average (Percent Change)



Past performance and current analysis do not guarantee future results.
As of April 30, 2019
Based on Bernstein global universe of large-cap developed-market stocks.
Long-term average is from January 1995 through April 30, 2019.
Source: IDC, MSCI, Thomson Reuters Datastream and AB

DO VALUE TRENDS MAKE SENSE IN A CHANGED WORLD?

It's clear that this changing world has become more challenging for value investors. At the same time, some of the market trends that we've seen just don't make sense, even in a new world order.

For example, some investors might think that because of the trends described in this article, the earnings power of value companies has been impaired. If so, maybe value stocks are cheap for a reason.

Our analysis suggests otherwise. In fact, the earnings growth expectations of value companies are very much in line with the long-term trend at 4.6% below those of their growth peers (*Display 5, page 7*). Yet, since late 2016, the valuation of value stocks versus growth stocks has fallen sharply.

So why the disconnect? We think it has more to do with the rush to growth than anything else. As the macroeconomic cycle enters its later stages, growth is harder to find—and investors are willing to pay more for high earnings growth. That's not a favorable environment for value stocks that tend to have somewhat weaker earnings growth profiles. But in our view, the unusually big discount of value stocks isn't justified when viewed through the lens of earnings growth. Remember that investing is about buying earnings and cash flows. This principle hasn't changed.

INVESTING IS ABOUT BUYING EARNINGS AND CASH FLOWS. THIS PRINCIPLE HASN'T CHANGED.

BACK TO BASICS: VALUATIONS STILL MATTER

If you believe that valuations don't matter anymore and the fundamentals of asset pricing have changed irrevocably, then perhaps value investing really doesn't have a future. And if you believe that the world will be dominated by a class of asset-light, all-conquering giants, then it's understandably difficult to see how a value approach will deliver long-term results. However, these are overly bold assumptions. We believe that many companies can thrive amid the structural changes in the global marketplace—and valuations still matter.

Similarly, the core principles of value investing described at the beginning of this article are still valid, in our view. Even as some industries become more concentrated and zombie companies take longer to disappear, competition can be expected to ultimately shake out the weakest companies and create conditions for industry efficiency and for undervalued companies to recover profitability. It might take longer than usual, and the path back to normal earnings—as well as the level of normal earnings—may be different than in the past. Yet we believe that companies will eventually be repriced based on the cash flows that they generate.

WHAT CAN VALUE INVESTORS DO?

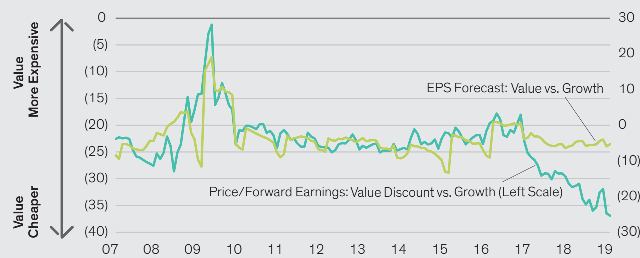
Seen in this context, we believe that value portfolios should sharpen their tool kits to position for a long-term recovery. For example, we think it's important to shift away from relying on P/B as a primary indicator of value, while putting much greater emphasis on price/cash-flow metrics.

At the same time, we cannot ignore the changes taking place in the world and the global marketplace. In our view, return models need to emphasize different types of valuation metrics for different types of companies, based on their asset intensity and cyclicality. And new risk-management tools such as cluster risk analysis can help identify correlated sources of risk among companies that might not be detected by traditional risk models or by fundamental analysis.

In AB's value equity portfolios, we are committed to applying the principles of value investing with a disciplined, research-driven process, while refining our tool kit to adjust to changing market conditions. Our approach is attuned to a changing world but also aligned with what we believe are investing axioms: investors still seek to buy undervalued shares of companies with underappreciated future cash flows and earnings potential, and share prices are still affected by emotional market behavior. What's more, many companies are delivering healthy cash flows that are not reflected in their share prices. As a result, we believe that the structural changes unfolding in global markets are creating new value opportunities. By adapting classic value investing techniques to today's challenges, we believe there is considerable opportunity for a bottom-up, value-oriented contrarian investment portfolio to deliver returns over the long term.

DISPLAY 5: DO TODAY'S VALUATIONS FAIRLY REFLECT THE EARNINGS POWER OF VALUE STOCKS?

MSCI World Value vs. MSCI World Growth (Percent)



Past performance and current analysis do not guarantee future results.

As of April 30, 2019

Source: Center for Research in Security Prices, MSCI, Thomson Reuters Datastream, Thomson Reuters I/B/E/S and AB

OUR VALUE APPROACH IS ATTUNED TO A CHANGING WORLD BUT ALSO ALIGNED WITH WHAT WE BELIEVE ARE INVESTING AXIOMS.

NEW YORK
1345 Avenue of the Americas
New York, NY 10105
(212) 969 1000

LONDON
50 Berkeley Street
London W1J 8HA
United Kingdom
+44 20 7470 0100

SYDNEY
Level 32F, Aurora Place
88 Phillip Street
Sydney NSW 2000, Australia
+61 2 9255 1200

TORONTO
Brookfield Place
161 Bay Street, 27th Floor
Toronto, Ontario M5J 2S1
(416) 572 2534

TOKYO
Marunouchi Trust Tower Main 17F
1-8-3 Marunouchi, Chiyoda-ku
Tokyo 100-0005, Japan
+81 3 5962 9000

HONG KONG
39th Floor
One Island East, Taikoo Place
18 Westlands Road
Quarry Bay, Hong Kong
+852 2918 7888

SINGAPORE
One Raffles Quay
27-11 South Tower
Singapore 048583
+65 6230 4600

LEARN MORE

ALLIANCEBERNSTEIN.COM