

# Risk and return of Value stocks in recessions

Value stocks perform poorly during recessions, but that should not deter potential investors from investing in them, since the downside has already been priced in. Consequently, Value stocks should also be the type of stock to bounce back the most when the economic outlook is expected to improve, research shows.

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Stocks that are priced low when sorted by their price/book ratio, generally referred to as 'Value' stocks, offer on average a higher return than stocks with a high price/book, so called 'Growth' stocks. Why is this so? And why does this effect not disappear as investors become aware of it? A part of the explanation could very well be found in a behavioral finance literature: Value stocks are often issued by boring firms and investors consistently misprice these stocks by overreacting to their gloomy outlook. As investors realize their mistake, Value stocks outperform the market. The exact, but opposite, argument can be used to explain the consistent underperformance of the expensively priced 'Glamour' (or Growth) stocks.

## Several reasons behind Value's solid returns

Many academic researchers do not find that this irrational behavior offers a satisfactory explanation. Instead, the focus has been on finding evidence that Value stocks are riskier than Growth stocks which, in turn, should give a common-sense explanation of the higher return. Even if two stocks have the same average risk, if one is riskier in bad times (recessions) when negative returns are particularly painful, that stock should be less attractive and therefore, with the same economic reasoning, offer a higher return. Indeed, there are recent studies supporting that this is exactly the case with Value and Growth stocks: Value firms earn a risk premium over and above that of Growth firms

because they are stuck with more unproductive capital in economically depressed states of the world and hence underperform in these periods where the price of risk is high.

## Value stocks and recessions

Since the US is now most likely in a recession, does this mean that Value stocks will give a bad return from now on and, consequently, that now is a bad time to buy them? Not really, as explained below.

If value is riskier during bad times, then Value stocks should be hurt most at the onset of a recession when it becomes more and more probable that the economy is going down, which also is pretty much what has happened in recent months. But the return of Value stocks (compared with their return during good times or compared with growth stocks) from this point forwards should actually be larger, on average, to compensate for the fact that the uncertainty about the outlook for the economy and financial markets is greater, and that the risk that things could become even worse is higher. In other words, the realization that an economy is heading towards a recession, leads to precipitous declines in Value stocks which are more sensitive to such conditions. Then, as the economy is predicted to be pulling out of the recession, Value stocks should see the greatest bounce back.

<sup>1)</sup> See Zhang, L., 2005, The value premium, *Journal of Finance* 60, 67-103, and Petkova, R. and L. Zhang, 2005, Is value riskier than growth?, *Journal of Financial Economics* 78, 187-202.

This is an important distinction. When looking back, and with knowledge of when the recession was anticipated, Value stocks should have underperformed, but from the point when the recession is priced in, they should instead outperform (on average). This is so, because the big price fall caused by the transition to recession has already happened. It should, of course, not be forgotten that the higher expected return from this point is a compensation for a higher current risk. That is, if the recession deepens, Value stocks are again the ones that should take the most punishment. If that happens, a new equilibrium will arise whereby Value stocks are re-priced in order to yield higher returns.

### Stock markets think ahead

Stock markets are forward looking. So the time when the fear of a recession is priced into stocks in general, and Value stocks in particular, is not when the recession actually started (which may not even be known until many months after). If one regresses stock returns on the current NBER (National Bureau of Economic Research) recession indicator, it is not very significant. However, if one uses a four-month lead of the NBER indicator, it is highly significant. The reason is that the financial markets often predict a recession in advance.

So, if one expects the economy to pull out of the current recession reasonably soon, value stocks could be well positioned to take advantage of this. It should be noted that even if Value stocks are riskier than Growth stocks, (particularly in bad times when positive returns are more appreciated), the extra return that they deliver may still exceed the premium required as compensation for the 'recession risk'. In other words, the Value premium that we know exists may be derived from a combination of rational as well as behavioral explanations.

### Value stocks may still be a good buy

Finally, two important facts should be remembered. First, it is not a bad time to buy Value stocks since fear of recession is already priced in, and the price discount which is one of the main attractions of value investment should be greater than it is during more normal conditions because of the perceived higher risk of a Value investment against a negative economic outlook. Second, the magnitude of the current recession is quite rare. The underperformance of Value versus Growth under these circumstances seems therefore to be a small price to pay for the outstanding performance under more normal circumstances.

### Value Stocks versus Stock Market in Recessions

