



Sparinvest: Value Investment in Times of Recovery

Because stock markets anticipate economic cycles, and because low-priced 'value' stocks tend to outperform other equities as countries emerge from recession, this is the asset class to watch for early signs of economic recovery. So says Danish fund manager, Sparinvest, whose research team has recently investigated the behaviour of value versus growth stocks over a number of recessions and concluded that value equities tend to be the biggest gainers as economic conditions improve.

By Senior Research Analyst, Henrik Amilon Ph.D., updated October 2009

For investment houses such as Danish Sparinvest, it is important to understand the secrets of winning investment strategies. For this reason, Dr. Henrik Amilon, Senior Research Analyst at Sparinvest has been investigating the performance of value and growth shares during 80 years worth of recessions to see how such periods affect the two strategies. Dr. Amilon concludes that: "Whilst value stocks can underperform during recessions, they should be the type of stock to bounce back the most when the economic outlook is set to improve."

Academic research has concluded that over most 5-year time periods, 'value' stocks (those stocks with a lower price-to-book ratio than the market average) tend to generate higher returns than more expensive 'growth' stocks. This fact makes value investment a consistently successful long-term strategy. But why does it work and why don't investors exploit this knowledge? This is where the academics fail to agree. There are two leading schools of thought.

- Advocates of the traditional 'efficient market theory' believe that riskier investments must be priced to offer a higher reward to investors – otherwise they would not buy them. They would say that value shares are inherently riskier and therefore only become attractive to investors at cheap and discounted prices. So there are no pricing discrepancies. Value shares need to be cheaper.

- Behavioural financiers, on the other hand, believe that the consistent outperformance of value investment is the anomaly that disproves the efficient market. They believe that we are psychologically programmed to avoid the unattractive in favour of the glamorous and popular – even when it comes to our investment habits. These human behavioural biases create mis-pricing opportunities for value investors as the earnings potential of unpopular companies is frequently overlooked.

So what happens during recessions? Why are value stocks perceived to underperform as we head into a recession and outperform as we head out of them?

In support of the traditional finance view whereby the premium available from value investment is simply a reward for risk, Dr. Henrik Amilon cites the academic, Lu Zhang¹. Zhang suggests that during times of economic slowdown, production reversibility is costlier for value firms than for growth firms. This is because value firms tend to have real 'assets in place' such as office buildings, manufacturing plants and large workforces whereas growth firms simply have 'growth options'. Obviously, theoretical expansion plans cost significantly less to reverse. This makes it much easier and cheaper for growth companies to respond to a recessionary environment. As the economic situation improves, however, it is the value companies that can respond more quickly to

1) 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.



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increased demand by simply reactivating their 'assets in place' whereas the growth companies still need to make significant capital investments to acquire such assets.

Behavioural financiers, on the other hand, offer a psychology-based explanation. They would say that stock prices are determined by the interaction of rational and irrational investors in the markets. Both kinds of investors can make systematic errors of judgement – especially when under increased risk and uncertainty. These errors affect stock prices. For example, rational investors may run up against 'limits of arbitrage'. (They may be convinced that a stock price will rise, but run out of investment time required for it to happen. In the famous words of Keynes, "Markets can stay irrational longer than you can stay solvent.") Irrational investors, on the other hand are attracted by such factors as glamour and popularity. This can cause them to pay a premium for stocks in companies with poor fundamentals but a good PR department. Eventually, as the threat of recession fades,

the market takes the time to reassess the fundamentals and converges to reach the rational decision about the worth of a stock. This is when the value stocks win out.

Sparinvest's Dr. Henrik Amilon points out that whilst there is some empirical evidence to show that value stocks are riskier than growth stocks in recessions, this evidence is not overwhelmingly strong and it is certainly insufficient to fully explain the large historical value premium. For this reason, Dr. Amilon believes that both rational and behavioural effects are at play in today's financial markets and he offers the chart below as evidence. It shows the performance of US value and growth stocks from December 1926-January 2009 mapped against the background of economic recessions occurring during that period.

"We can clearly see that value stocks underperformed strongly during the Great Depression and the subsequent 1937 recession," he points out. "Of course all recessions

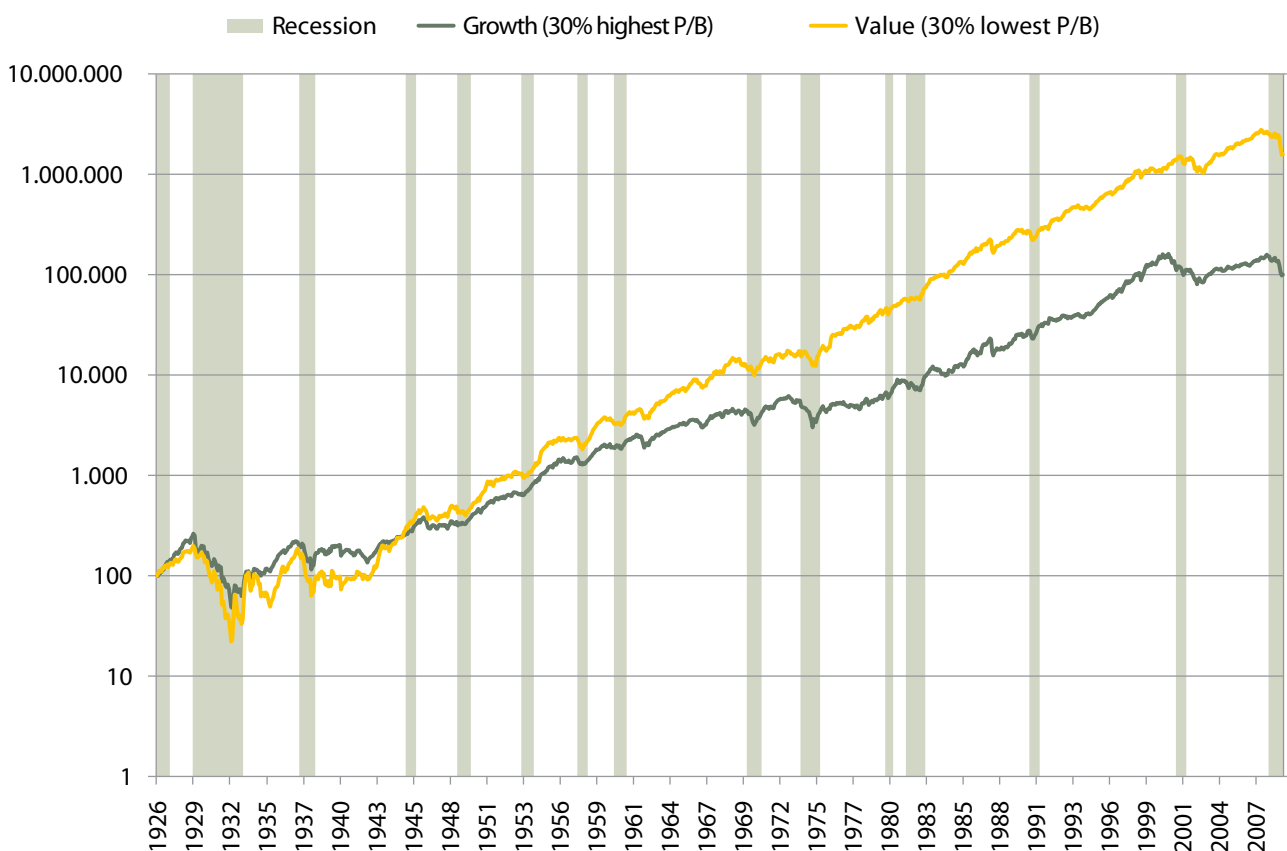


Figure: Value and Growth Stocks in Recessions: \$100 invested December 1926 – January 2009 (Recessions defined by NBER - National Bureau of Economic Research). Source: Sparinvest

are compared with the 'Great' one, so it is conceivable that there is a 'legacy issue' for value stocks here; a perception that they consistently perform worse during recessions.

"However, the chart plainly shows that most of the time, there is not a great deal of difference between the behaviour of value and growth shares during recessions. Both suffer. A closer inspection reveals that although the relative outperformance of value stocks vs. growth stocks is smaller when entering into recessions compared to more normal times, in absolute terms value stocks are still superior. Likewise, when exiting from recessions the value premium is larger than its average. The key thing is what happens in the long run, and here the price of staying out of value stocks is quite visible. The end-point of the value portfolio is more than 10 times that of growth! So, unless one is better than the market in predicting recessions, avoiding value stocks can turn out to be a very costly business"

Update October 2009

The National Bureau for Economic Research (NBER) is a research organisation dedicated to promoting a greater understanding of how the economy works. The NBER has calculated that the trough for the most recent business cycle occurred in August 2009, Dr Amilon has therefore updated his research to cover 15 complete business cycles. He has also calculated the average annual returns for Value and Growth stocks from October 1926 to August 2009 in order to give show the extent of the historical 'Value Premium'.

Based on data from 15 full business cycles, Dr Amilon concludes that:

- Recessions are only a brief part (just over 20%) of the business cycle. The peak-to-trough phases from Dec 26 – Aug 09 involved only 215 months out of a total of 993.
- Only in 'Early Recession' do equities in general have a negative return
- Only in the 'Late Recession' do Value stocks underperform Growth stocks and, even then, only modestly so. In all other phases, Value has been the better investment.
- During the expansionary phases, Value stocks have an outstanding performance.

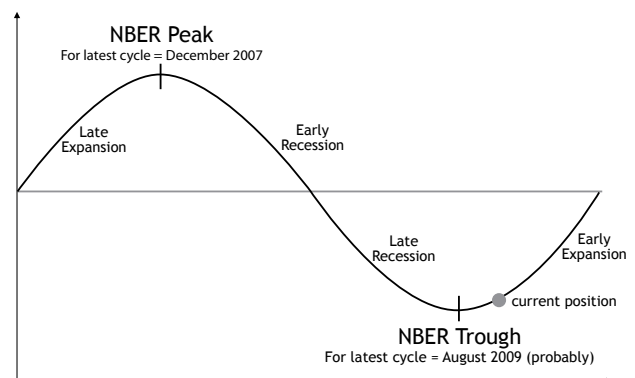
Average Annual Returns December 1926 – August 2009

Cycle Type	Growth stocks	Value stocks
Early Expansion	39.5%	57.1%
Late Expansion	32.1%	56.2%
Early Recession	-13.3%	-12.0%
Late Recession	10.9%	8.0%

"The numbers clearly show that Value stocks have on average performed exceptionally well during periods of economic expansion," says Dr Amilon.

"This suggests that to reap the highest benefits, investors should adopt a Value investment strategy as soon as there is evidence of an economic recovery."

Business Cycle Phases



In order to investigate the performance in different business cycle phases, the number of months between peaks and troughs defined by the NBER are divided into equal halves to indicate 'early recession' and 'late recession'. The same is done with the periods between troughs and peaks in order to capture the 'early expansion' and 'late expansion' phases

Dr. Henrik Amilon is Senior Research Analyst in Sparinvest's Asset Allocation Team. Amilon holds a degree in engineering physics, and earned his doctorate in Finance from Lund University in Sweden. Amilon has also held the positions of Senior Economist at the European Central Bank and visiting Professor at the University of Sydney's School of Finance and Business.'

See also

<http://www.youtube.com/watch?v=Q0dmliNlrZ0>

■ About Sparinvest

Founded in 1968, Sparinvest is one of Denmark's leading independent asset management companies, managing and advising on assets valued at over €12 billion (as at end September 2009), including one of the largest equity funds in Denmark.

Owned today by broad range of institutional shareholders, Sparinvest has the freedom to pursue its own investment philosophy and style with a view to providing 'prudent investments' for its clients.

In 2001, Sparinvest S.A. was established in Luxembourg and a number of Luxembourg-domiciled funds were created for the purpose of pan-European distribution. The Sparinvest SICAV, a UCITS III-compliant umbrella fund is now authorised for distribution in 16 European nations.

Sparinvest has established an excellent reputation within the investment industry for the success of its strategic asset allocation approach when constructing portfolios for investment mandates and because of its outstanding track record in value investment.

Sparinvest SICAV is a Luxembourg-based, open-ended investment company. For further information we refer to the full and/or simplified prospectus and the current annual / semi-annual report of Sparinvest SICAV which can be obtained free of charge at the offices of Sparinvest or of appointed distributors together with the initial statutes of the funds and any subsequent changes to such statutes. Investments are only made on the basis of these documents. Past performance is no guarantee for future returns. Investors may not get back the full amount invested. Investments may be subject to foreign exchange risks. The investor bears a higher risk for investments into emerging markets. The indicated performance is calculated Net Asset Value to Net Asset Value in the fund's base currency, without consideration of subscription fees. For investors in Switzerland the funds' representative and paying agent is RBC Dexia Services Bank S.A., Zurich Branch, Badenerstrasse 567, P.O. Box 101, CH-8066 Zurich. Published by Sparinvest, 28, Boulevard Royal, L-2449 Luxembourg.