



## IDENTIFYING VALUE

### ***No, this time is not different.***

*Our Theory of Systematic Value – Goran Vasiljevic, CIO*

We believe as we have for the last 25 years that value investing is the most superior long term investment strategy available. However, we also accept the notion that short term outcomes in the investment world often do not reflect the quality of the process or vice versa. As such, we believe that currently the markets are

irrationally concluding the demise of value investing and current developments are not validated by any theory or sound process. This paper highlights some thoughts on the theory of value investing, why we believe that value will continue to work and that short term results should not affect the validity of value's existence.

After an extremely difficult decade for value, investors with continued conviction face the market with their backs up against the wall. Articles of the end of value began emerging, while investors have become increasingly unsettled, observing the bull run whilst not invested in market-dominating quality and growth stocks.<sup>1</sup> Investors are buying business models as opposed to businesses, with the number one fundamental – cash generation – becoming less and less important in the context of the price paid. At least for now.

This phenomenon has not occurred for the first time. Even considering the immense length of this anti-value cycle, there is a precedent for this situation, as documented by O'Shaughnessy Asset Management in their recent article "Value is Dead, Long Live Value".<sup>2</sup> The questions we must ask ourselves is: how can it be possible to find mispricings in companies which everyone believes to be great businesses? What unique skill set does one possess when buying new business models that lead to more insights than the optimistic market is already pricing in? And how can the price paid for an asset become so disconnected to the underlying fundamentals, despite knowing that there is always a degree of uncertainty involved in the future and that more things can happen than one anticipates.

### **When the going gets tough**

As a former athlete, this situation is not new to me. When you look at the most famous tennis players of all times – Djokovic, Federer, Nadal, Becker – they all have the same answer when facing pressure and adverse situations. When they enter a rough patch, they state that they have developed a process with their team and need to continue believing in it and do what they must do. They continue to work harder and follow the process until the situation turns around for the better sooner or later – because the process they decided on works and the final ingredient is discipline.

As a tennis player, you need to accept the hard truth that no matter how good you are, you can't win every game. Often this will happen despite playing your best and giving it all you've got. You can have a bad day or simply just bad luck. And while the other side may be better on a given day, that says nothing about them

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<sup>1</sup> CNBC: "Is value investing dead? It might be and here's what killed it" <https://www.cnbc.com/2019/06/21/is-value-investing-dead-it-might-be-and-heres-what-killed-it.html>, as of 08.08.2019.

<sup>2</sup> Meredith, C.– O'Shaughnessy Asset Management: "Value Is Dead, Long Live Value", <https://www.osam.com/pdfs/research/Value-is-Dead-Long-Live-Value.pdf>, as of 08.08.2019.



being better in the long-run. The only thing that matters is that the process is right, that it is constantly evaluated and tracked for the best outcome possible.

This situation is quite similar to investing. When things get rough, we continue working on and following our process and believing in what works. Conviction is an extremely important factor to maintain the necessary discipline for this process. No one can know for sure what will happen tomorrow – but one should know what one will fundamentally believe in and know how one should respond to a range of outcomes. Similar to sports, situations can change drastically – making the winners of today the losers of tomorrow, or vice versa.

## The Process is Key

Nobody knows what precisely will happen in the future. All we have is the information available at the time of the decision, with which we can approximate the distribution of outcomes and probabilities. The best that we can aim for is to identify this range of scenarios correctly. When multiplying the probabilities with their respective present values, we derive the expected value for each decision, the foundation of decision making.

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*“It may rain tomorrow, or it may not, but nothing that happens tomorrow will tell you what the probability of rain was as of today.” – Howard Marks*

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Naturally, this process may yield volatile outcomes – every decision includes probabilities and even a seemingly safe bet with a 90% probability of success will lead to failure every 10<sup>th</sup> time. On the other hand, there are plenty of “bad bets” to engage in. The lottery would be an example of this – engaging in it is a negative expected value decision. Nevertheless, some get lucky. That does not make the decision any wiser – described in Figure 1 as “dumb luck”.

**Figure 1: Overview of Process vs. Outcome Evaluation**

PROCESS USED TO MAKE DECISION	OUTCOME	
	Good	Bad
Good	Deserved Success	Bad Break
Bad	Dumb Luck	Poetic Justice

Source: Russo, E. and Schoemaker, P. “Winning Decisions”

In his book “Theory of Poker” David Sklansky summarizes this quite well:

*“Any time you make a bet with the best of it, where the odds are in your favor, you have earned something on that bet, whether you actually win or lose the bet. By the same token, when you make a bet with the worst of it, where the odds are not in your favor, you have lost something, whether you actually win or lose the bet.”<sup>3</sup>*

This notion is key to investing. Investors constantly need to make decisions with uncertainty as an omnipresent element, rewarding and punishing them on a tick-by-tick basis.

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<sup>3</sup> Sklansky, D. "The Theory of Poker." Two Plus Two Publishing LLC (2007): p. 10.



In order for an investor to succeed in a probabilistic environment, a process following expected value maximization needs to be strictly followed, no matter how hard it may be in the short term. The investor needs to accept this and stay disciplined. Diverging from it when pressure increases is a near-certain defeat for a good process. The underlying process needs to be developed, valid, verified and based on sound economic reasoning. It makes up the driver for long term performance.

Having said this, an issue investors face with this is the so-called “paradox of skill”.<sup>4</sup> One can gain proficiency, find the best opportunities and follow an established, sound process. But in investments, one is not alone in this game and not everyone can beat the market. The other market participants are hunting for returns as well, and the stakes are high. Theories, research, investment techniques are consistently refined and improved upon and overall skill is increasing. The paradox of skill states that an increase in skill will not necessarily minimize the impact of luck. Quite the opposite may occur: it comes down to relative skill. If the spread in skill is high, skill will have a larger impact. If a field is competitive, marginal skill advantages should still win in the long run – but luck will play a larger role in shaping outcomes than perhaps back in the times when equities were considered boring. This makes it even more important to hone one’s skills as well as stick very precisely to the process – mistakes are near-guarantees for failure, while success is not granted easily.

## Why Value Works – A Story of Risk and Behavior

We’ve established the need for a systematic process – but why should value outperform in the first place and why do we continue to pursue value in our process?

In academic and empirical research, two camps have emerged within the last two to three decades. The big debate is not on the question **IF** value works – though the recent uninspiring performance has brought up that question as well (note that the timeframe is far too short and we see no indication for the fundamentals of economics changing to make for any evidence). The big debate is based on **WHY** value should work.

The first camp, let’s refer to it as the Fama-French camp, believes that value performance is derived from risks that must be compensated for.<sup>5</sup> The second camp believes in behavioral flaws, heuristics and biases, which provides foundation for value to outperform in the long run. They believe that current events get extrapolated too far into the future, too much leaning toward positive and negative extremes due to the underlying uncertainty. As we are emotional beings, such uncertainty can lead to irrational decisions which can adversely affect wealth creation.<sup>6</sup>

We at Lingohr & Partner believe in a combination of both factors. From the Fama-French camp, there are more – at least perceived – uncertainties facing value stocks. For the sake of the paper and in line with the market’s opinion of risk, we will group uncertainties together with other forms of risks. And there are a myriad of them – volatility (or high betas), business risk, leverage, valuation risk, duration or cyclical risk. These uncertainties lead to discomfort, which in turn leads to irrational behavior – which again, in turn, increases uncertainty and pressure – and the cycle goes on. On top of all, agency risk further enhances these pressures.

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<sup>4</sup> Mauboussin, M. and Callahan, D. “Alpha and the Paradox of Skill.” Credit Suisse Global Financial Strategies (2013).

<sup>5</sup> Fama, E., and French, K. “The Cross-Section of Expected Stock Returns.” The Journal of Finance 47, no. 2 (1992): 427-465.

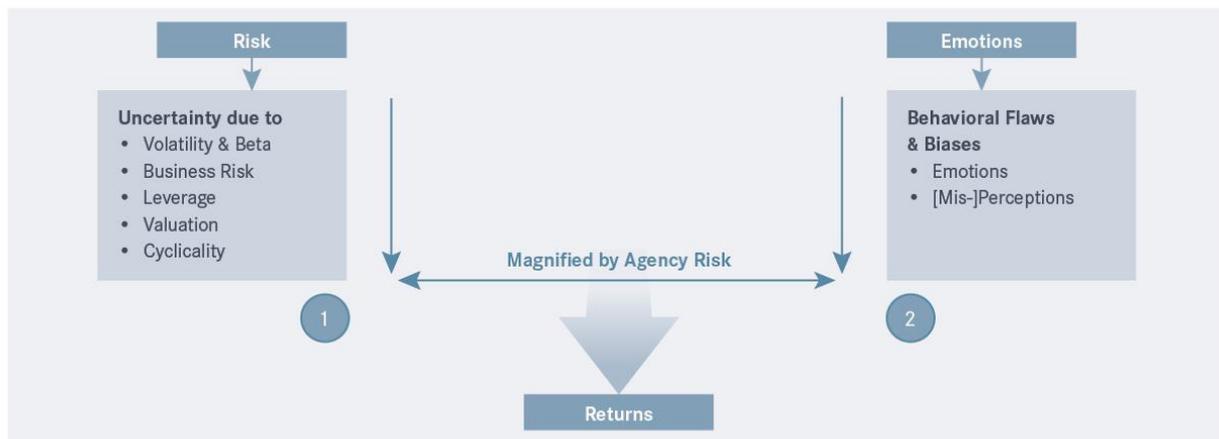
<sup>6</sup> Lakonishok, J., Shleifer, A. and Vishny, R. “Contrarian Investment, Extrapolation, and Risk.” The Journal of Finance, Vol. XLIX, No. 5 (1994): 1541-1578.

Lakonishok, J., Shleifer, A. and Vishny, R. “Good news for value stocks: Further evidence on market efficiency.” NBER Working Paper No. 5311 (1995).

Tversky, A. and Kahnemann, D. “Judgment under Uncertainty: Heuristics and Biases.” Science 185, no. 4157 (1974): 1124-1131.



**Figure 2: Risk and Return**



Source: Lingohr & Partner.

The market as a whole is impacted by this. In certain phases, the market will focus very strongly on some risks, only to leave out other risks that aren't the current focus or that go against whatever is in trend. At the moment, for example, it seems as though business risk with regards to disruptors seems highly prioritized by the market, whereas valuation risk from inflated values relative to their fundamentals is seemingly ignored.

Let's say for example that you want to outperform but only have two companies to invest in. One is Amazon and the other is Macy's. Which one of these businesses appear to be more risky, and which stock should empirically then yield the highest return? The company with the highest growth and high margins, or the company with a higher degree of volatility, cyclical and business risk? In theory, Macy's investors should be compensated for the additional risk they take on. These risks – business risk, economic cyclical, and general uncertainty – can be seen in many of today's value stocks. These "real" risks lead to agency risk and behavioral flaws, the factors identified by the second camp. The more uncertainty an investor faces, the more pressure builds up. For long term investors, the short term should not have such a strong impact. That is where the psychological phenomenon "myopic loss aversion" comes into play. It describes an extreme focus on the short term, leading to overreactions to recent losses to the demise of long term performance. Bernatzi and Thaler show that investors who regularly analyze their portfolios and the fluctuation of values implicitly accept lower returns than investors who evaluate outcomes less often.<sup>7</sup> The reason is that the probability of observing a loss is much higher when investors look at their portfolio in shorter intervals.

This is described well by Joel Greenblatt in his recent discussion with Richard Pzena: *"The best performing mutual fund for the decade of the 2000's actually earned over 18% per year over a decade where the popular market averages were essentially flat. However, because of the capital movements of investors who bailed out during periods after the fund had underperformed for a while, the average investor (weighted by dollars invested) actually turned that 18% annual gain into an 11% loss per year during the same 10 year period."*<sup>8</sup>

As investors feel their losses, investment managers come increasingly under pressure, enhancing agency risk. Market and investor pressure causes more emotional behavior, clouds judgment and causes mistakes to occur

<sup>7</sup> Bernatzi, Shlomo and Thaler, Richard H. "Myopic Loss Aversion and the Equity Premium Puzzle." *The Quarterly Journal of Economics*, Vol. 110 No. 1, (1995): 73-92.

<sup>8</sup> Joel Greenblatt - Keynote Presentation: Ben Graham VI.

<http://cfany.gallery.video/fullconference/detail/video/6053271135001/joel-greenblatt-keynote-presentation-ben-graham-vi>, as of 08.08.2019



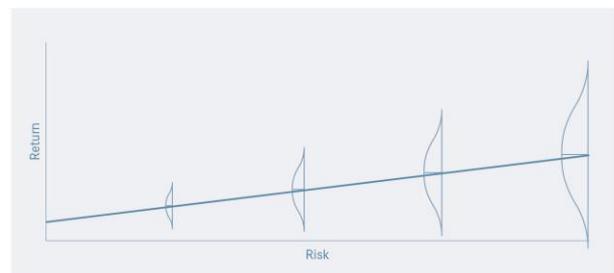
- ultimately leading to mispricing. Numerous studies and books have been published on this subject, with examples of behavioral risks including but are not limited to the following:

- Adjustment and anchoring bias
- Availability bias
- Base-rate neglect
- Confirmation bias
- Fear of missing out (FOMO)
- Groupthink
- Halo effect
- Herding & peer pressure
- Mean reversion underestimation / confusion
- Myopic loss aversion
- Outcome bias
- Representativeness bias
- Social proof
- Sunk cost
- Survivorship bias

Value derives its extraordinary long term returns from a combination of uncertainty arising from different types of risk, emotions and agency risk. All of these factors are intertwined in our view and we don't believe one has to be strictly in one camp of the value debate. The markets are dynamic and things change, however, one thing will not change. One cannot expect to have value outperform for him/her without the presence of discomfort. Free lunches are not given in the market, and the real source of value can be found in the discomfort others feel when faced with uncertainty, but in reality, everything in investing faces uncertainty. Less visibility and a wider spread of outcomes lead to more uncertainty. This, in turn, leads to more perceived risk, which enhances agency risk and increases emotional processes. This also works the other way around: the less risk is perceived, the more willing an investor becomes to pay a high multiple and to take on more valuation risk.

**Figure 3: Risk and Return**

The risk-return relationship can be viewed as seen in Figure 3. The higher the visibility of a company and the lower the fundamental variance of outcomes is, the lower the return distribution is. The more one moves to the right on the risk axis, the higher the distribution of outcomes but also the higher expected returns become. This is how the relationship between risk and return should work. This also doesn't mean that just because something is more risky and has a higher expected return, the higher return will materialize in every case – otherwise there would be no risk in the first place!



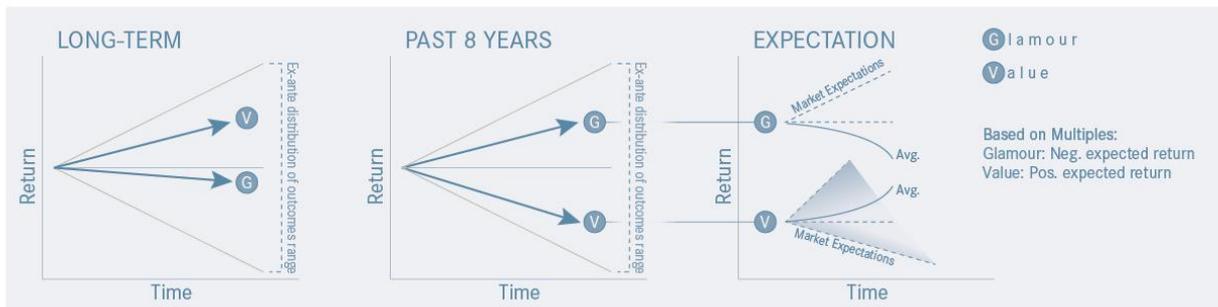
Source: Oaktree Capital Management L.P.

Figure 4 contrasts long term returns with those of the last 8 years. While value was perceived riskier in the long run, it yielded higher returns. At the same time, buying popular “glamour” stocks was a safer option, but yielded a lower performance in the long run. The past years have been very different though. Due to a mirage of reasons, which we will more quantitatively elaborate on in a future paper, large, expensive stocks outperformed. Instead of investors exiting their expensive investments, past performance – ironically – acted as a magnet and merged with perceived business stability, pushing valuations to ever greater levels. The opposite happened to value, with stocks become continuously cheaper and investors afraid of past



performance exiting investments at fire sale prices – a great example of behavioral risk. This has led to record valuation dispersions. According to a recent study by Pzena, expensive stocks are currently averaging price to earnings (P/E) levels above 80x while value stocks trade at just 8x.<sup>9</sup> The market is anticipating extreme continued growth for expensive stocks and perpetual negative growth for value stocks. Distortions at these levels are rare and heavily skew the probability of outperformance (blue line in the right graph) in favor of value investments.

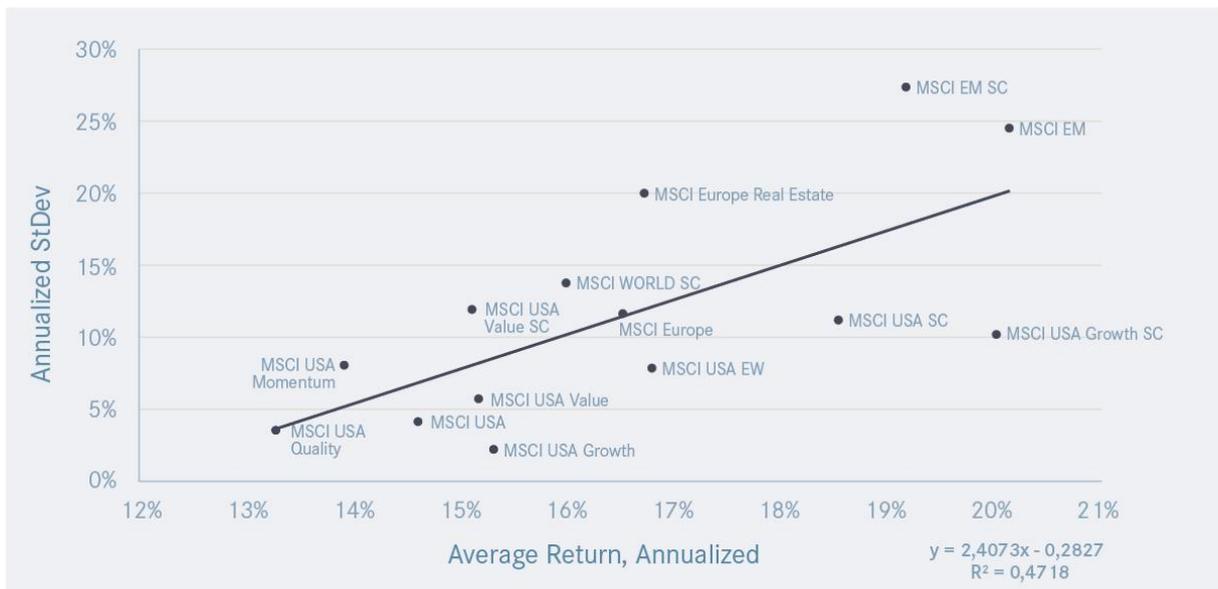
**Figure 4: Value and Glamour – Anticipation vs. Outcome**



Source: Lingohr & Partner.

This can also be tested empirically. When defining return volatility as risk, we can observe a tendency to be rewarded for taking on risk in the past as seen in Figure 5. The results are quite in line with what is expected: The more volatile an investment style is the more an investor is compensated for taking on such risk.

**Figure 5: Risk and Return – Observed returns and standard deviations for select asset classes, 2001-2008**



Source: MSCI Index Data, Lingohr & Partner.

<sup>9</sup> Pzena Investment Management. "Second Quarter 2019 Commentary" (2019).



Since 2011, this relationship has inverted:

**Figure 6: Risk and Return – Observed returns and standard deviations for select asset classes, 2011-2018**



Source: MSCI Index Data, Lingohr & Partner.

All in all, we know that to outperform, an investor needs to take on more risks or perceived risk of some sort. In the last decade, the investment styles with some of the least amount of risk beat the market. What we see is that quality has lower volatility, which makes sense given the lower perceived business risk. Nevertheless, quality has managed to outperform and continues to price in very high future expectations. This stands in stark contrast to value, which includes disrupted stocks and those which faced more uncertainty and business risk. This style has underperformed and is accordingly trading at recession-level valuations. Investors were negatively compensated for additional risks! How can one earn extraordinary returns by buying the least volatile instruments, without feeling any discomfort or pressure? How is it possible to beat the market with the least risky investment styles? Such a trend counters any economic intuition. But of course, outliers occur – and the market can become irrational for periods of time. Even a bet with a 90% success probability will be wrong 10% of the time. Winning or losing a bet does not change the probabilities – the process will determine the winner in the long run. Even though there is irrationality, a return to fundamentals works like gravity. The market can jump up high into the air, but the market will also come down. And the higher and more extreme the jump, the harder the fall may be. The market can and should permanently increase in value – but that's not due to the jump, that's due to the floor, the real economic data, rising.

The market has become emotionally charged – not completely surprising following the global financial crisis and previously unseen interest rate levels. Evidence for this can be seen in multiples. Multiples are a great proxy for valuation and explain a set of expectations in just one figure. High multiples signify high expectations – the opposite goes for low multiples. Today, quality & growth baskets are trading at extremely high expectations, while value is trading at alarmingly low multiples. These situations are results of periods of factor based under- and outperformance. In this case, value underperformed. Based on fundamental notions, such as valuations being the anchor for stock prices in the long run, empirical and academic studies as well as over 25 years of value investing experience, Lingohr & Partner has established a process to buy stocks with an above-average expected return. In the near past, this has not provided us with the return we expected. As



other investors exit value investments due to behavioral – not fundamental – reasons, valuation dispersions keep rising. Poor performance leads to a continuous increase in emotional behavior.

## Outlook

Where do we stand now? We think that the current underperformance is causing investors to overly emphasize the outcome versus the process. This in turn resets expectations of value to the lowest point ever. Two important factors lead us from here: firstly, the valuation of an investment at its starting point will strongly influence its return. This also goes for aggregates in factors, where this relationship holds significant explanatory power for future returns. Secondly, we think the market could be acting irrationally due to behavioral constraints (loss aversion) given the disappointing outcome in recent years. A re-setting of multiples signals lower expectations by also increasing expected returns.

This solidifies our optimism for value. At current levels, we see strongly increased expected returns, not only from the “natural” value drivers but from the potential in valuation convergence derived from the excessive sell-off in recent years. Quality on the other hand, faces a set of extremely high expectations as implied by the price. In conclusion, the market is once again extrapolating past performance too far into the future, putting multiples at all-time highs – and paving the way for value to arrive again.

In conclusion, while we are facing pressure and adversity, we see no reason for value to be dead. Quite the opposite is the case: we are very optimistic. We see more irrationality and behavioral flaws than just a few years before. Empirically, this can be viewed by extreme price dispersions between companies and the negative relationship between fundamentals and price movement. Just as it was back in my days as an athlete, the process is well defined and short term results will not shake the foundation of how the game is played. The markets are acting out, but our conviction enables us to continue forward with a strictly disciplined approach. We will continue working hard, conducting our research and enforcing our processes until the situation reverts back to normal and beyond.

Sincerely,

Goran Vasiljevic & Team



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