

Value Stocks – Not the Bargain They Used to Be.

– Michael Mack, Portfolio Manager

Following age old investing advice to buy low, value stocks are appealing to most investors because of their potentially attractive prices below fair value.

In theory, buying stocks that are trading below their fair value (or at a discount) should lead to better than average returns for an investor. Warren Buffett, a student of Benjamin Graham, has made the idea of value investing a mainstay in the investment world.

Historically, value stocks have outperformed growth stocks by 4.5%¹. This, along with several respected investors' interest in value stocks, has driven investors to allocate a large percentage of their portfolios to these value stocks. Despite its popularity, value stocks have lagged the broader market over the past 10 years.

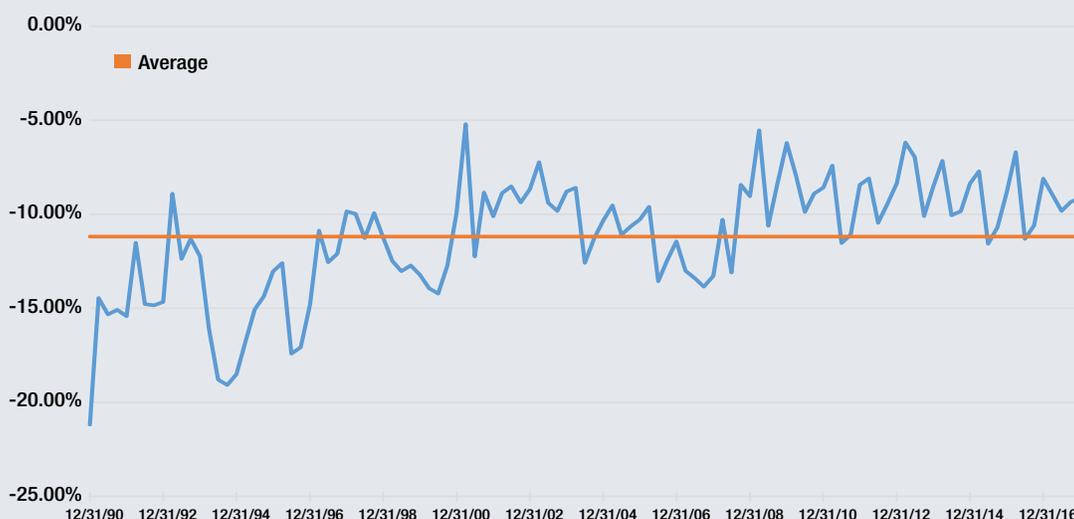
“ Price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when they advance a great deal.

– Benjamin Graham,
Father of Value Investing

1) Value stocks aren't as cheap as they used to be.

Value stocks are trading at a discount, but they are not as discounted as they used to be. The percentage difference between the market's P/E, as measured by the Russell 1000, and the value index's P/E has narrowed, meaning value stocks, while still cheaper than the broad market, are not as cheap as they used to be comparatively. On average, value stocks trade at an 11% discount to the market. Today, they are trading around a 9% discount.

% P/E discount - Russell 1000 Value vs Russell 1000
(12/31/90 - 12/31/17)



Source: FactSet

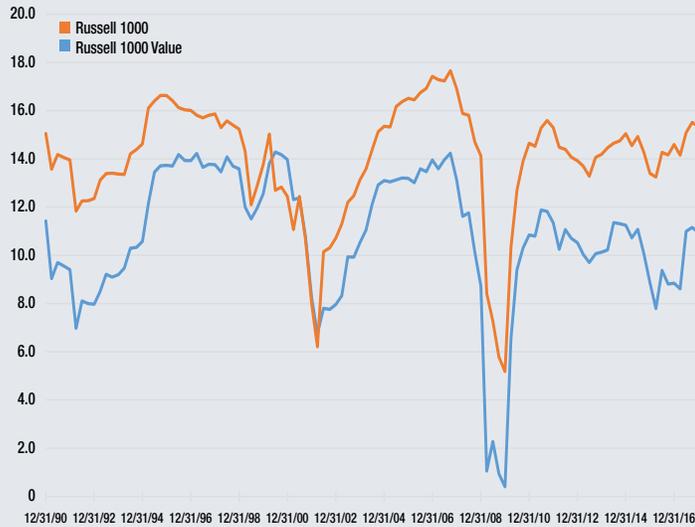
¹Fama French, 1927 - 2017

2) The index tilted towards lower quality stocks.

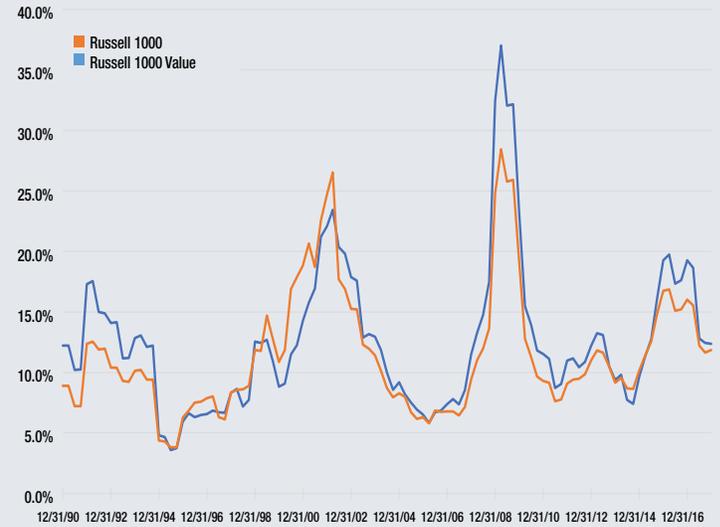
It's important for companies to receive a solid return on the investment they make in their business. Evaluating return on equity (ROE), value stocks are earning only 11¢ profit for every \$1 they spend in equity vs the market earning 15¢ in profit for each \$1 in equity. Producing lower returns on their equity means the company is of lower quality.

Value stocks have been trading at a discount in part because there are more companies in the value index reporting negative earnings than in the general market.

ROE - Russell 1000 Value vs Russell 1000 (12/31/90 - 12/31/17)



% of Stocks with Negative Net Income Over the Last 12 Months (12/31/90 - 12/31/17)



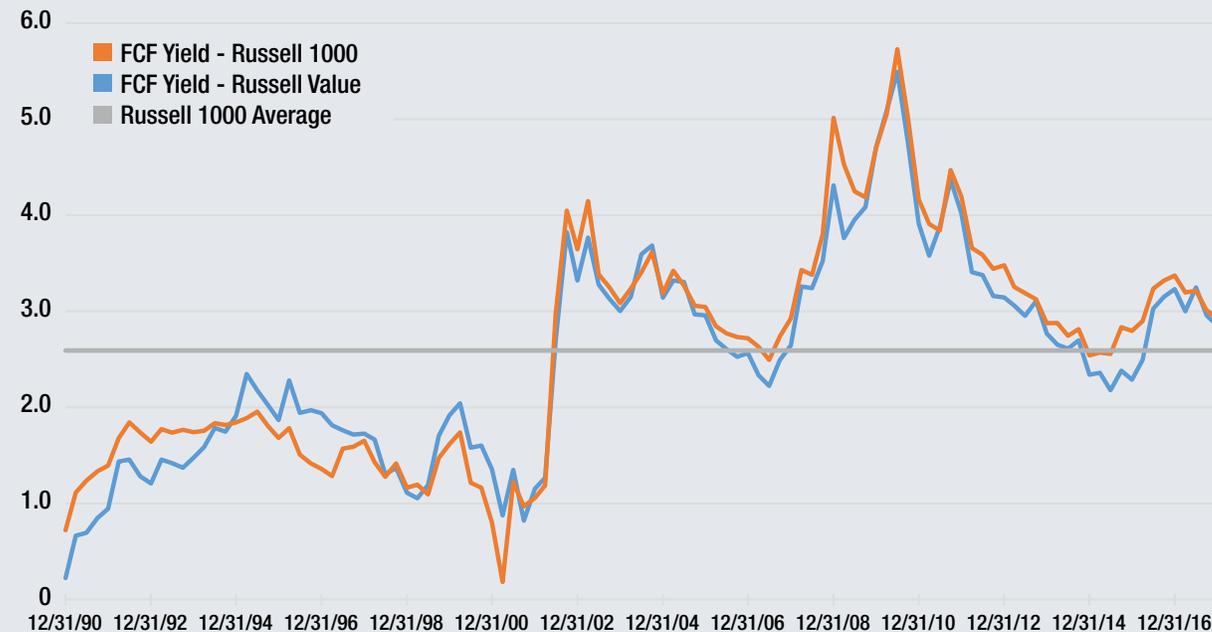
Source: FactSet

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. YOU CANNOT INVEST IN AN INDEX.

3) Value stocks have lower free cash flow yields.

Given that value stocks tend to trade at a discount, investors may assume they would also have higher free cash flow yield (FCFY). In the last few years, this has not been the case. Value stocks have lower FCFY than the market.

Free Cash Flow Yield (12/31/90 - 12/31/17)



Source: FactSet

Free Cash Flow (FCF):

A company's cash flow from operations minus capital expenditures (expenses, interest, taxes, and long-term investments)

Free Cash Flow Yield: FCF/EV.

Measures a company's total free cash flow relative to its enterprise value. This is an internal statistic and does not constitute investor yield.

An Alternative to Value Stocks

Examining the value index using P/Es, ROE, net income and FCFY, investors can see that its less than stellar metrics likely contributed to value's underperformance versus its benchmark. While it is still important to own value in a portfolio, it may be time to consider an alternative way of selecting value stocks.

Screening an index for high free cash flow yield may be a good way to find the opportunity across both value and growth categories. Stocks with high free cash flow yield exhibit favorable characteristics vs the value and growth indexes.

Quality

Traditionally, value stocks offer a lower cost, but at lower quality. In screening by free cash flow yield, investors do not lose the quality.

- Russell 1000
- Russell 1000 Value
- 100 companies with the highest FCFY in the Russell 1000 Index

Source: FactSet

Return on Equity (ROE) (12/31/90 - 12/31/17)



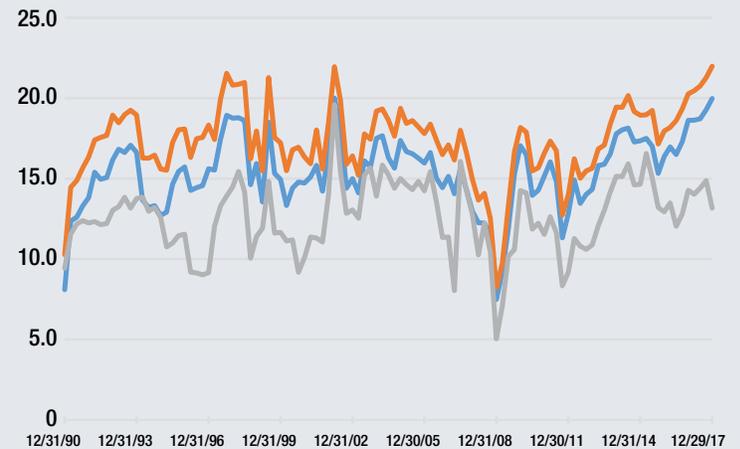
Value

Value stocks usually trade at a discount to the market, but free cash flow yield can offer a greater discount.

- Russell 1000
- Russell 1000 Value
- 100 companies with the highest FCFY in the Russell 1000 Index

Source: FactSet

Price to Earnings Ratio (P/E) (12/31/90 - 12/31/17)



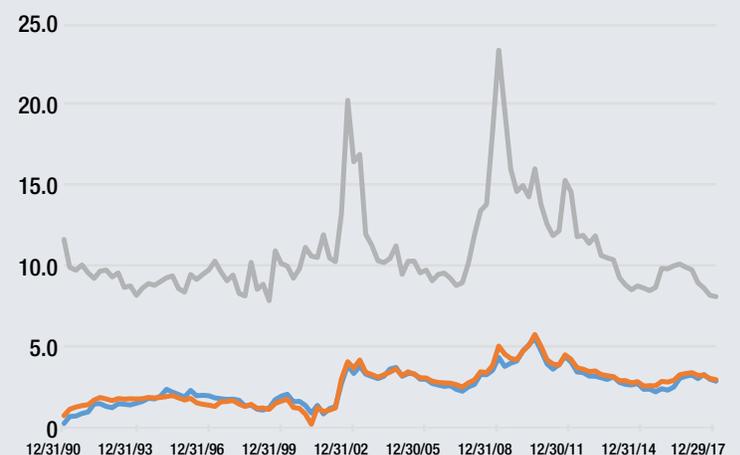
Free Cash Flow Yield

Companies with high free cash flow may perform better over time because the ability to generate a high free cash flow yield indicates a company is producing more cash than it needs to run the business and can invest in growth opportunities. Given this is a valuation metric, investors may think the value index would have a higher FCFY than the market, but historically, this has not been the case.

- Russell 1000
- Russell 1000 Value
- 100 companies with the highest FCFY in the Russell 1000 Index

Source: FactSet

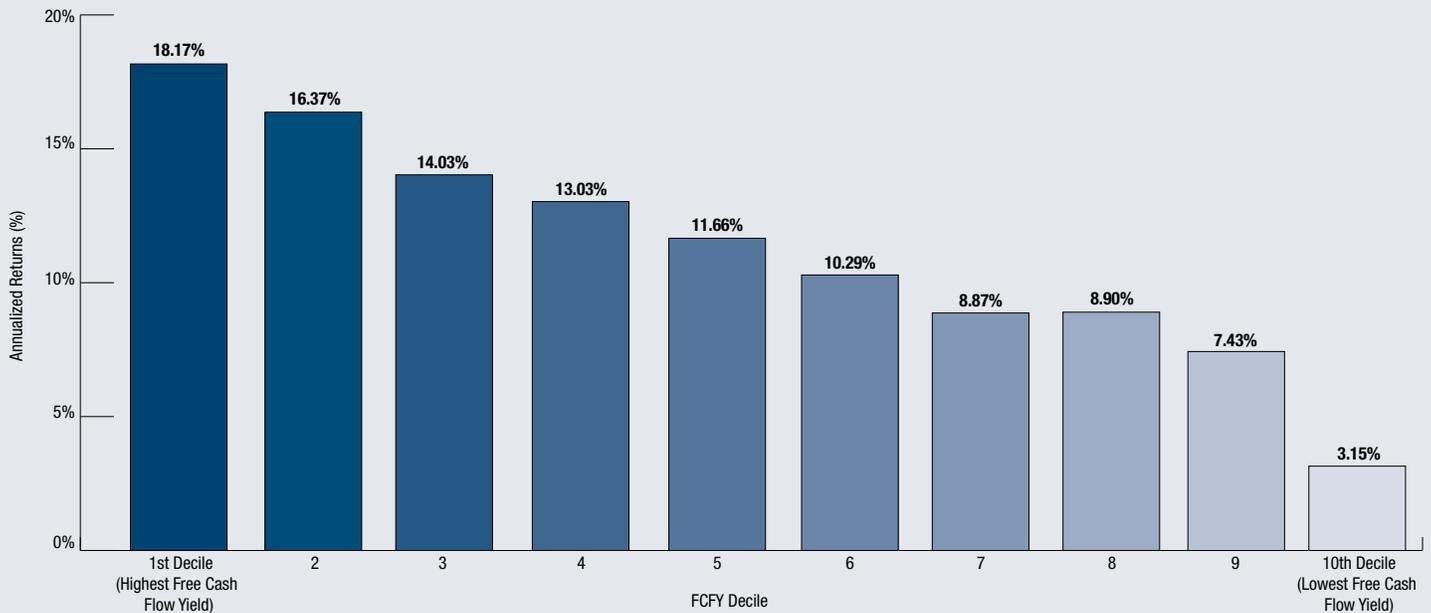
Free Cash Flow Yield (FCFY) (12/31/90 - 12/31/17)



Historically, Free Cash Flow Yield Outperforms.

Investors may achieve higher returns when using free cash flow yield as the value metric to screen for stocks. In the chart below, companies with the highest free cash flow yield (1st Decile) outperform companies with the lowest free cash flow yield (10th Decile) over time.

Free Cash Flow Yield by Decile Returns, Russell 1000 Index
(12/31/91 - 12/31/17)



Source: FactSet. Data is composed of the Russell 1000 Index excluding financials. Each decile is composed of approximately 85 stocks (10%) based on free cash flow yield, equal weighted.

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P/E ratio is a fundamental measure commonly used to determine if an investment is valued appropriately. Each holding's P/E is the latest closing price divided by the latest fiscal year's earnings per share. Negative P/E ratios are excluded from this calculation.

Return on equity (ROE) is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. $\text{Return on Equity} = \text{Net Income} / \text{Shareholder's Equity}$

Russell 1000 Index is a market-capitalization weighted index representing the top 1000 large-cap stocks in the Russell 3000 Index.

Russell 1000 Value Index is composed of large- and mid-capitalization U.S. equities that exhibit value characteristics.

Russell 1000 Growth Index is composed of large- and mid-capitalization U.S. equities that exhibit growth characteristics.

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