ADVANTAGE ACTIVE: VALUE LIES IN THE EYE OF THE BEHOLDER....AND THE INDEX PROVIDER?

With roots dating back a century to Graham and Dodd, value investing has enjoyed longs periods of success, even if the most recent decade was a challenge. However, defining value investing can be far more complex than it would appear on the surface, as the cornerstone of nearly every investment approach centers on buying undervalued securities provided by an inefficient market. How one determines whether a security is undervalued and what metrics are applied to make that determination is far from uniform.

Particularly in today's markets, the definition of "value" varies greatly between active managers and, surprisingly, index providers like FTSE Russell. Investors are well-served to know what they own, as varying "beholders" may see value in vastly different ways—resulting in dramatically different outcomes. The recent resurgence in value's performance has spurred renewed interest, and given the differences described below, the advantage may well lie with disciplined, active value managers.

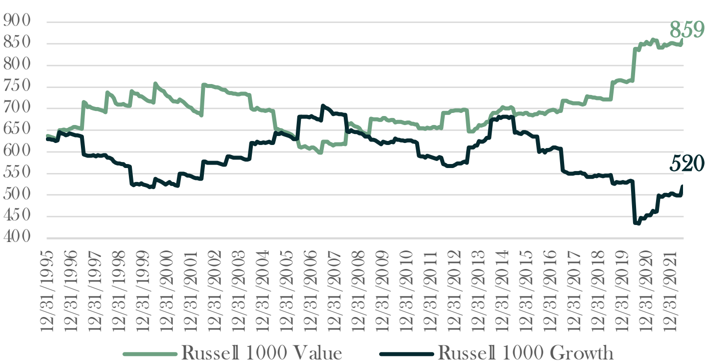
At the core of it, the difference in approaches between active value managers and passive index providers is analogous to the adage that "price is what you pay; value is what you get." Index providers typically rely on just a few quantitative value metrics, applied without adjustment, to score securities as value or growth which are then sorted from smallest (or "cheapest") to largest. These rankings do not equate to "value," in that they provide no insight into whether a security is undervalued or overvalued. That would require an analysis of intrinsic value, performed by an active value manager, to discern.

In the case of the Russell indices, popular benchmarks for active value managers, the only valuation metric considered is Book-to-Price ("B/P," which is simply the inverse of Price-to-Book, or "P/B"). While B/P has historically been a widely regarded metric, today most active value managers take a multi-faceted view when assessing value than just one metric, like B/P, to avoid potential value traps and affirm their views on intrinsic value.

These issues are further compounded by how the Russell indices decide which stocks go into the value index versus the growth index. Their methodology seeks to balance the total market value of securities in the value index to the growth index based on their scoring system. The concentration of mega-cap growth securities that emerged before and into the pandemic of 2020 has distorted the Russell 1000 Value Index, a common large-cap value benchmark, by adding many stocks that are not truly "value" into the Index. Balancing the total market capitalization between the Russell 1000® Growth and Russell 1000® Value Indices required pushing a significant number of growth companies into the Value Index to offset the likes of Apple, Microsoft, Amazon, and the rest. As shown in the chart below, the Russell 1000 Value Index has 859 holdings, a staggering 86% overlap considering the 1000 potential securities of the Russell 1000 Index.

NUMBER OF STOCKS IN INDICES

December 31, 1995 – June 30, 2022



Source: FactSet.

This trend continued in June 2022, with the Russell 1000 Value Index gaining names that could hardly be thought of as value by investors—Robinhood, GameStop, Peloton, and WeWork! In aggregate, the 92 new additions in June came with staggeringly poor fundamentals and significantly higher valuations, a 65% premium, as shown in the chart on the right. In fact, their inclusion nearly doubled the total number of non-earners in the Index as well. The last time a similar gap emerged in the number of holdings between the Russell 1000 Value and Russell 1000 Growth was during the 1999-2000 technology bubble, which lead to one of the strongest periods of outperformance for value—and in particular, active value managers including Barrow Hanley—in the last 30 years.

CHARACTERISTICS COMPARISON:

92 New Additions to Russell 1000 Value Index		Russell 1000 Value Index	
NEGATIVE EARNINGS LAST TWELVE MONTHS	40%	NEGATIVE EARNINGS LAST TWELVE MONTHS	21%
DO NOT PAY A DIVIDEND	72%	DO NOT PAY A DIVIDEND	28%
FORWARD PRICE/ EARNINGS RATIO	21.0x	FORWARD PRICE/ EARNINGS RATIO	12.7x

Source: Barrow Hanley.

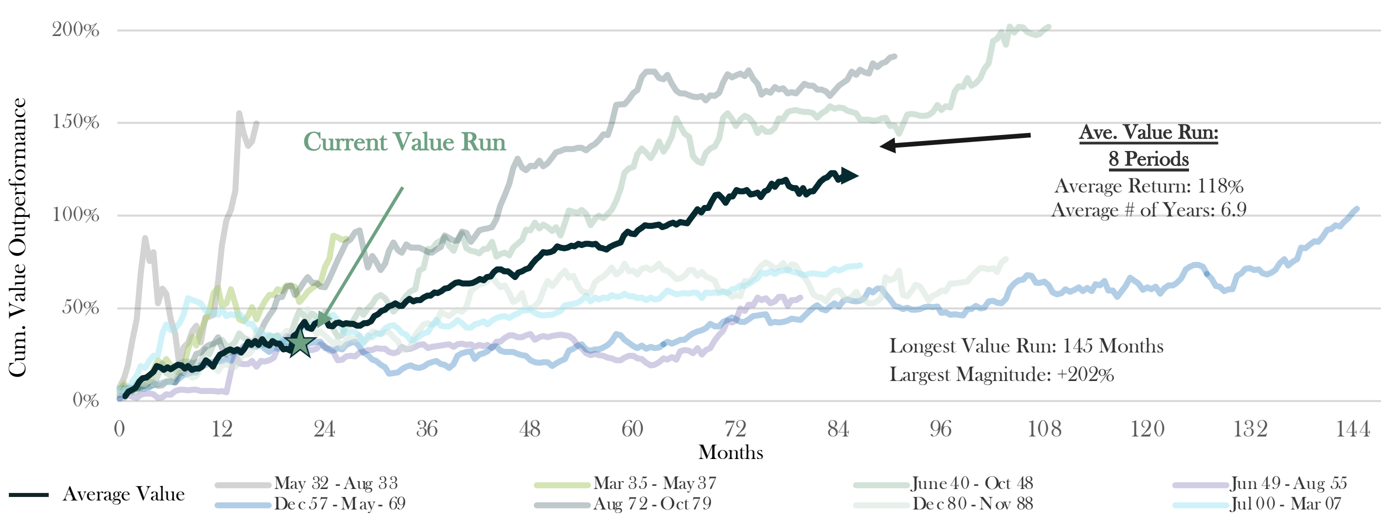
Distorting the Value Index through the inclusion of non-value companies creates opportunities for even more differentiated performance by true value managers.

Looking forward, the outlook for value remains optimistic. Many of the trends that presented headwinds over the last decade such as easy monetary policy and low inflation appear to be transitioning back to more normal, historic levels. Over nearly 100 years, there have been 8 periods following growth-led markets, such as the one just witnessed. Those runs have seen significant value outperformance, averaging nearly 7 years in length and 118% outperformance in magnitude, as noted in the chart below.

Given we are roughly two years into the current value run, the potential remains for the trend to continue for quite some time. Active managers who stayed true to their value discipline may well enjoy even greater success in such a backdrop, as investors return to rewarding companies with attractive valuations and improving, strong fundamentals.

OUTPERFORMANCE OF VALUE AFTER GROWTH-LED MARKETS

1932 – June 2022



Fama-French data 1932-1978; Russell 1000 Growth and Value data 1978-2017.
Source: Barrow Hanley.

ABOUT BARROW HANLEY GLOBAL INVESTORS

Founded in 1979, Barrow Hanley is a diversified investment management firm offering value-focused investment strategies spanning global equities and fixed income. Recognized as one of the few remaining firms dedicated exclusively to value investing, Barrow Hanley enjoys a boutique culture with a singular focus to assist clients in meeting their investment objectives. Barrow Hanley stewards the capital of corporate, public, multi-employer pension plans, mutual funds, endowments and foundations, and sovereign wealth funds across North America, Europe, Asia, Australia and Africa. For further information, please visit www.barrowhanley.com.

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