The Death of Value

“A big enough to deliver, small enough to care”
On October 24, 2017, famed value investor and hedge fund manager, David Einhorn, in his letter to investors published the same day, mused “Perhaps there really is a new paradigm for valuing equities and the joke is on us. Time will tell.” On the day he made that statement, the Russell 1000 Value Index was up 9.7% for the year while the Russell 1000 Growth Index had gained over 24%.\(^1\) This has been the case for the better part of 10 years now. I am sure Einhorn feels a little bit like all of us, frustrated and questioning, “is it actually different this time?” “Is value investing a thing of the past?” Probably not.

Let's start by defining value investing. A value investment is an investment where the intrinsic value of the company’s stock is greater than the stock’s market value. A company’s intrinsic value can be determined by using different valuation models such as discounted cash flow or multiples.\(^2\) The idea behind value investing is being prudent and not overpaying for an investment. As we have referenced in past articles, (Triweekly, January 6, 2017 “The Belief in Value”) Eugene Fama and Kenneth French proved in their 1993 Nobel Prize winning study “that investors can expect a higher return over time when the relative price being paid for an investment is part of the equation.” In another study conducted last year by Bank of America/Merrill Lynch found value as the true historic winner. “Since 1926, value stocks returned 17% yearly on average, compared to just 12.6% for growth”\(^3\)

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\(^2\) [https://www.investopedia.com/terms/l/large_value_stock.asp](https://www.investopedia.com/terms/l/large_value_stock.asp)


The recent popularity of the FAANG stocks (Facebook, Amazon, Apple, Netflix and Google) has driven the growth and market indices to all-time highs. This high flying, growth centered, valuation no longer matters, attitude gives our portfolio management team pause. Do people really understand what they are paying for these companies’ stocks? Growth started to outperform Value about 10 years ago when the financial crisis began. Value investing’s underperformance to growth will not always be the case as these cycles usually last between 7-10 years. We are currently 10 years into this 7-10 year cycle......any questions?

If being near a cycle end isn’t enough, here are three more compelling reasons to discuss value investing with your clients.

1) **Reversion to the Mean** – In finance, “mean reversion is the assumption that a stock’s price will tend to move to the average price over time” and “that periods of lower returns are then followed by compensating periods of higher return” and vice versa. From today’s price levels, mean reversion would clearly favor the value stocks.

2) **Improving economic growth** – The US and world economies have been experiencing slow economic growth since the financial crisis. With unemployment reaching near record lows here domestically and the recovery beginning to take hold worldwide, industrial and manufacturing companies (traditional value staples) are positioned to benefit.

3) **Higher interest rates** – Our Federal Reserve is committed to normalizing US interest rates. Rising rates are very helpful to the financial sector whom has suffered for years from historically low rates. The primary way banks make their money is to attract deposits, “then lend them out at a higher rate.” When rates are low bank’s profits get squeezed. Banks and most financial service companies are considered to be value investments.

Investors often have short memories. They are influenced by greed and fear. The financial press and other media outlets focus our attention on the share price performance of stocks like the FAANGs, and they rarely discuss the ridiculous price one must pay to receive a dollar’s worth of earnings. At LCA, it is not that we don’t own growth stocks, we do. However, we pay close attention to investment valuations and believe value investing will continue to offer investors a higher return over time.

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5 [https://en.wikipedia.org/wiki/Mean_reversion_(finance)](https://en.wikipedia.org/wiki/Mean_reversion_(finance))

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