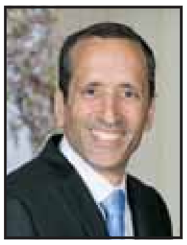
A Return to Traditional Values



By Jonathan Caplan

The rallying cry for the need of society to return to traditional values is most commonly associated with political parties and religious activist groups. So why are investment pundits and professional portfolio managers now embracing the emerging trend of a return of some traditional values on Wall Street? To be sure, there are no signs of an outbreak of religious zeal or political activism on Wall Street. The modus operandi of striving to capitalize on financial opportunities has not become an anachronism.

But, in my view, there are growing signs that Wall Street is returning to some of its traditional roots. Traditional investment principles appear to be coming back into vogue. This is music to the ears of those who have essentially eschewed the proliferation of newer and more alluring asset classes these past few years including SPACs (special purpose acquisition corporations); cryptocurrencies (like Bitcoin); non-fungible tokens (NFTs); and "meme" stocks (which I wrote about in my April column).

Many neophyte investors—or dare I say, speculators—tend to define value in terms that I consider spurious and fraught with risk. For example, speculators in cryptocurrencies have dubbed this relatively new invention as "an investment class," a form of "digital gold" and "a store of value." In my humble estimation, it is a stretch to refer to an asset that recently plunged over 30% and then rallied by a similar amount within 12 hours as "a store of value."

Defining Value

The traditional definition of value investing was established many years ago by academicians and economists such as Benjamin Graham, who is regarded by many as "the father of value investing." In his first published book, "Security Analysis," Graham laid out clear criteria for differentiating between investing and speculating. He posited that "an investment operation that promises safety of principal and an adequate return" should be the primary measure to be considered an investment rather than speculation.

Renowned investor Warren Buffet, of Berkshire Hathaway fame and known to many as "The Oracle of Omaha," referred to Graham's book as "the best book about investing ever written." While Buffet adapted some of Graham's principles to a new and expansive paradigm, the general principles of value investing are largely associated with both Graham and Buffet.

The Decline in Traditional Value Investing

For the past decade or so, in the wake of the financial crisis, value investing has gradually fallen out of favor. Portfolio managers have turned their attention—and dollars—to stocks with higher rates of growth, regardless of traditional value metrics. This trend hit a fevered pitch during the COVID-19 pandemic. Companies such as Zoom and Peloton, which benefited greatly from stay-at-home mandates, became the epicenter of investors paying increasingly higher prices for their growth potential. These stocks were revalued higher based on investor euphoria for a potentially elongated economic lockdown—but not based on traditional metrics such as earnings and dividend payouts.

Times Are A-Changin'?

But beginning in late 2020, when new COVID-19 vaccines began to proliferate, the market once again seemed to be embracing value stocks. Companies that will benefit from a cyclical economic recovery and potentially higher interest rates have recently been performing much better than the growth stocks, as evidenced by the outperformance of the S&P 500 Value Index over the S&P 500 Growth Index.

Will the nascent trend of value stocks outperforming growth stocks continue? While the continued outperformance of value stocks is uncertain, historical experience suggests that the trend can continue for an extended period of time. Moreover, with many expecting interest rates to move higher rather than lower over time, it could cause investors to favor stocks that are more modestly priced. There is growing chatter that growth stocks could feel meaningful pressure if interest rates move up significantly. Conversely, traditional value sectors, such as the banking sector, could be a beneficiary of higher interest rates, providing banks with higher earnings on their loan portfolios.

The Value Trap

Let me be crystal clear: Successful investing does not mean eschewing innovative growth companies. Moreover, companies such as Eastman Kodak (the sixth largest company in the S&P 500 in 1982 according to ETF Database), seen by many as a value stock, did not fare well in subsequent decades. Kodak filed for bankruptcy in 2012. In retrospect, management did not adapt well to a rapidly changing technology landscape. Thus, one needs to make sure that the companies in which one invests have the wherewithal to continuously adapt to evolving competitive threats.

Investing in stocks of companies that demonstrate growth characteristics and that are modestly valued could be viewed as the holy grail. But few stocks exhibit both features of low valuation and compelling growth dynamics. Thus, when stock prices overall are seemingly trading near full valuation, as many pundits believe is the case today, the ability to uncover attractive value opportunities becomes more challenging.

Finding the Intersection Between Value and Innovation

Investing in the stock market, particularly when indices are hovering near record territory, speaks to the need for investors to become increasingly selective. Moreover, investors need to have a greater understanding of the companies in which they invest. Bull markets, as well as economic cycles, have limited lifespans. While broad stock indices, as well as economic growth, historically rise over long periods of time, short-term risks and rewards are more parlous. Thus, I advise equity investors to seek out investments that are conservatively valued, where only reasonable expectations are factored into the market price, and have the potential to perform well given the uncertain economic landscape.

CONTINUED ON P. 87