Value returns:
Bringing the "multi" back to multi-factor

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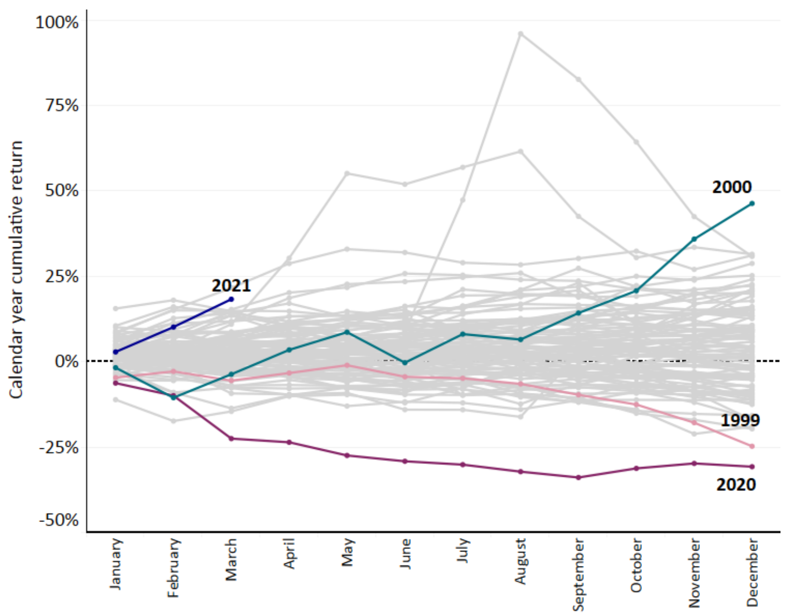
Long-suffering factor investors may only be willing to whisper it, but the data say it loud and clear: value is back. After its worst year on record in 2020, the factor delivered its best return since 1943 in the first quarter of this year.[1]

After such a powerful reversal, investors are anxious to predict what's next and position their portfolios accordingly. As passionate advocates of the Churchillian idea that "the farther back you can look, the farther forward you are likely to see", in this note we drill down into almost a century of data to find out more about the pattern of value factor performance and what it might mean for future multi-factor returns.

Of course, markets change over time. But history suggests good news for investors with value exposure. Dramatic comebacks like we've seen this year are not unusual, especially after significant setbacks. In fact, many of the value factor's best years have closely followed its worst ones. In this context, and with clear macroeconomic catalysts in support, the recent rally could have further to run. For multi-factor investors, this would bring back an important source of long-term returns that has lately been conspicuous by its absence.

Chart 1: Calendar year cumulative returns to the Fama French book-to-market value factor, 1926 to 2021



Source: Matthias Hanauer, Kenneth R. French Data Library. Data as of 31 March. Kenneth French Data Library includes all NYSE, AMEX and NASDAQ stocks for which data is available. Past performance is not a guide to future performance.

[1] This analysis is based on the Fama French "book-to-market" factor, which compares companies' market capitalization to their book value. Other approaches to measuring value, such as the one we use in our multi-factor investment process, have seen similar, albeit less pronounced, volatility.

From famine to feast

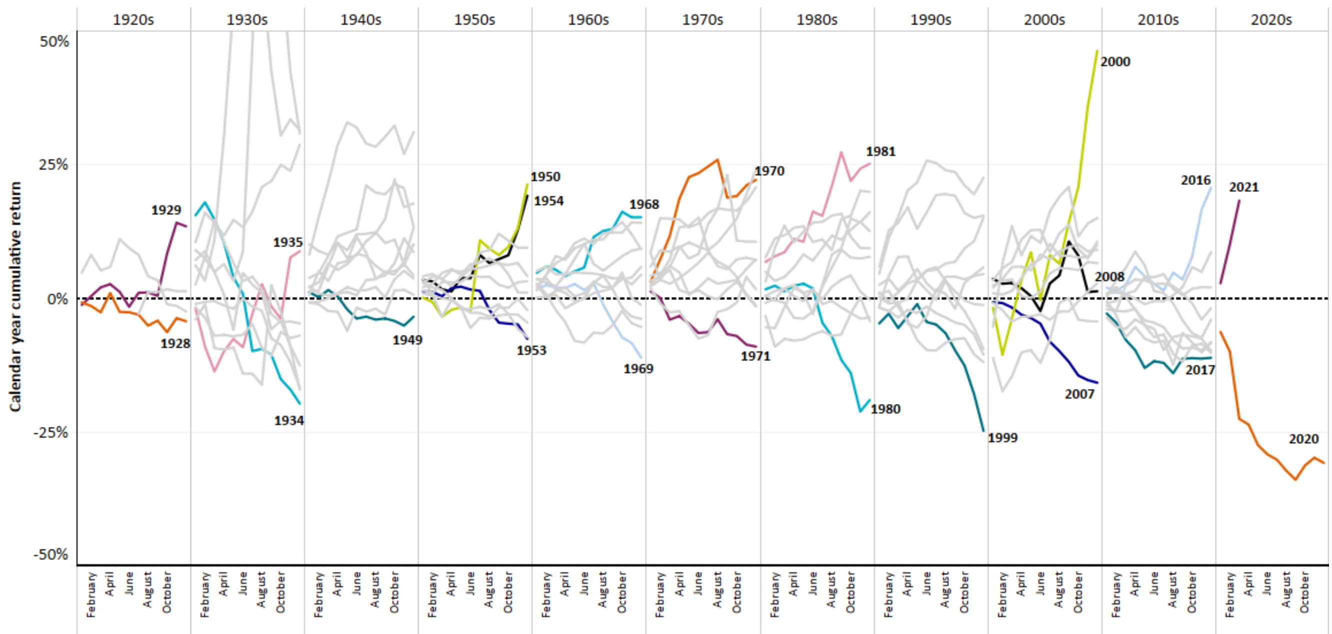
The chart above shows the data underpinning this analysis. From 1926 to 2021, we use the monthly performance of the value factor traditionally favored by academics – known as "book-to-market" – to create cumulative calendar-year return series. We highlight four of our 95 years (1999, 2000, 2020 and 2021) that best illustrate one reason for factor investors' current excitement: they demonstrate that significant drawdowns for value have often been followed by equally pronounced recovery.

Prior to 2020's -31% return, 1999 was the worst year on record for the book-to-market factor. As the tech bubble inflated, lowly valued stocks were left behind, resulting in deep underperformance. When the bubble burst in early 2000, however, value stocks rallied sharply. As the chart shows, the first year of the new millennium remains the best-ever for the factor.

Valuation-oriented investors who suffered through even weaker returns in 2020 than during the tech bubble will be hoping that the factor's first-quarter comeback is an early sign of history repeating itself.

A more detailed investigation provides additional examples of the same dynamic. The chart below splits the same data into decades for ease of reading and highlights significant, consecutive-year, reversals. On top of 1999/2000 – and, so, far, 2020/21 – we also find shifts from famine to feast for value investors in 1928/29, 1934/35, 1949/50, 1953/54, 1969/70 and 1980/81. Shifts from feast to famine in 1968/69, 1970/1971 and 2016/17 add to the picture of cyclicality.

Chart 2: Calendar year cumulative returns to the Fama French book-to-market value factor, by decade[2]



Source: Kenneth R. French Data Library. Data as of 31 March. Kenneth French Data Library includes all NYSE, AMEX and NASDAQ stocks for which data is available. Past performance is not a guide to future performance.

Importantly, this cyclicality is not peculiar to value investing. Periods of strong and weak returns are part of all investment approaches, albeit on different schedules. This has traditionally been one of the benefits of multi-factor investing as investors who are exposed to a range of complementary factors can offset weakness in one area with strength in another. Cycles where the scale of underperformance for a single factor overwhelms all others, as was the case with value last year, are quite rare.

[2] The outsized returns for the book-to-market factor in the 1930s occurred in 1932 and 1933 as the world began to recover from the Great Depression. The factor ended both years with returns of more than 30%, having peaked at even higher levels in previous months.

Catalysts for a continued value recovery

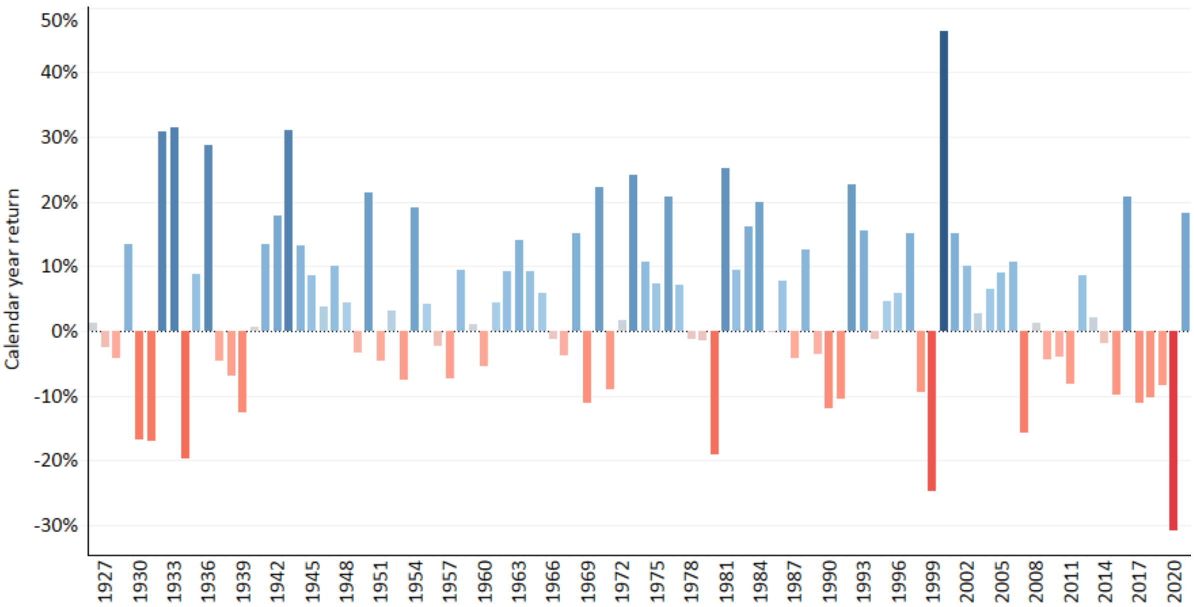
The drivers of factor strength and weakness can be hard to discern but have typically been attributed to macroeconomic forces and swings in investor sentiment or explained as functions of starting valuations.

Over the past hundred years, we note that the balance of drivers has varied by cycle. The reasons for the value rebound in 2000 – which lacked a conclusive macroeconomic trigger, but saw a clear shift in investor sentiment against a backdrop of stretched valuations – were not the same as that of 1981, which came shortly after the election of a new US president and as the country emerged from its worst recession since the Great Depression. While the recent rally has much in common with these and other prior recoveries, there are, as always, aspects that are specific to the current market environment.

For example, although value's recent resurgence may follow hot on the heels of a political transition in the US and as the world begins to climb out of a historically deep recession, today's economic backdrop is quite different to 1980. When the Reagan administration came into office, inflation and interest rates were near record highs; today, they have only recently begun to rise from almost record lows. Indeed, the tick-up in real rates in the first quarter – amid expectations of a rebound in economic growth and the potentially inflationary effects of stimulus measures designed to counter the COVID-19 crisis – has been closely correlated with the improvement in value factor returns. Upward pressure on both fronts is seen as being one of the key macroeconomic drivers of a continued value comeback as longer duration assets start to price in higher discount rates.

Comparisons of today's market and the tech bubble also have some, albeit imperfect, utility. In both cases, the value factor had endured a historic run of underperformance prior to its renaissance. Value's travails leading up to March 2000, however, were relatively short and sharp, while in the recent cycle they were protracted. As a result, valuation spreads looked particularly attractive on both occasions. Nonetheless, while certain parts of the market recently traded at similarly exuberant levels as in the late nineties, many of last year's top performers were considerably better supported by fundamentals and much of the most speculative behavior was outside of large cap public equity markets. These differences have led many to question whether value's current resurgence can be as strong as in the early 2000s, where its best year on record (2000) was followed by six consecutive years of excess returns (see chart 3).

Chart 3: Calendar year returns to the Fama French book-to-market value factor



Source: Kenneth R. French Data Library. Data as of 31 March. Kenneth French Data Library includes all NYSE, AMEX and NASDAQ stocks for which data is available. Past performance is not a guide to future performance.

Positioning for a multi-factor recovery

In our view, value should play a role in any long-term investment strategy. While factor timing is notoriously difficult, the rationale for buying companies below their intrinsic value is timeless, so instead of trading in and out of the factor, we focus on developing better ways to capture it than the simple approach shown in this paper.

Importantly, as a fundamentally oriented multi-factor investor, we also advocate pairing value with other factors, such as quality and investor sentiment. By blending value with these factors, which provide better insight into companies' future earnings growth, we aim to build portfolios that don't depend on a single factor to generate excess returns.

The past several years have left investors in no doubt about the risks of single-factor strategies. However, 2020 was also unusually cruel to multi-factor strategies. Given the depth of value's weakness, returns for even well diversified investors were at the mercy of this one exposure.

Those circumstances seem highly unlikely to continue. Not only have value's biggest setbacks often been followed by its biggest comebacks, but a favorable macroeconomic backdrop, shifting investor sentiment and particularly appealing relative valuations all look supportive for lowly valued stocks. In this context, at the very least, multi-factor investors might look forward to being multi-factor investors again.