



Staying the Course in Value Investing

EXECUTIVE SUMMARY

In 2015, growth stocks in the United States and around the world outperformed value stocks by one of the widest margins since the global financial crisis. Although value stocks have outperformed growth stocks for extended periods over most of the last 90 years, the decade 2005-2015 has been one of the few ten-year periods in which value has lagged growth.

While Dodge & Cox is a value-oriented investment manager, we understand that there are inevitably periods of time when value is trumped by growth. But we have reasons to believe the current divergence may be destined to narrow and even reverse. In our opinion, these market forces are creating considerable opportunities for value investors. This view is not based on blind faith in a single investment approach nor a conviction that markets must inevitably revert to the mean. Rather, it grows out of a deep understanding of the ways in which markets have historically responded to fundamental value.

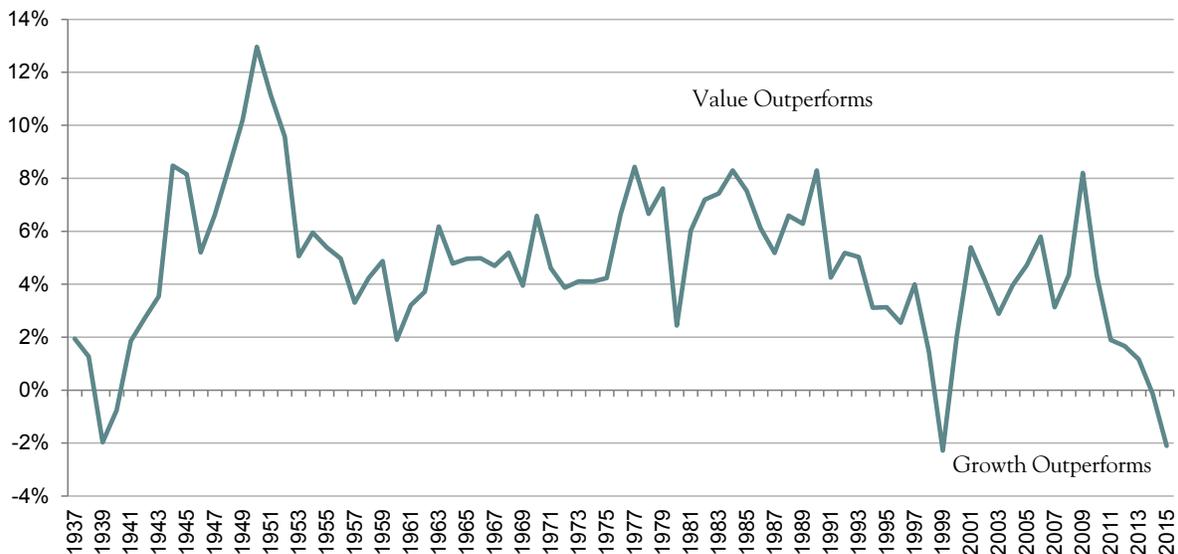
We believe having patience and persistence and retaining a long-term investment horizon are essential to long-term investment success. Hence, we encourage our shareholders and clients to take a similar long-term view of investing.

THE GROWTH VERSUS VALUE DEBATE

One of the enduring debates in equity investing has been between those investors who emphasize value and those who emphasize growth. For analytical purposes, the entire equity market can be divided into growth and value stocks based on such attributes as price-to-book (P/B) and price-to-earnings (P/E) ratios. Generally, stocks that have higher valuations are considered “growth” stocks, while those with lower valuations are “value” stocks.

Over the years, the relative performance of growth and value has seesawed, but value strategies have nearly always outperformed over horizons of a decade or more. In fact, there have only been three times over the past 90 years when value has underperformed for a ten-year period in the United States: the Great Depression (1929-1939/40), the “Technology Stock Bubble” (1989-1999), and today (2004-2014/15).^(a)

Rolling 10-Year Total Return Difference: Fama-French HML (Value vs. Growth)

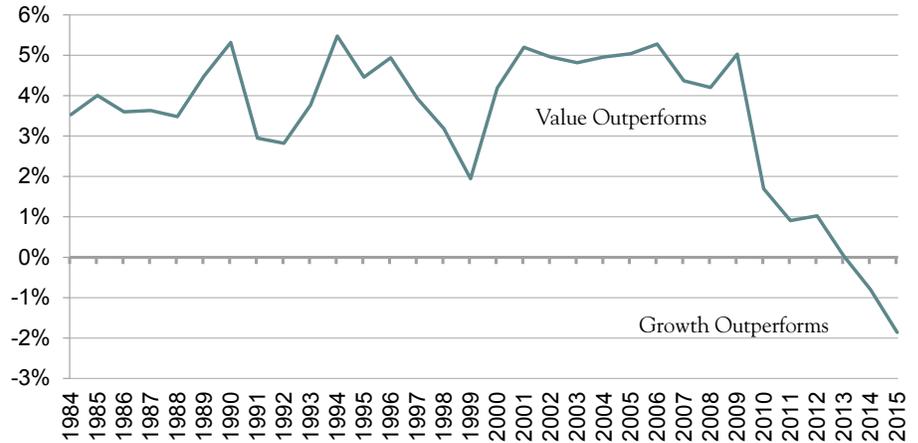


Source: Kenneth French's Data Library.

The general outperformance of value stocks has been reaffirmed in a variety of studies. For example, Josef Lakonishok, Andrei Shliefier, and Robert Vishny found value stocks outperformed growth stocks throughout the period from April 1968 to April 1990.^(b)

Moreover, the outperformance of value stocks has also been an international phenomenon. In “Value Versus Growth: The International Evidence,” published in 1997, Eugene Fama and Kenneth French found that value strategies outperformed growth strategies on a global basis.^(c) In “Value and Momentum Everywhere,” a separate research team^(d) later concluded value’s outperformance was a pervasive market phenomena across the United States, United Kingdom, continental Europe, and Japan. This theme is evident in the chart to the right, which shows that up until recently, value consistently beat growth over rolling 10-year periods in the developed world (excluding the United States).

**Rolling 10-Year Total Return Difference:
MSCI EAFE Value Index vs. MSCI EAFE Growth Index**
Developed World
(excluding United States)



Source: MSCI.

Meanwhile, emerging markets have become an increasingly important component of the global equity marketplace. The emerging markets of Africa, Asia, Central and Eastern Europe, Latin America, and the Middle East differ from one another in many respects, but when examined collectively, value stocks in these markets have recently underperformed growth stocks as well.

**Rolling 10-Year Total Return Difference:
MSCI Emerging Markets Value Index vs. MSCI Emerging Markets Growth Index^(e)**



Source: MSCI.

In a variety of markets, as measured by a variety of benchmarks, the last decade has clearly been a very distinctive period in which growth stocks have outperformed value stocks. 2015 was a particularly dramatic example of this phenomenon in the United States: The Russell 1000 Growth Index had a 5.7 percent total return last year, which was nine percentage points ahead of the Russell 1000 Value Index.^(f) That was the widest performance gap between the two since 2009.

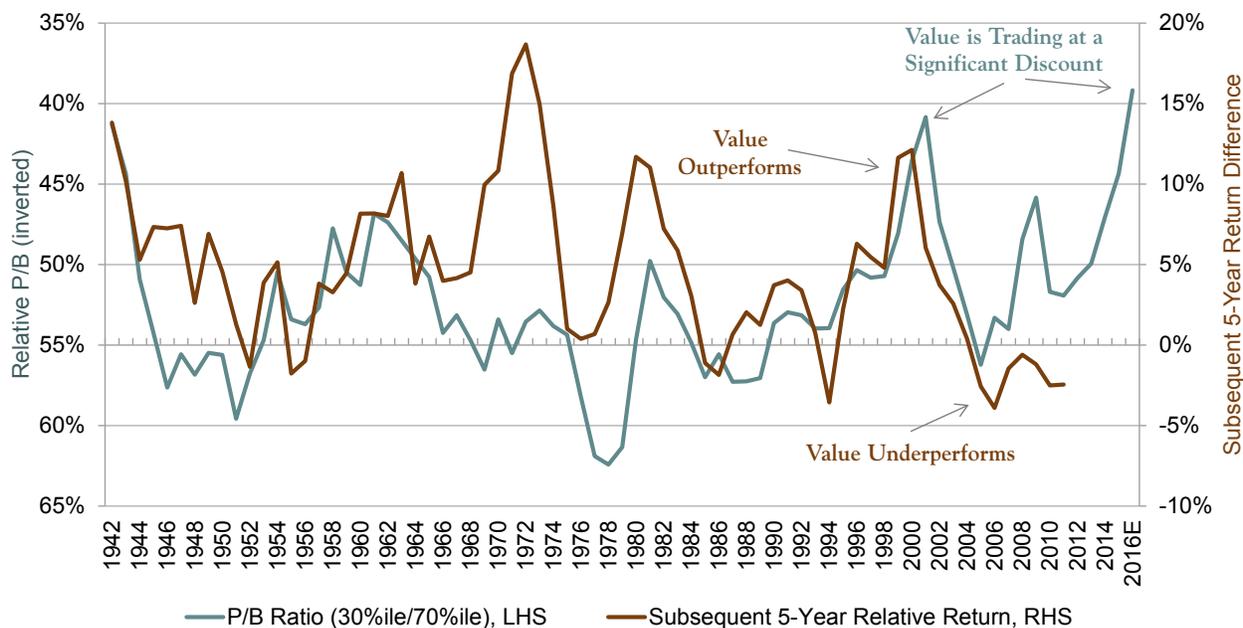
THE MAGNITUDE OF POTENTIAL OPPORTUNITIES

As 2016 began, growth equity valuations had become more expensive than at any time since the technology stock bubble of the late 1990s, while value languished. As a result, the valuation differential was significantly wider than it typically is. The historical record suggests that long-term returns to value investing have been highest after these periods.

Historically, returns to value-focused strategies have been closely related to valuation spreads. When stocks are relatively cheap, they offer a greater potential for higher future returns. This is essentially a mathematical truism: The more undervalued a stock is, the more its price may potentially appreciate as the share price moves to reflect its intrinsic value.

This has been demonstrated by Eugene Fama and Kenneth French.^(g) We used their universe of large-cap U.S. stocks listed in the United States and sorted them into three groups based on their P/B ratios. Analyzing this data, we found that over subsequent five-year periods, the “low P/B” portfolio outperformed the “high P/B” portfolio by an arithmetic average of 4.48% per year. This five-year performance differential varies over time, as plotted in brown in the following chart.

Value Stocks Have Tended to Outperform When They Are Particularly Inexpensive
 Relative Valuations and Subsequent 5-Year Returns: Low vs. High P/B Portfolios^(h)



Source: Dodge & Cox's calculations using portfolio returns and P/B data from Kenneth French's Data Library.

The historical experience is that lower valuation stocks have tended to outperform when they are particularly inexpensive, as they are today. As shown in the graph above, based on a P/B measure of valuation, markets are at the historical extreme since 1942, with a 60% price discount relative to the high P/B portfolio. While the choice of stock valuation metrics will affect the size of the discount that is calculated, this trend holds true across all metrics that we have studied. Whatever measures are employed, value stocks are trading at significant discounts to historical norms.

VALUATION DISPARITIES HAVE WIDENED

The sources of these sizable disparities can be found by examining both the growth and value segments of the market. Around the world, investors have been favoring stocks with strong expected growth prospects, driving the price of high valuation stocks even higher. In the United States, most notably, in 2015 the “FANG” stocks (Facebook, Amazon, Netflix, and Google) gained \$450 billion of market cap through the end of the year, a 61% jump, while their combined earnings rose only 21%. Netflix’s stock surged 134% in 2015 and Amazon shot up 118%, while Facebook rose 34% and Google (now Alphabet) increased 45%. At the end of 2015, Netflix was trading at 409 times trailing earnings and Amazon at an even loftier 538 times.

While growth stocks have been rising sharply, there has been considerable weakness in certain value-oriented sectors, most notably Energy, Financials, and Materials. There are a variety of concerns about these sectors of the economy and skepticism about their future prospects.

These forces have been felt even more strongly in a number of emerging market countries. In some, export revenues have fallen because their economies are based on selling commodities, and several of them are oil producers. Some have experienced constrained demand as a result of sluggish growth rates in the industrial countries that are their main customers. Many have also felt the impact of the economic slowdown in China, which has become a major export market for many developing nations as well as a source of direct investment.

In 2015, emerging market stocks were further impacted by the strength of the U.S. dollar. This made many imports more expensive, and it also made managing debt more costly. Funds flowed out of emerging markets, reflecting increased doubts about the narrative that the emerging markets will be the epicenter of future global economic growth.

LONG-TERM OPPORTUNITIES FOR PATIENT INVESTORS

Value investors, like Dodge & Cox, now see opportunities arising out of the wide gap that has opened up between the valuation of growth stocks and value stocks. This view is based on our expectation that investors will recognize that the share prices of sound but deeply discounted value companies offer substantial upside potential. The market may not immediately respond to the intrinsic value of companies as measured by sales, cash flow, earnings, or book value multiples, but over time market prices tend to move toward fundamental value.

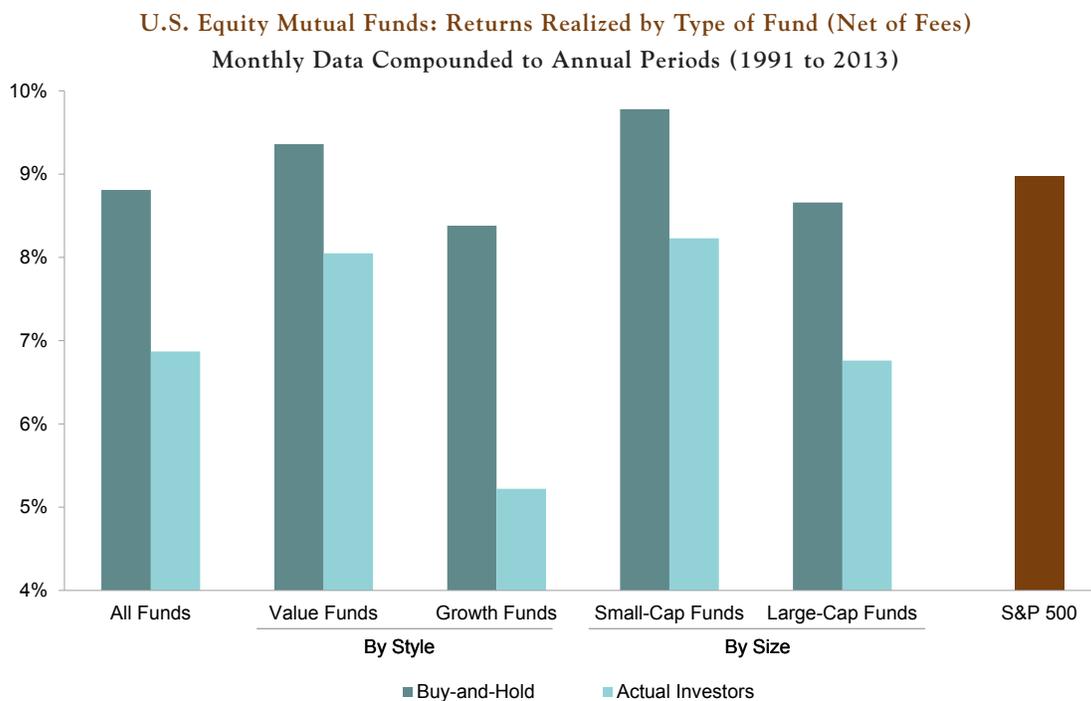
Thus, we see good reason to believe the growth versus value disparities will narrow and, in fact, return to more characteristic relationships, with value outperforming growth over the long term. “This time it’s different” is an anthem that has led many investors astray in the past. To be sure, the future is not inevitably a reprise of the past, but the fundamental forces at work in a market tend to lead to certain outcomes over the long term.

Of course, every stock whose price has been knocked down is not a value opportunity. In a number of cases investors have correctly responded to diminishing opportunities resulting from faltering markets, inadequate products and services, or discernible weaknesses in management and governance. But value investors who test and retest their investment hypotheses are finding that this is an excellent time to search for major bargains. Those who remain steadfast have good reason to believe they can reap long-term benefits as markets return to the kind of relationships that have been dominant over a number of decades.

THE IMPORTANCE OF STAYING THE COURSE

All too many investors move in and out of investments at precisely the wrong time: They jump into individual issues or funds at what turns out to be the end of a period of good performance, and they rush out after a period of poor returns—only to find that they have sold at the bottom. Chasing past returns in this fashion ends up hurting their long-term investment results because it is exceedingly difficult to pinpoint turns in the market or in the performance of individual funds. In fact, just being in or out of a market for the few days in which dramatic movements occur can have a sizable impact on longer term performance.

Morningstar observed that because of poorly timed buy and sell decisions, over the ten years ending December 31, 2014, the average U.S. equity investor and international equity investor earned 1.0 and 1.2 percentage points less, respectively, per year than the average mutual fund’s published return.⁽ⁱ⁾ Another study, “Timing Poorly: A Guide to Generating Poor Returns While Investing in Successful Strategies,”⁽ⁱ⁾ also found that the returns investors actually earned were much lower than the return they would have earned buying and holding their funds through the 22-year period under analysis. In fact, this held true across all fund types. Over the last 20 years, mutual fund investors appear to have given up approximately 2% per year because of ill-timed buy and sell decisions.



Source: Hsu, Jason, Brett W. Myers, and Ryan Whitby. “Timing Poorly: A Guide to Generating Poor Returns While Investing in Successful Strategies.”

Having patience and maintaining a long-term investment horizon are essential to achieving long-term investment success in any market. This seems particularly true in the current market environment, when we see reason to believe the recent relationships between growth and value appear poised to begin shifting.

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- ^(a) Value versus growth as measured using Fama-French's High minus Low (HML) framework. HML is one of three factors in the Fama-French model (see Fama, Eugene F., and Kenneth R. French. "Common Risk Factors In The Returns On Stocks and Bonds." *Journal of Financial Economics* 33, no. 1 (1993): 3-56.) and accounts for the spread in returns between value and growth stocks. The Fama-French portfolios used to calculate the chart include all New York Stock Exchange (NYSE), American Stock Exchange (AMEX), and NASDAQ stocks with the necessary data. Calculated based on data from Kenneth French's website (<http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/index.html>), which was derived from the CRSP (Center for Research in Security Prices)/COMPUSTAT merged database.
- ^(b) Lakonishok, Josef, Andrei Shleifer, and Robert W. Vishny. "Contrarian Investment, Extrapolation, and Risk." *The Journal of Finance* 49, no. 5 (1994): 1541-1578. The sample period covered April 1963 to April 1990. Since the strategies required 5 years of past accounting data, the portfolios were formed beginning in April 1968. The universe of stocks included all NYSE and AMEX stocks with the necessary data.
- ^(c) Fama, Eugene F., and Kenneth R. French. "Value Versus Growth: The International Evidence." *The Journal of Finance* 53, no. 6 (1998): 1975-1999.
- ^(d) Asness, Clifford S., Tobias J. Moskowitz, and Lasse Heje Pedersen. "Value and Momentum Everywhere." *The Journal of Finance* 68, no. 3 (2013): 929-985.
- ^(e) The performance data for the MSCI Emerging Market Growth Index and MSCI Emerging Markets Value Index has only been available since 2000. Hence, the rolling 10-year returns start in 2010.
- ^(f) The Russell 1000 Growth Index is a broad-based, unmanaged equity market index composed of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Value Index is a broad-based, unmanaged equity market index composed of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.
- ^(g) Fama, Eugene F., and Kenneth R. French. "The Anatomy of Value and Growth Stock Returns." *Financial Analysts Journal* 63, no. 6 (2007): 44-54.
- ^(h) Calculated based on data from Kenneth French's website (<http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/index.html>), which was derived from the CRSP (Center for Research in Security Prices)/COMPUSTAT merged database. Kenneth French computed book equity to market equity breakpoints at the end of each June. The breakpoints for year t use all NYSE stocks that have a market equity for December of $t-1$ and (positive) book equity for the last fiscal year ending in $t-1$.
- ⁽ⁱ⁾ Kinnel, Russel. "Mind the Gap 2015." *Morningstar*, August 2015.
- ^(j) Hsu, Jason, Brett W. Myers, and Ryan Whitby. "Timing Poorly: A Guide to Generating Poor Returns While Investing in Successful Strategies." *The Journal of Portfolio Management* 42, no. 2 (Winter 2016): 90-98.