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Business Day

After Sell-Off, Moment to Shine for Stocks on Sidelines

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COMMON SENSE

In January, Seth Klarman, a billionaire who runs the Boston-based Baupost Group investment partnership, warned in his annual letter to clients that "a skeptic would have to be blind not to see bubbles inflating" and cited the "nosebleed stock market valuations" of companies like Netflix and Tesla Motors.

And that was before the maker of Candy Crush Saga went public.

"All the crazy stocks were up," said Bruce Greenwald, the director of a value investing program at Columbia Business School. "It's been absolutely ridiculous." King Digital Entertainment, the maker of Candy Crush, "is a perfect example," he said. "No company has ever had a valuation like that based on one hit game."

This week, the bubbles have been popping. After closing at $455 a share in March, Netflix closed on Friday at $326.71, a drop of 28 percent. Tesla closed at $255 in March. This week it fell to $203.78, down 20 percent.

They're not the only so-called momentum stocks that have deflated. Twitter was down a staggering 44 percent from its recent high, Facebook was off nearly 18 percent and Amazon has dropped 23 percent.

Their plunge seemed to lead the broad market lower this week, even though market averages remain close to record highs.

The sell-off has been bad news for many hedge funds and growth-oriented investors, but it's providing a rare moment in the sun for so-called value investors, who focus on out-of-favor stocks with relatively low valuations, often measured by price-to-earnings ratios. Although Warren E. Buffett, arguably the country's most famous and successful investor, is a longtime champion of value investing, value investors rarely garner the celebrity or media attention of their flashier high-growth counterparts.

"Growth gets so much publicity, especially during a hot market," James Cullen, a longtime value investor, told me during the market turmoil this week. Mr. Cullen is chief executive of Schafer Cullen Capital Management, which manages about $19 billion. "It's always been that way. The market keeps hitting new highs and people get excited. They want to chase momentum."

That is one of the enduring paradoxes of the stock market: Numerous studies demonstrate that over extended periods, value stocks outperform growth stocks by a significant amount. Mr. Cullen said that his firm's research showed that $1 million invested in the Standard & Poor's 500-stock index in 1968 would have been worth $79 million by the end of 2013. But $1 million invested in the 20 percent of the S.&P. 500 with the lowest price-to-earnings ratios would have been worth $578 million.

On an annualized basis for the period from 1968 to 2012, growth stocks (the top 20 percent of the S.&P. 500 based on price-to-earnings ratios) returned 7.9 percent, while value stocks returned 13.8 percent, according to Mr. Cullen's research. Growth stocks outperformed value stocks in only four of the 46 rolling five-year periods during that time span.

Academic studies have reached similar conclusions. A seminal work by Eugene Fama, a professor at the University of Chicago, and Kenneth French, a professor now at Dartmouth, in 1993 demonstrated that value stocks and stocks from small capitalization companies — companies with a market value of $300 million to $2 billion — have higher expected rates of return. Professor Fama and Professor French recently updated their work with the benefit of an additional 20 years of data, and found that "the value effect shows up consistently" no matter the size of the company, although, "as is well known, the value effect is stronger among small stocks."

Why would such an anomaly persist? Professor Greenwald points to what is known as the "lottery preference." People "will always overpay to try to get rich quick," he said. "That's why lotteries never fail even though they're bad investments." People also believe stories with "complete certainty that they cannot know to be true," he added. "Portfolio managers are always saying things like, 'Tesla is the future,' or 'Amazon will dominate the web.' "

Mr. Cullen agrees that the answer lies in behavioral science. When he started in the business at Merrill Lynch in 1965, he said, "The older guys were wearing suspenders and smoking cigars and talking about dividend-paying stocks. We said, 'Dividends are boring.' It was a bull market. Color TV was new, and everyone wanted one. You had IBM, Xerox, airlines. The potential seemed phenomenal. So who cared about dividends? I didn't have a clue, but I should have listened to those older guys. Sixteen years later, the Dow was still at 1,000, and the high-flying stocks went nowhere. But if you bought the bottom 25 percent of the S.&P., you were up over 1,000 percent in the same period."

Value stocks almost never generate much excitement or garner headlines and media coverage. Mr. Cullen's firm examined the top-performing market segments in every year from 1985 to 2004. Value stocks of large cap companies — companies with a market value of more than $10 billion — had the highest average annualized rates of return, 14.5 percent. But they were the top-performing asset class in only two of those 19 years. They were never the worst-performing asset class.

By comparison, Mr. Cullen's firm found, foreign stocks were the best-performing asset class in six years, as were small-cap stocks — the kind of performance that receives attention. But foreign stocks were also the worst-performing asset class in seven years, and small-cap stocks were the worst in six.

Another problem may be that value investors are rarely, if ever, the life of the party. They may not be as dour as short-sellers, who bet on market declines, but by nature they tend to worry. Consider Mr. Klarman's missive to his investors: "When the markets reverse, everything investors thought they knew will be turned upside down and inside out. 'Buy the dips' will be replaced with 'What was I thinking?' Just when investors become convinced that it can't get any worse, it will. They will be painfully reminded of why it's always a good time to be risk-averse, and that the pain of investment loss is considerably more unpleasant than the pleasure from any gain."

The four rolling five-year periods in which growth stocks did better than value stocks were 1986-90, 1987-91, 1995-99, and 1996-2001, which isn't especially comforting considering that the stock market crashed in 1997 and 2000. "In a big bull market like the 1990s, you're going to underperform," Mr. Cullen said. "People kept asking, 'When are you going to be right?' Until you've lived through something like that, you just don't get it. Young people today are making the same mistakes."

That's not to say that value investors think the market is on the brink of another crash. "By many measures, it's overvalued, but it's not 2007," Professor Greenwald said. "Small-cap and midcap value stocks aren't cheap by historical measures," he said. But what's interesting are the big, stable large-cap stocks that are trading at low multiples. He mentioned Nestlé, which has a high dividend and has a global, diversified stable of products. He added, "Microsoft and Oracle look good on valuation measures. It's the nonsizzle stocks that will make money."

Mr. Cullen said his firm was shifting from consumer staples stocks to health care and technology companies. "We like cash cows with good dividends." He also cited Microsoft, along with Intel and Samsung, as among his top holdings.

Mr. Klarman would not comment, but his letter said he was still finding opportunities in various asset classes. (He recently invested in some shopping centers in Spain.) At the end of the year, Mr. Klarman's largest holdings were the chip maker Micron Technology, the biotechnology company Theravance, the satellite broadcaster ViaSat and the oil giant BP.

Mr. Cullen said that after periods of market turmoil, clients tended to be a little more receptive to his message. "After a week like this, I used to always send a note to my clients. I try to keep them from thinking short term and keep preaching the same concept and hope they stay out of trouble."