



Friday Morning Coffee

Nr. 88 — Reversal to the mean

It is still too early in the year with less than 20 active trading days to draw any conclusions. We note however that the beginning of the new decade was quite unfavorable for value since the MSCI Europe Value Index underperformed the MSCI Europe Growth Index by 3.5% year-to-date. As in the US, European investors appeared to prefer highly valued technology companies to their lowly valued cyclical counterparts. We find this surprising as the business climate in Europe starts to noticeably improve.

There is however another force at play that makes us believe that value is about to make a strong return: **reversal to the mean**. From a statistical perspective at least, **value investors are on the high road** as shown in these 2 graphs from Fama, French & StarCapital :

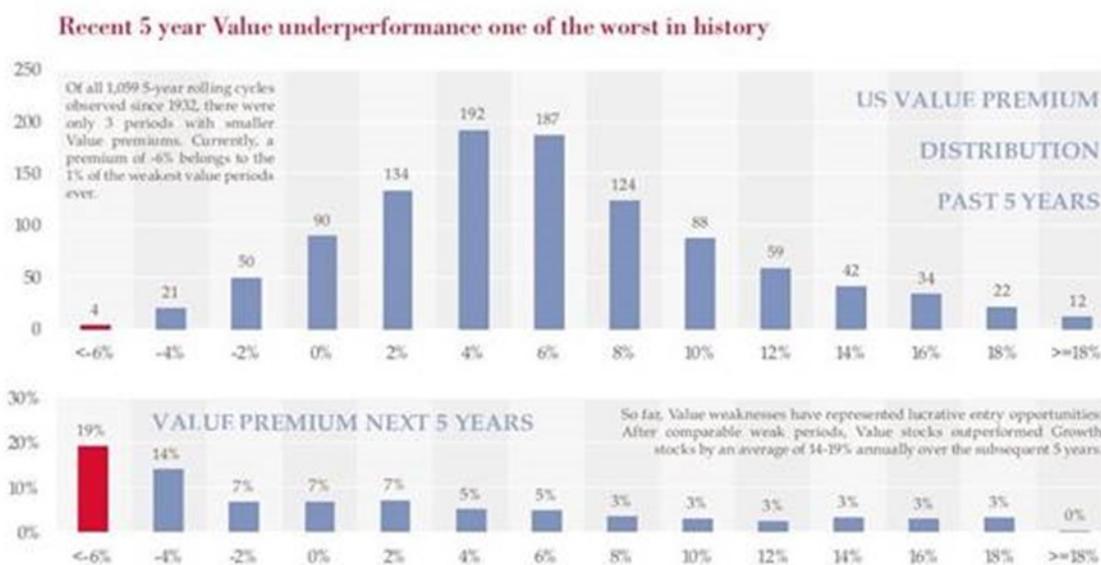


Figure 2: The charts show the distribution of the same Fama and French HML Value premium and the Value premium of the subsequent five years (p.a). Source: Fama, French, StarCapital as of August 2019.

The 2 graphs are based on the US stock market that has the longest historical data available, in this case since 1932.

The upper graph shows a histogram with the historical distribution of 5 year rolling performance of value against growth. **In 4 observations, value underperformed growth by more than 6% a year over 5 year periods. In 21 cases, value underperformed between 6% and 4% annually over 5 year period, and so on.**

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Interestingly enough, there were **only 3 periods where value did worse than today on a 5 year rolling return basis against growth. Statistically we are currently in one of the 4 worst periods out of 1059 observations since 1932, so the far tail of any normal distribution.**

The bottom graph gives another interesting perspective. What happens if an investor put money into value just at the moment he had the performance in the above graph. It gives us a sense on how dependent the future performance of value is of the entry point chosen by investors. It illustrates how the value premium, i.e. the performance difference between value and growth, evolved in the next 5 years after the investment. In red, the study shows that historically the period of worst performance of the value style was the best entry points to invest in value stocks as they outperformed growth by an average 14-19% annually over the subsequent 5 years.

We conclude that, if history is any guide, today is a fantastic time to look at value stocks. This is exactly what we do at ECP.

I wish you a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
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