The Value of Character in Retirement Portfolios

The performance of value strategies in recent years has led some to question whether the traditional signals of underpriced stocks remain a reliable source of long-term excess returns, as they have since emerging in the wake of the Great Depression. We think ongoing structural changes in the economy may be at least partially to blame for the modern underperformance.

While the knowledge-based businesses emblematic of the new economy increasingly are focused on the development of intangible assets rather than the property, plant and equipment investments that were the hallmarks of the old guard, current financial accounting standards fail to capture the bulk of these. These omissions suggest to us that traditional metrics like book value may understate the true value of many businesses and distort the valuation ratios often used to identify mispriced stocks. They also suggest that research-driven managers able to capture the character of a business and the full range factors that drive its performance—both tangible and intangible—may be well positioned for a potential return to long-term growth/value norms.

While this current period of underperformance relative to growth is unique in its duration and magnitude, value investing historically has rewarded patience. In First Eagle's view, an attractive business purchased with a "margin of safety" (or discount to our estimate of intrinsic value) will more often than not potentially offer value to investors with longer time horizons—such as American workers on the multi-decade journey of accumulating assets sufficient to support their lifestyles in retirement.

Key Takeaways

- The ongoing structural shift toward a knowledge-based economy heavily reliant on intangible assets has presented a challenge to investors seeking to identify undervalued stocks.
- While growth indexes have outperformed consistently since the global financial crisis, 2020 was a generationally poor year for value. As a result, relative valuation metrics between growth and value stocks entered 2021 at levels not seen since the dot-com era.
- In our view, value investment should begin with defining the fundamental character of a business—the tangible and intangible assets that drive its performance—before assessing its price. The concept of value becomes a much broader tent when investment isn't limited to only the statistically cheapest cohort of stocks.
- Retirement plan investment menus composed of a diverse range of strategies—including research-driven value equity—may enable participants to construct portfolios that offer a smoother experience over time, encouraging adherence to long-term plans that seek a steady compounding of assets in real terms.

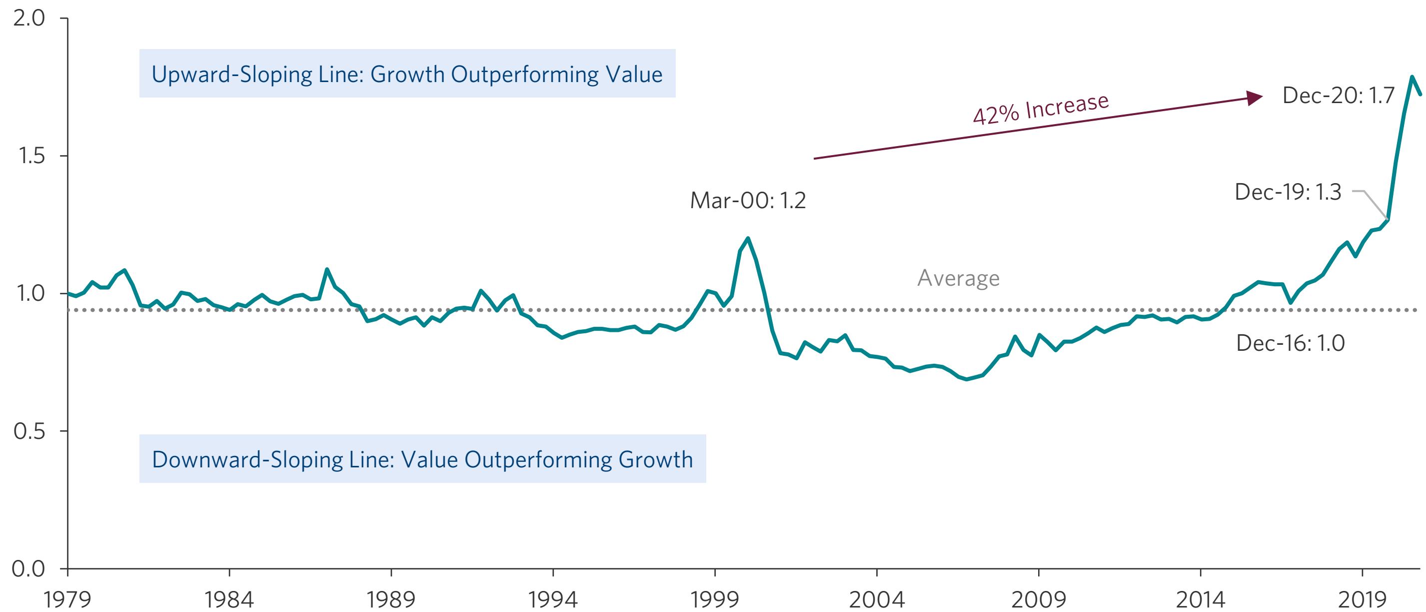
> The recent return bifurcation has driven the relative prices of growth and value indexes to levels around 50% higher than those that prevailed at the peak of the dot-com boom in 2000.

From "Making Stuff" to "Doing Stuff"

Over the past decade, the MSCI World Index has compounded at an annualized rate of 9.9%, with the MSCI World Growth Index climbing 12.8% compared to the 6.8% increase in the MSCI World Value Index—meaningful, but within the historical norms of cyclical variation.[1] Due in part to the dynamics that emerged in the wake of the pandemic-related disruptions of first quarter 2020, however, 2020 was a generationally poor year for value. While the MSCI World Index was up 15.9%, the growth component returned 33.8% compared to a 1.2% decline in value; this 35% spread almost defies belief given that the growth and value indexes have a long-term historical correlation in excess of 0.9. Spreads between growth and value were similar in the US, as the Russell 1000 Growth Index posted a 38.5% return during 2020 compared to the 2.8% return of the Russell 1000 Value Index.[2] As shown in Exhibit 1, the recent return bifurcation has driven the relative prices of growth and value indexes to levels around 50% higher than those that prevailed at the peak of the dot-com boom in 2000.

Exhibit 1. The Price of Growth Stocks Relative to Value Stocks Has Pushed beyond Dot-Com Bubble Levels

Price Ratio of MSCI World Growth Index to MSCI World Value Index; January 1979 = 1.0



Source: Bloomberg; data as of December 31, 2020.

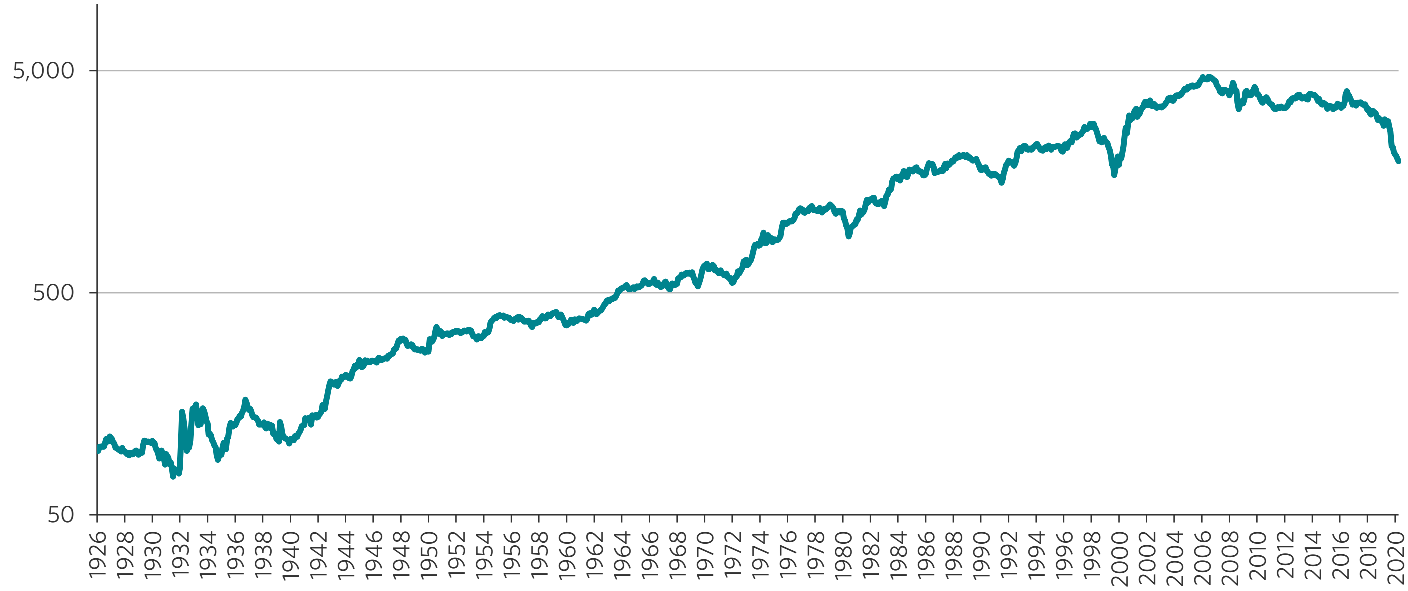
Past performance does not guarantee future results.

Given the lengthy and ongoing divergence between growth and value, it can be easy to forget that these investment styles have traded leadership in recent decades; taking an even longer look back, as in Exhibit 2, value has outpaced growth more often than not since the Great Depression. One potential headwind for value of late may have been ongoing structural changes in the economy, which can be stylized broadly as a shift from the old economy to the new, from "making stuff" to "doing stuff." Services accounted for 70.6% of US GDP in third quarter 2020,[3] an all-time high, and the increasingly knowledge-based drivers of economic activity, particularly in the US, point to the greater influence intangible assets now have on corporate performance. Such assets have been shown to help businesses strengthen their market positions and profitability without a corresponding increase in fixed capital investment, particularly in industries like technology, healthcare, nondurable goods and telecommunications.[4]

1. Source: FactSet; data as of January 12, 2021.
2. Source: FactSet; data as of January 5, 2021.
3. Source: US Bureau of Economic Analysis; data as of January 12, 2021.
4. Özgür Orhangazi, "The Role of Intangible Assets in Explaining the Investment-Profit Puzzle," *Cambridge Journal of Economics*, Vol. 53, Issue 5 (2019).

Exhibit 2. ...Value Has a Long History of Outperformance

Fama/French Value Factor Cumulative Excess Return on a Logarithmic Scale, July 1926 through September 2020; Index, July 1926 = 100



Note: The graph depicts the Fama/French HML (high minus low) factor, which reflects the relative performance of stocks with high book-to-market (value stocks) versus those with low book-to-market (growth stocks).

Source: Kenneth R. French data library; data as of November 30, 2020.

Past performance does not guarantee future results.

How Long Can a Dot Stay Hot?

In our view, the most serious risk retirement investors face is the permanent impairment of capital; in fact, ERISA directs fiduciaries to focus on market drawdowns when building investment lineups (e.g., sponsors must "minimize the risk of large losses"). Take first quarter 2020, for example; while sharp selloffs like this often are viewed through the prism of sequencing risk—e.g., the drawdown's impact on the recent retiree, who suddenly finds her nest egg trimmed by 20% and has little opportunity to recover the difference—market shocks are an obstacle retirement savers of all ages must overcome to reach their goals. Not only do mathematics become a headwind following a large loss, the study of behavioral finance tells us that volatile periods increase the likelihood that participants will act in opposition to their long-term needs.[5]

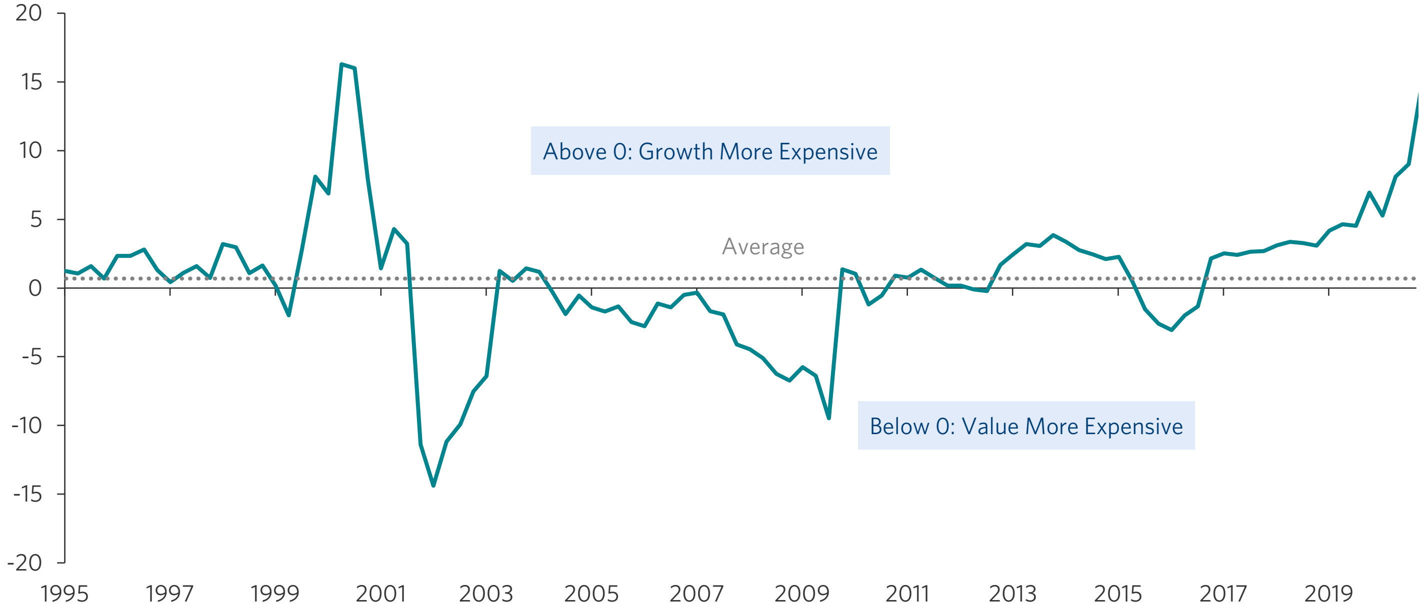
The 401k industry maintains a troubling short-termism that compromises the ability of sponsors and participants to identify investments that may prove to be more resilient over the long term.

Despite the extended and nuanced investment horizon facing retirement savers, the 401k industry maintains a troubling short-termism that compromises the ability of sponsors and participants to identify investments that may prove to be more resilient over the long term and best suited to mitigate against the permanent impairment of capital and thus maximizing the accumulation of wealth. The relative performance of growth and value stocks in recent years is illustrative of this. While trends since the global financial crisis have generally favored the former, market valuations for some of these stocks have grown at a rate well in excess of their fundamentals. As depicted in Exhibit 3, multiple expansion has pushed the enterprise value/EBIT ratio of the MSCI World Growth Index relative to the MSCI World Value Index to the highs not seen since the dot-com bubble era.

5. Meir Statman, "Behavioral Finance: The Second Generation," CFA Institute Research Foundation, 2019.

Exhibit 3. The Outsized Rally in Growth Stocks Has Stretched Relative Valuations

Trailing 12-Month Enterprise Value/EBIT Ratio, MSCI World Growth Index Minus MSCI World Value Index; March 1995 through December 2020



Source: Bloomberg; data as of December 31, 2020.

Investment menus composed of strategies with diverse risk and return characteristics and complementary performance drivers may enable participants to construct portfolios that offer a more cushioned ride across the retirement journey's rough patches.

Extrapolating trends is a risky way to commit capital, particularly when these trends reflect an extraordinary operating environment like 2020. Some of the factors that led to the extreme gap in valuation between growth and value last year—namely, the near-complete shutdown of the more mature, physical components of the economy whose participants tend to populate value indexes—have a natural elasticity to them and are likely to revert. In fact, there were signs in the fourth quarter that investors had begun to take notice of these shifting dynamics. In what was a strong period for equities across the board, value outperformed growth both globally (15.7% for the MSCI World Value versus 12.5% for MSCI World Growth) and within the US (16.3% for Russell 1000 Value versus 11.4% for Russell 1000 Growth).[6]

While the allure of the "hot dot" can't be discounted, investment menus composed of strategies with diverse risk and return characteristics and complementary performance drivers may enable participants to construct portfolios that offer a more cushioned ride across the retirement journey's rough patches, with the potential for reduced short-term volatility and limited downside capture, which, in turn, would likely encourage adherence to long-term plans that seek a steady compounding of assets in real terms over time.

Defining Value Stock by Stock

To put a finer point on our earlier statement about the relative performance of value in 2020, last year was a generationally difficult year for statistical measures of value; that is, for market indexes—and the passive strategies that seek to track them—composed of stocks considered cheaper than average by some fundamental valuation metric or combination of metrics like price-to-book-value or price-to-earnings. The primary flaw with such indexes and strategies is that the quantitative process used to build them assumes that, while price may diverge across securities, business character is homogenous.

In our view, a far better approach to value investment begins with defining the character of a business before assessing its price. By avoiding the assumption of homogeneity, the quantification of price becomes conditional to a comprehensive appraisal of

6. Source: FactSet; data as of January 5, 2021.

a business and the concept of value becomes a much broader tent. Rather than being limited to only the statistically cheapest group of stocks, this approach centers on identifying the intrinsic value of a business based on the specific tangible and intangible attributes that can be expected to drive its cash flows over time. In this manner, any business available for purchase at a discount to its estimated intrinsic value should be considered for investment independent of the style bucket into which index providers have placed it.

However, these intangible assets for the most part are not captured by current financial accounting standards, which presents a challenge to investors seeking to identify undervalued stocks based on traditional metrics that seem to have become increasingly unmoored from the intrinsic value of many businesses. As a result, it seems more likely that index-based value strategies would be skewed toward the stocks of cheap but flawed companies.

We've found that high-quality intangible assets often manifest as an advantaged market position for the company in possession of them. Dominant players in their space—whether it's bicycle gears or commercial ice makers or computer software—typically are able to scale fixed costs across a larger volume of production, which should result in lower production costs compared to the competition and thus greater free cash flow per unit. This cash flow generation allows these companies to steadily reinforce their already advantaged positions; that is, it may enable them to expand the moat around their business. The incumbency of such companies—typically already well-entrenched in their industries and in possession of the unique management and technical expertise that implies—can be difficult to unseat. We find that portfolios selectively constructed of these types of stocks have offered an investment experience differentiated from traditional indexes

Conclusion

Value investing historically has rewarded patience, and we are confident that a business with high-quality assets—tangible and/or intangible—has the potential to benefit its investors over time.

This current period of underperformance relative to growth may be unique in its duration and magnitude, but reports of value investing's demise are nothing new. In fact, one noteworthy *Barron's* cover story asked, "What's Wrong, Warren?" in December 1999—just a few months before the dot-com crash provided a definitive answer to the titular question.[7] While we are not forecasting a collapse of such proportions, the efficiency of today's equity markets suggest to us that it's doubtful any segment can be so permanently mispriced that it will always outperform. Value investing historically has rewarded patience, and we are confident that a business with high-quality assets—tangible and/or intangible—has the potential to benefit its investors over time more often than not if purchased with an appropriate "margin of safety."

While 2020 account statements may present a sunny picture for retirement savers in general, the investment landscape maintains a darker hue. The end point of the Covid era and its many dislocations—including the beyond-extraordinary central bank intervention that enabled risk markets to recover—remains uncertain despite the rollout of vaccines. In the meantime, many businesses remain shuttered and unemployment remains both high and bifurcated, highlighting the K-shaped recovery that appears to have taken hold in the US. While plan sponsors can do little to hasten the post-Covid return to normalcy, they can ensure their participants have access to resilient investment strategies that best position them to compound assets over the long term in pursuit of their retirement goals.

7. Andrew Bary, "What's Wrong, Warren?" *Barron's*, December 27, 1999.

The **MSCI World Growth Index** captures large and mid cap securities exhibiting overall growth style characteristics across 23 Developed Markets (DM) countries. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend.

The **MSCI World Value Index** captures large and mid cap securities exhibiting overall value style characteristics across 23 Developed Markets (DM) countries. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield.

The **Russell 1000® Growth Index** measures the performance of the large cap growth segment of the US equity universe. It includes those Russell 1000® companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000® Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

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Indices are unmanaged and do not incur management fees or other operating expenses. One cannot invest directly in an index.

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