

Passive investment or active growth management? Value beats them both

George Athanassakos
Tuesday, September 22, 2009

George Athanassakos is a professor of finance and holds the Ben Graham Chair in Value Investing at the Richard Ivey School of Business, University of Western Ontario.

A recent study by Standard & Poor's shows that "Index funds beat managed rivals in the long term." The report shows that only 16.7 per cent of active funds beat benchmarks over three years with the number falling to 7.6 per cent over five years. These findings are consistent with previous evidence, both academic and practitioner.

This and similar studies, however, report the average performance of active funds, in general, and compare that with passive funds. But what about factoring in the investment style of the actively managed funds? Is it possible that value investing outperforms both an active growth and a passive investment strategy?

In a recent study I carried out with HBA and MBA students at the Richard Ivey School, I found that actively managed value investing outperformed both index funds and active growth management.

Using Canadian data for two distinctly different subperiods 1985-98 and 1999-2007, we excluded income trusts and financial services firms to make the exercise more manageable. We also required that companies had a December fiscal year-end and a stock price over \$1.

Subject to the above screenings, we ended up with a total number of 406 companies in 1985-98 and 377 companies in 1999-2007.

As a first step, we formed quartiles by sorting stocks by price/earnings (P/E) ratios and then stocks within each P/E quartile were sorted by price/book value (P/BV). As is typical for this type of study, we defined the low P/E - low P/BV group of stocks as value stocks and the high P/E - high P/BV as growth stocks. This is the first step, or search process, followed in pursuing a value investing strategy.

To prevent problems from the inclusion of negative or extremely positive P/E and P/BV ratio firms, and eliminate likely data errors, we excluded negative P/E and P/BV ratios, as well as P/E ratios in excess of 150 and P/BV in excess of 20. In the first subperiod, this left us with 79 companies in the low P/E - low P/BV (value) basket and 85 companies in the high P/E - high P/BV (growth) basket. In the second subperiod, we ended up with 48 companies in the low P/E - low P/BV basket and 59 companies in the high P/E - high P/BV basket. We then compared the returns of the previously identified value stocks with those of the growth stocks.

We find that a strong and pervasive value premium existed in Canada over our sample subperiods. For 1985-98, the average annual value premium (i.e., value stock less growth stock returns) was 2.4 per cent. For 1999-2007, the average annual value premium was 16.6 per cent. The Sharpe ratio - an indicator of risk-adjusted returns - of the value stocks far exceeded the Sharpe ratio of growth stocks, indicating that the naively chosen value stocks of the first step had a better risk-adjusted performance than growth stocks over our sample subperiods.

We next focused on the low P/E - low P/BV stocks, which we carefully valued to identify the truly undervalued stocks and determine whether value investors add value by being able to find truly undervalued stocks from the universe of the possibly undervalued stocks identified during the search process. We estimated the intrinsic value of each stock in the low P/E - low P/BV group using both a balance sheet and a cash flow approach and a lot of strategic analysis.

Once the intrinsic value was estimated, the entry price was set at two-thirds of the intrinsic value, which factored in the margin of safety required by value investors. If a stock price was below the entry price, a decision was made to invest in this stock because the stock was undervalued. Otherwise, a decision was made not to invest in the stock for the following 12-month period. At the end of each 12-month period, stocks were liquidated and annual returns were calculated for this period. The process continued for every subsequent 12-month period. The total number of stocks found to be truly undervalued corresponded to 44 firms in the first subperiod and 33 in the second subperiod. Then, we compared the returns of the truly undervalued stocks to those of the naively chosen value stocks of the search process.

We find that value investors do add value, in the sense that their process of selecting truly undervalued stocks produced significantly positive excess returns over and above the naive approach of simply selecting low P/E - low P/BV ratio stocks. The average outperformance in subperiod 1985-98 was 1.10 per cent, while in subperiod 1999-2007 was 13.20 per cent. Again, the Sharpe ratio for the undervalued portfolios was higher (indicating better risk-adjusted returns) than for the naive portfolios.

To get a sense of absolute returns, the average annual return of the truly undervalued portfolio was 14.2 per cent in 1985-98 and 34.5 per cent in 1999-2007. The truly undervalued portfolio outperformed the naive value portfolio, as well as the growth and market portfolios, by a wide margin. This performance, on average, persisted over a 22-year period.

Francis Chou of Chou Associates Management had it right in his last speech to my value investing students: "What one should be looking for is a performance in the long run that beats the market on average." And he went on to show that he and other value investors beat the market about 60 per cent of the time. This is consistent with my findings.