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The Death of Value Investing?

It looks like another poor year for value stocks. Through mid-December, they have plummeted nearly 8% while growth stocks are essentially flat. This is on the heels of several years of underperformance. For example, in the past five years growth stocks have done nearly twice as well as value stocks. Looking back a decade, the growth stock index has just about doubled while value stocks are up a paltry 39%.

Some are arguing this is proof value investing no longer works. The economy is too fast moving and different from anything we have experienced before. Deflationary forces, Central Bank meddling, innovation, complexity and globalization are exposing a stark new reality: the old rules no longer apply. If you are not nimble, you will lose. Simply put, buying undervalued assets and then being patient, the essence of value investing, is from a bygone era.

It is quite understandable to question the value of value investing in light of recent facts. However, before dancing on the grave of value investing, let us consider how value investing works…and why it works. Taking the time to understand these factors may lead you to agree with my conclusion: that value investing not only remains relevant, but we may actually be on the verge of a multi-year period of outperformance. Let's have a look.

The issue of performance is tied to time horizon. Academic research shows value-investing works, but only over the long run. Tweedy Brown has an excellent piece, *What Has Worked in Investing*, on their website, http://tweedy.com/resources/library_docs/papers/WhatHasWorkedFundOct14Web.pdf. It is a summary of value-investing precepts and includes nearly all of the factors that I use for investing.

There are numerous studies showing why value investing works. Benoit Mandelbrot, one of the giants of 20th Century mathematics and a gadfly to Finance Academics, says the reason why it works is, "…just common sense: A stock for which you overpay from the start is less likely to give you a profit." Value investing also works due to simple math: value stocks have higher free-cash-flow-yields. Over the long run, this equates to higher returns.

Another way of thinking about why value investing works has to do with the "fear" premium it gives to investors. To reap the benefits of the premium and achieve satisfactory long-term results, there are two conditions that must be met:

First, you must be comfortable taking a contrarian position. In other words, you are buying things that others shun and avoiding what is popular. That is hard to do, but is necessary. Contrary to conventional wisdom, it means ignoring stock quotes, focusing solely on the underlying assets that the stock itself represents instead. It also means buying early and selling early.

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Second, as Yale's David Swensen says, "early looks a lot like wrong." It takes time to benefit from compounding cash flows, so value-investing requires patience. In fact, the secret to a successful investing life can be summed up as this: (1) buy quality, (2) do not overpay, and (3) be patient. We humans find this last part of the equation to be the most difficult.

So far, we have discussed why value investing generates positive absolute returns. It is also important to look at relative performance. In this context, recent value-investing underperformance is nothing new and an excellent study by Research Affiliates* confirms that factor investing (using time-honored strategies such as value investing) is a long-term mean-reverting process. They further show that most investors, particularly institutional investors, do not have the patience to benefit from this mean-reversion.

The latest example of a long-term mean-reversion cycle that works in value's favor started in the late 1990s, back in the days when the stock market was America's pastime. As is the case today, value stocks were cheap relative to the rest of the market, and had underperformed for many years.
Once the "dot.com" era ended, however, the reversion-to-the-mean adjustment started. The result? So far in this Century, value stocks are up about 80% versus a negative 6% return for growth stocks. During that stretch, a "Boglehead" who bought and held the S&P 500 Index fared even worse: a negative return of more than 20% over 15 years.

Value investing is somehow thought to be old-fashioned, although it only dates to the 1930s. By comparison, momentum investing can be traced to the 17th Century, technical analysis to the late 1800s, and growth stock investing to the 1920s. The Quants have been with us since 1900. The only old-fashioned thing about value investing is our belief that instant gratification is the result of luck, or a statistical fluke. It is the bedrock of a strategy to make the market your servant, not your master.

Now lets get to some solid examples. Two picks that I believe illustrate a contrarian mindset and which follow value investing precepts are the Gap Inc. and Boardwalk Pipeline Partners, LP. Both companies are in out-of-favor industries. There is a narrative that retailing has no future because Amazon is conquering the world. Pipeline companies are as cheap as they were during the financial crisis because of energy prices being at 11-year lows. Pessimism is rife in both industries.

The Gap sells private label merchandise online and globally through some 3,500 stores. Brands include The Gap, Old Navy, banana republic, Athleta and Intermix. Their business is intensely competitive and Gap has felt pressure from the likes of H&M and Zara. Nonetheless, Gap is well managed and enjoys a Return on Invested Capital of over 20% and Return on Assets of roughly 15%.

Gap is a "contrarian" opportunity with low valuation and heavy insider ownership. Only 6 of 38 financial firms have a buy recommendation on the stock according to S&P. Gap trades for only 10X earnings, or 40% cheaper than the stock market. It enjoys a free-cash-flow yield of 12%. The company pays an attractive dividend of $0.92 per share, for a 3.6% yield, but the payout ratio is only 40%, so that still leaves a significant sum to reinvest in the business and buy back stock. This is not a prediction, but it is noteworthy that the dividend has more than doubled over the past 5-years. The Fisher family owns 41% of the shares.

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One of the knocks against Gap is that it will not be able to grow. This is not news, as Gap has not grown for over a decade. Even if the pessimists are correct going forward, Gap can still be a good investment.

In the past decade, the company has reduced share count by some 52%, while also reinvesting in the business and paying a competitive dividend. The result? *Earnings-per-share* have grown on average by 11% per year during that time and its *dividend-per-sh*are has quadrupled. In other words, Gap has been a growth stock even though its business has stagnated. All because of its free-cash-flow.

Going forward, I believe it is possible Gap could actually grow its underlying business. The company has made investments in technology and has improved its supply chain. Athleta is a relatively new brand and could be an engine of growth. Gap is expanding in China, recently opened a store in India, and is well-positioned to serve the aspirations of the emerging middle classes of Asia where they currently have some 385 stores and growing. Here in the U.S., the various Gap brands remain the go-to place for consumers seeking casual basics at affordable prices. These consumers may start to spend their oil windfall now that lower oil prices have finally filtered down to them.

So long as Gap's business is thought to be "treading water," its shares will probably go nowhere. However, sentiment around Gap's growth prospects is so negative that any positive surprise would likely propel the stock much higher. My thesis is that the company could easily earn $4 a share within 5-to-7 years. If this is accompanied by some good news on the growth front, then a P/E multiple of 15X would not be out-of-line at all. That would make it a $60 stock.

Our other example, Boardwalk Pipeline is a Mid-Stream Pipeline Master Limited Partnership (MLP), and represents the potential for high future income streams and long-term capital appreciation.

Boardwalk is part of America's essential energy infrastructure. They move, gather and store natural gas in the US, operating over 14,000 miles of pipelines and underground storage caverns. The business model is that of a toll-taker with long-term, in many cases 18-year fixed-fee, take-or-pay contracts with mostly investment-grade customers. This firm should benefit from the trend of power companies replacing coal with natural gas.

Their core business is in transition, but it continues to generate robust distributable earnings. The MLP industry is out-of-favor—down some 46% this year—and Boardwalk is the cheapest stock in its peer group by far. Loews Corp, controlled by the Tisch Family, owns 51% and historically has been a good steward of long-term capital.

Many of the assets that comprise Boardwalk were put together before the "Shale Revolution," when North-Easterners mostly got their Natural Gas from the Gulf and the West. Over the past 5 years, discoveries in the Marcellus and Utica Regions created a sea change for the entire Energy Complex and Boardwalk was no exception: their pipelines run down the Ohio River to the Mississippi and fan out east and west from Louisiana. Although the pipelines are in an attractive location, the flow within the pipes reflects pre-"Shale Revolution" realities.

Some 22 months ago the firm said they needed to spend money to better position their assets to profit from the new realities. Some of the funding would come from a relatively modest capital raise, issuing some stock and some debt. But most of the money to pay for the multi-year project would come from

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internally-generated cash. The strategy is to fix the business with minimal equity dilution and to keep its investment-grade credit rating.

Their annual distribution was therefore cut from $2.13 a share all the way down to only $0.40. Nearly two years on, this transition appears to be going well and within budget. Most of the capital projects should be finished within 18 months, but it could take 2 years for the turnaround. Meanwhile, Boardwalk's Distributable Cash Flow yield is 11%. It is selling at a 25% discount to its book value.

Once Boardwalk's capital projects are completed in the next 18 to 24 months, the annual distribution of $0.40 should increase. Some analysts believe per unit distribution in 2017 will be $1.68 and grow from there. More pessimistic analysts are calling for an increase to only $1.49 within 3 years. But either scenario would represent a double-digit distributable yield based on the current share price.

Boardwalk is a publicly traded partnership and special tax rules apply. It generates a K-1, which some people find annoying and it is not suitable for retirement plans due to UBTI. We do not give tax advice so please consult your tax professional before investing. It is estimated that 80% of the distributions are sheltered from tax.

The Value Index used is the *iShares Russell 2000 Value Index ETF* (NYSEARCA:IWN) and the Growth Index is the *iShares Russell 2000 Growth Index ETF* (NYSEARCA:IWO). Index used for the S&P 500 Index is the *SPDR S&P 500 ETF Trust (NYSEARCA:SPY)*. *The Research Affiliates article, "If Factor Returns Are Predictable, Why Is There an Investor Return Gap?" can be found at https://www.researchaffiliates.com/Production%20content%20library/If%20Factor%20Returns%20Are%20Predictable_Why%20is%20There%20an%20Investor%20Return%20Gap_pdf.pdf

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