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INVESTMENT IDEAS

Time is right for value stocks

2008 is a year of opportunity, if you take the long-term view, writes **Carl Stick**

WARREN BUFFETT is quoted as having said: "You're neither right nor wrong because others agree with you. You're right because your facts are right." By contrast, an equity sales broker was recently overheard offering the following advice: "I don't know the company at all, but the hedge funds are all over it. So I suggest that you should think about selling."

Mr Buffett is fortunate in having time on his side – his investors are willing to wait for him to be proved correct – while the broker was vindicated by the subsequent deterioration in the share price of the company in question.

Financial markets display a surfeit of contradictions. For every buyer there is a seller; there are "bull" markets and "bear" markets; there are growth stocks and there are value stocks; there is globalisation and there is decoupling. Last year was a great year for mining stocks and the emerging markets; it was a terrible one for financials, housing stocks and property vehicles.

Growth was the buzzword, yet as we enter the third month of 2008, a gloom has descended, and we worry about a global recession.

In recently published research, James Montier, global equity strategist at Société Générale, described how in "the dash to trash and grab for growth", markets are failing to price in recession. Value stocks were out of favour throughout 2007, as investors chased growth as a hedge against inflation. However, if Mr Montier is correct, any pursuit of growth at this stage of the economic cycle is fraught with peril.

Market commentators often refer to a "reversion to the mean". In essence, growth stocks are afforded high ratings on account of their historic growth rates, and the extrapolation of these trends into the future. Yet, basic economic theory argues that industries enjoying such growth attract new entries and capital expenditure, and economic returns get competed away. Thus, growth rates tend to revert back to historic norms. Over-enthusiastic analysts then have to play "catch up", and share prices fall back as investors recognise that the period of high growth will not last long enough to justify the ratings once afforded.

In a recessionary environment, all these forces are accelerated. It has been argued that it is this forecast bias for growth, and the subsequent (dare I say, inevitable) disappointment, that are the principal contributors to the conclusion that value ultimately outperforms growth. Value stocks — that is those with low prices relative to book value; low prices relative to earnings forecast — are priced to disappoint, while growth stocks are priced to exceed expectations, despite the fact that this rarely happens across an economic cycle.

If value strategies are most likely to underperform during the last gasps of a bull market when, to quote Mr Montier again, investors "flail around looking for the hope of growth", we are now approaching the time of greatest opportunity for value strategies.

The key to much of this is timing. Hedge fund activity is clearly shortening the investment cycle. The leverage that hedge funds bring to bear exacerbates the reaction of a share price to news, or more pertinently, the prospect of news or rumour. Over the short-term then, investment return is based upon being on the correct side of a trade, not on fundamental valuation. Broking advice is reactive, because analysts are not incentivised to produce insightful research; instead, they are encouraged to generate deal flow.

Nevertheless, if one looks beyond the next three to six-month period, when markets are expected be very volatile, there is a large window of opportunity. Share prices will be weak, but in many cases, there will be an over-reaction. Value-investing means acquiring businesses on a long-term view, based upon an assessment of their inherent value. It is a process of risk reduction, whereby earnings risk is replaced by the insurance of balance sheet strength. Assets with an intrinsic worth are preferred to those with merely the promise of future earnings. One should look for industries where experts, the industry protagonists themselves, are buying assets. It is true that many of these companies are in consumer-oriented industries such as housing, property and leisure, where there is the risk of further disappointment.

However, in many cases, prices are already reflecting this, and are failing to recognise the strength of asset-backing. We are confident these shares will recover, and when that recovery happens, it will do so very quickly. This is in contrast to other sectors such as utilities and tobacco, where valuations – while recognising the defensive nature of these industries – are at historic highs, and yields are at historic lows. A sensible roadmap for 2008 might be to target large cap value early on, then to exploit opportunities away from the mainstream as the year progresses.

This will be a difficult year. However, we feel that there are strong similarities between now and the period after the dot-com bubble, when equity markets struggled for an extended period. Importantly, this period laid the foundations for so many value strategies.

The market will continue to get stories wrong; brokers will still ring up with short-term ideas, but long-term value investors will view 2008 as a year of substantial opportunity.

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