P E R S P E C T I V E

Never Has a Venial Sin Been Punished This Quickly and Violently![1]

February 19, 2020

We certainly know that contrarian valuation-based factor timing tilts are low Sharpe ratio strategies (very low short-term, somewhat better medium- to long-term) that are rarely immediately rewarded (few have such timing luck).[2] Thus, as you're all likely well aware by now as we keep repeating ourselves, we recommend "sinning a little" and only doing so at extremes. We wrote about (and implemented in the appropriate places) such a timing sin late last year, moving to a small overweight of the value factor (remember – value is only a part of our process). We only sinned a little (thank God for small favors!). Again, while we know such tilts are rarely, if ever, instantly rewarded, it's also rare for them to be instantly incredibly punished (simply because "incredibly punished" is, thankfully, a rare thing). Well, welcome to 2020.

To get a sense of the magnitude, let's start with the most basic data.[3] Take the Russell 1000 Growth and Value series starting in 1991. We consider this a pretty simplistic form of value investing, but it captures the core concept and is widely followed. From January 1st until February 13th of 2020 the cumulative daily return difference between the two is -6.4% (take a guess which one of the two was worse).[4] Comparing this period to all rolling periods of the same number of days going back to 1991, this difference falls below the 3rd percentile. Of course, that includes such famous events as the technology bubble of 1998-2000 and the GFC of 2008-2009. If you only look at 2010 to today, this is the zeroth percentile event. That is, in a decade quite bad for value investing, the start of 2020 is the absolute worst 6-week period.[5]

Doing the same comparison among small stocks (Russell 2000 value vs. growth) from 1993 onward yields nearly identical results. The results are the same—or even worse —if you use academic measures of value, including measures that are industry neutral.

The point is a simple one. Value has started 2020 with an extremely severe loss versus very long-term history, and, defined in a wide variety of ways, the worst loss yet (examining all of the same 6-week length periods) over the entire long 2010-2020 value drawdown.

So, what are we going to do? Well, when it comes to making big changes to the process, very little. It would be a fair critique to say that this piece is largely just "quantitative whining." First and foremost we're executing our preferred strategy of not making panicky changes to our process that would have (note the tense) alleviated recent pain. Nothing has changed save value has gotten cheaper this year. We will continue to watch the value spreads, and consider doing a bit more of a tilt if they ever, which we hope not to see but will persevere if necessary, get to tech bubble levels, or conversely if they remain high but are running into less of a negative trend headwind.

I have been a pooh-poohher (if that's not a word, it should be) of some who compare this current value pain to the tech bubble. We have found value spreads are quite wide today, but not tech-bubble wide.[6] Though I have to admit, while you don't come to me for my feelings about markets (I make no claim to be better than anyone else in this regard – and I don't think anyone is that great!), I will say comparisons to the tech bubble, in terms of seeing more radical events (no more slow steady losses for value, now it's very quick big ones!), and the widespread embracing by many of all the reasons (which they usually have never mentioned before) as to why value is never going to work again (my colleagues have a paper on this I hope to blog about soon), are converting me. It's getting very bubbly out there (number two here details how I try to use this word as little as possible – but more than I would've when emerging from the University of Chicago many, many years ago).

Again, our plan is to do very little. That doesn't mean we don't question everything constantly ("doing very little" does not apply to research into what's going on or trying, as we always are, to improve strategies). But, if that questioning doesn't result in damning evidence (again, the paper by my colleagues is forthcoming!), it means sticking with the process.

We've seen this movie before a few times and we know how, but definitely not when, it ends. We believe that sticking with the process is the only way to achieve the long-term gains we seek (and which won't always be provided by a long-only market that continues to levitate). We also know that sticking with something that's good through its occasional very bad times, and even acting as a contrarian when others are finding newly created (and creative) reasons to throw in the towel, is very difficult.[7] But this very difficulty is a large part of why we believe it's long-term rewarded, and much harder to arbitrage away than some seem to think. As they say, if something were easy, everyone would do it.[8]

[1] We had an amazingly similar experience of rapid punishment in the tech bubble. We published this "stick with value it looks better than ever" paper using data through November of 1999. The next three months were horrendous for value – like record setting horrendous with the tech bubble peaking with a blow-off top in March of 2000. Of course, in the paper we made it very clear we were making medium-term forecasts (we used a three-year horizon) and even with that horrendous start it did eventually work out kind of well for us and our clients…

[2] Though, despite bitter experience, the day after you put on such a tilt part of you does come in to the office genuinely expecting it to start working ASAP. We are all that naïve…

[3] To keep this simple, and because the message is the same, I only address the USA here. But the extreme value drubbing this year-to-date is a global phenomenon (Europe terrible, emerging markets terrible, Japan merely bad). I'm confident that were we to assess the rarity and extremeness of this year-to-date globally the results would be even more extreme than I document here. Also, the data here ends on Feb 13th. Updating it through today would be still worse.

[4] It rhymes with "schmalue".

[5] It's not precisely six weeks but I'm going to call it that as it's very close and much simpler to write.

[6] You will come across some research that shows value is even cheaper than the tech bubble. We've generally found these pieces to be using fairly cherry-picked value measures over strange universes and using odd portfolio construction. It's quite enough for us to be much of the way there without going full tech bubble…

[7] I often go further noting that changing your process, not because you're following some disciplined pre-specified plan (e.g., using trends, which we in fact do a bit in our alpha oriented multi-factor processes), but because you're in pain (of course, you never say you're changing because of the pain, it's always justified with some ex post research) is the only -5 Sharpe ratio strategy (gross, there are plenty of -5 net strategies! – and, of course, please don't take the -5 too seriously!) I've ever encountered (yes, this is an anecdotal observation, not data). If I could bottle it and do the opposite I would (it's hard to bottle the precisely calibrated point of human caving/rationalization!).

[8] It's ironic that one of the reasons some say value won't work anymore is it's too crowded and everyone knows about it. Uh, no. It's out of favor, hated, and cheap, even if widely known. If Yogi Berra was a value critic he'd say "that strategy is so popular nobody does it anymore."

described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.

Data information:

Russell indices, source: Bloomberg

The Russell 1000 Growth Index is a composite derived from the Russell 1000 Index that includes large and mid-cap companies located in the United States that also exhibit the growth investment style.

The Russell 1000 Value Index is a composite derived from the Russell 1000 Index of large and mid-cap companies located in the United States that also exhibit the value investment style.

The Russell 2000 Value Index is a composite derived from the Russell 2000 Index of small cap companies located in the United States that also exhibit the value investment style.

The Russell 2000 Growth Index is a composite derived from the Russell 2000 Index of small cap companies located in the United States that also exhibit the growth investment style.

HML series, source: AQR, AQR Data Library:

Pricing and accounting data are from the union of the CRSP tape and the Compustat/XpressFeed Global database. The universe is all available common stocks in the merged CRSP/XpressFeed data.

HML: book equity (BE) divided by current total market value of equity (ME). To obtain shareholders' equity we use Stockholders' Equity (SEQ) but if not available, we use the sum of Common Equity (CEQ) and Preferred Stocks (PSTK). If both SEQ and CEQ are unavailable, we proxy shareholders' equity by Total Assets (AT) minus the sum of Total Liability (LT) and Minority Interest (MIB). To obtain book equity (BE), we subtract from shareholders' equity the preferred stock value (PSTKRV, PSTKL or PSTK depending on availability). We assume that accounting variables are known with a minimum 6-month gap and align book price of the firm at the end of the firm's fiscal year ending anywhere in calendar year to June of calendar year

Fama French's HML: to compute book to market ratios, we scale BE by the ME at fiscal year end following Fama and French (1992, 1993 and 1996).

HML Devil: to compute book to market ratios, we scale BE by the current ME at the end of each month following Asness and Frazzini (2013).

Industry neutral: The intra-industry version ranks stocks within industries only so as to take no industry bets. The industry classification is based on SIC (Standard Industrial Classification) codes before 1986 and MSCI GICS (Global Industry Classification Standard) codes after 1986. The long side of each portfolio includes the best (cheapest) 30%, while the short side includes the worst (richest) 30%. The long and short sides are then market-cap weighted.

Hypothetical AQR Long/Short Factor, source: AQR:

The AQR Long/Short Valuation factor is a U.S valuation theme backtest utilizing the full set of underlying factors that compose the Valuation theme within AQR's Global Stock Selection strategy to evaluate stocks and create a long-short, market-neutral and industry-neutral equity portfolio based exclusively on these signals within the U.S. region. Within the composite of Value signals are: B/P, E/P, S/P, CF/P, and some other proprietary value measures. The Valuation Theme is designed to capture the tendency for relatively cheap assets to outperform relatively expensive ones. Backtest returns are gross of advisory fees and transaction costs from February 13, 2020 (when data is available). The backtest utilizes a monthly rebalancing schedule and target 7% annual volatility. The investment universe is U.S. large cap. The risk model used is the Barra U.S. Equity Risk Model (USE3L).

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