



FACTOR / STYLE INVESTING

Are Defensive Stocks Expensive? A Closer Look at Value Spreads

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For several years, many investors have been concerned about the rich valuation of defensive stocks and how that may crimp returns. We analyze the relative prices of these stocks using value spreads and find that they are not particularly expensive today.

More generally, valuations may be of limited efficacy in predicting style returns. We find that for most asset classes, cheapening valuations coincide with poor performance. However, this relationship turns out to be weaker for long/short factor portfolios where several mechanisms — such as changing fundamentals or evolving positions — seem to loosen the link between value spread changes and strategy returns. We illustrate this through a puzzling case where a defensive long/short strategy performed well when its value spread normalized from unusually rich levels.

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