Q & A:

Value Is In the Eye of the Beholder

George L. Smith III, CFA
Senior Vice President,
Member, Investment Policy Committee

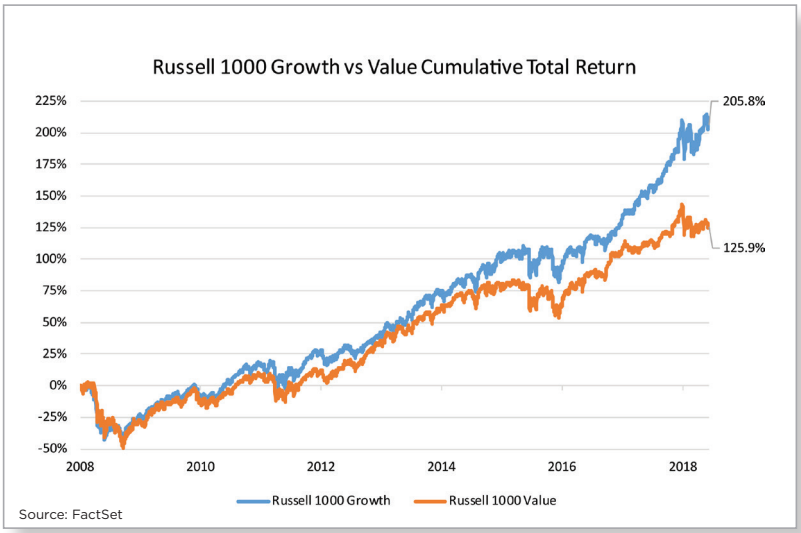
The numbers are staggering. Value investing has underperformed growth investing by a wide margin in recent years. This trend has continued with vigor thus far in 2018. George Smith weighs in on the potential in value investing.

What is value?

Investors have traditionally defined "value" stocks as those that appear cheap on a price/book or price/earnings basis. We think value is in the eye of the beholder. Put simply, we define it as buying something for less than its worth. It does not matter to us whether textbooks define a stock as "growth" or "value" so long as we think we are getting a good deal. Oftentimes, getting such a deal can entail having a differentiated perspective and a willingness to embrace a contrarian stance. A good growth story can also be a so-called "value" if investors are under-estimating the company's long-term earnings potential or overstating short-term headwinds.

Why has value lagged growth in recent years?

Value stocks have under-performed growth stocks by 61% since 2008 and have trailed in 7 of the past 11 years. We have been in a relatively low growth economic environment. Hence, investors have been willing to pay a premium for growth due to scarcity. The technology sector has been a market leader. FAANG (the acronym for Facebook, Amazon, Apple, Netflix and Google) appears to have become a household term. The popularity of these large cap technology leaders is understandable given their consistent growth and ostensibly unassailable dominance. However, we have also seen situations where other internet/technology companies have been dragged up alongside the juggernauts despite having less defensible competitive positions. Such companies may have near-term momentum, but their future positions are not nearly as certain as their stock prices seem to indicate.



What is the opportunity?

Investors gravitating towards momentum has coincided with an unwillingness to look at businesses facing headwinds, even if they are short-lived in nature. It has been easy to buy market leaders and enjoy the ride. We have even seen some so-called "value" investors start to take meaningful positions in tech leaders for fear of missing out. Shares of some neglected companies now seem to offer favorable risk/reward profiles. Put differently, the spread between the market's "haves" and "have nots" has widened. There are many cases where businesses are being materially disrupted (oftentimes by the aforementioned technology juggernauts) and should be avoided. However, there are also cases where good businesses are underpriced and worth a look. Our job is to identify such situations. We should also note that we are not necessarily negative on the tech sector. We just think some other stocks may also enjoy some sun at some point.

What causes this dynamic to change?

That is the million dollar question and a tough one to answer. Normally, these cycles ultimately revert to a mean. The most recent, and extreme example, is the collapse of the tech bubble in the early 2000's and subsequent outperformance of value investing. A notable difference is that today's market darlings are much more profitable than those that fueled the bubble. However, there is a common thread wherein investors are often dismissing shares of companies that lack current momentum. There is an old saying that "good things happen to cheap stocks". At some point, we should see buyer exhaustion for the FAANGs and other areas should pick up steam, especially if economic growth accelerates.

How have Davenport's portfolios reacted to this environment?

We have maintained our approach to investing. We go wherever we see value. Our strategy can entail "leaning into the wind" when we deem necessary. In other words, we are willing to be contrarian and look at stocks that are out of favor. This approach can require patience, but can be lucrative over time. The current momentum-oriented environment seems to be broadening our opportunity set.

If you have any questions about the topics covered in this handout, contact your Davenport Investment Executive or call (800) 846-6666.