FIRST QUADRANT

FQ INSIGHT:

The Valuation of Value

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SOME VALUE MEASURES LOOK STRETCHED

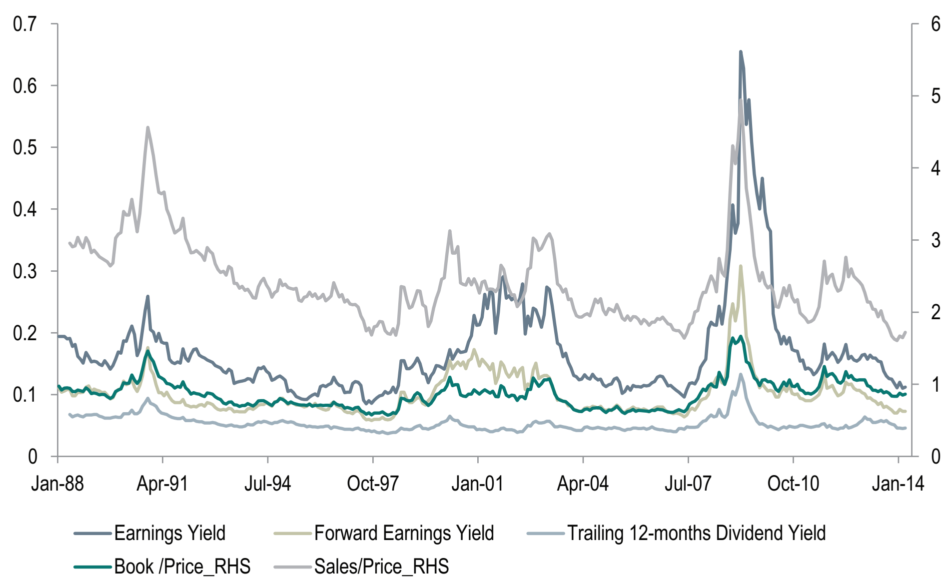
Stock markets in the US rallied strongly in 2013, substantially outpacing fundamental measures of corporate performance such as earnings growth. While the overall market became more expensive over the course of 2013, whether the market is overvalued on a longer term perspective or compared with other asset classes is a matter of heated debate. With respect to FQ's investment process, we also monitor the valuation of segments within the equity market, which has prompted concerns about some value measures.

EXHIBIT 1 shows valuation spreads for 5 value measures.[1] While none of the value measures we track looks cheap, we find that sales/price (S/P) and forward earnings/price (FE/P) are notably expensive compared to history. The spreads between the cheapest and most expensive quintile of stocks ranked on those measures are unusually compressed. This suggests that opportunities to generate alpha by emphasizing low S/P and FE/P stocks have diminished.

EXHIBIT 2 shows a z-scored version of the same valuation spreads as in EXHIBIT 1.[2] With z-scoring, we can compare more directly variables that have different average values and variability.

EXHIBIT 1: VALUATION SPREAD FOR VALUATION FACTORS

(January 1988 - March 2014)

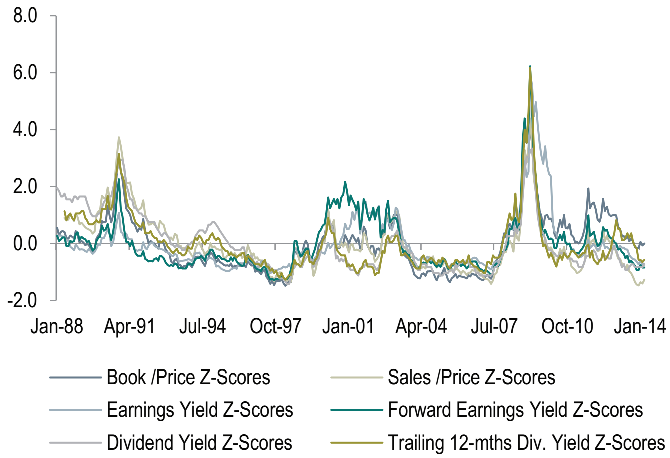


Sources: First Quadrant, L.P., Russell, MarketQA, Compustat, I/B/E/S

Past performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss.

EXHIBIT 2: VALUATION SPREAD FOR VALUATION FACTORS

(January 1988 - March 2014)



Sources: First Quadrant, L.P., Russell, MarketQA, Compustat, I/B/E/S

The spreads for S/P and FE/P are currently as compressed as they have been over the last 25 years. Trailing earnings/price (E/P) is also compressed. Book/price is close to its 25 year average.

While valuation is important for assessing the future prospects of value strategies, other factors matter, too, such as the business cycle and investor risk aversion. These latter influences have been somewhat more positive for value strategies. Loose monetary policy appears to have lowered investor risk aversion, and encouraged flows to riskier asset classes and riskier segments of the equity market, including value stocks and small companies. Gradual improvement in economic conditions also supports value over growth stocks as investors become less fixated on solvent companies with robust income streams – qualities more often found in growth stocks – and more interested in hunting for bargains.

Our research shows that, much of the time, business cycle and risk matter more than valuation in determining whether value measures are successful. Nevertheless, the valuation spread may be viewed as a kind of margin of safety for value strategies. While a highly compressed valuation spread may not be the catalyst that drives a reversal of factor performance, it reduces the potential reward and increases the risk of value exposure.

According to our analysis, there is a modestly predictive relationship between valuation spreads and subsequent performance of value strategies. When valuation spreads are unusually compressed, the subsequent performance of value strategies tends to be weak. On average, the relationship is modest, although it appears to be stronger when valuation spreads are unusually narrow or unusually wide.

Our investment process uses a composite of several value measures, including the ones we singled out here as having unusually compressed spreads, S/P and FE/P . In December, after a year in which the performance of those value measures was strong, we decided to reduce by 50% the weight of value factors in the investment process, for reasons covered above. Lacking a catalyst, we were not predicting a reversal in the performance of value, but believed that the potential for further reward from value had eroded.

The value factors in our investment process did undergo a period of negative returns, but as the exhibits show, not enough to make much of a difference to the narrow valuation spreads. Many of the conditions that propelled the market last year are still in place, although valuations are more stretched and investor sentiment has improved. For now, we maintain a reduced level of exposure to value (though still positive), and wait for further increases in valuation spreads or the appearance of another catalyst.

Endnotes

[1]The way we assess the valuation of a factor such as S/P is by monitoring the valuation spread. We compute the valuation spread by ranking all of the stocks in the Russell 1000 by the valuation measure we are interested in, e.g., S/P. The next step is to calculate the average S/P of the stocks in each quintile, then subtract the average S/P of the most expensive quintile from the average S/P of the cheapest quintile. We make this calculation every month, and compare the current spread with its history. If the current spread is wide compared to history, then there are big valuation differences between the cheapest and most expensive stocks, which suggests that there will be opportunities to make money by purchasing cheap stocks and selling expensive stocks. If the current spread is narrow compared to history, this implies that there are fewer opportunities to make money using valuation, and that the risk of losing money from valuation positions has increased.
[2]To z-score a time-series variable, we take the variable at each point in time, subtract its average value over the time period and divide by the variable's standard deviation.

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