

Boston Partners

Value investing's five principles that have stood the test of time

Boston Partners Senior Portfolio Manager Mark Donovan looks back on his experience spanning decades to highlight the universal truths that can guide all investors in a transitioning market.

There are few phrases in finance that are more tired, simple, or consistently proven false than the assertion that 'this time, it's different'. And more than 85 years after Sir John Templeton identified these as the four most costly words in finance, the only things that have changed have been the reasons cited to explain why one market boom is any different or more rational than the market cycle that preceded it.

In the 1980s, the junk bond-fueled leveraged buyouts were supposed to revolutionize how stocks were assessed and valued; in the 1990s, the dotcom boom was premised on a misbelief that metrics like P/E ratios no longer mattered; and the speculative excesses that led to the 2008 financial crisis were set in motion by complex fixed income derivatives that could supposedly de-risk and democratize the credit markets.

More recently, the unforeseen events of a global pandemic derailed high multiple momentum-driven stocks which investors piled into over the past few years with a disregard for valuations. These days, the 'this time, it's different' crowd is quick to cite either digital disruption or the rise of passive investing to support fresh claims the old rules don't apply.

Revisiting the founding principles

Given the clockwork-like cyclicity of these pronouncements, though, it can be worthwhile to regularly revisit investing's five foundational principles. In our experience, the following five fundamental truths

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have stood the test of time, even as these principles seem to be discounted during temporary bouts of market irrationality. These unspoken rules, that have been proven time and again, can also serve as a valuable reminder that mean reversion is to finance what gravity is to physics.

This is not to say that markets can't evolve. The growth of passive investing, for instance, has certainly elongated market cycles. But over the past 40 years – having invested across varying market conditions and amid periods marked by technological breakthrough – it's clear that certain principles are as true today as they were a century ago.

The future is unknowable

The fact that we cannot predict the future is perhaps the most obvious of these fundamental truths. What makes this point particularly relevant today is the research-driven arms race being waged across the asset management industry to gain any edge, however fleeting or illusory.

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This may have hit a peak last year, with the launch of an AI-driven hedge fund that pays data scientists in cryptocurrency to crowd-source updates to its algorithmic, machine learning model. But even spreadsheets can become a dangerous diversion when they feed into overconfidence. The ease with which analysts can create elaborate forecasts, incorporating an endless number of currency assumptions, oil-price scenarios, or a range of monetary-policy possibilities creates to a paradox of choice. And rather than offering any clarity, this forward-looking scenario-building adds to the noise and generally distracts more than it divulges.

Bottom up beats top down

Related to the idea that the future is unknowable is the fact that many investors can pay undue attention to macroeconomic factors. It's not that investors shouldn't be aware of what's going on in the economy or understand how it can influence an investment thesis; it's just that the odds are stacked against those who claim to have any unique insight.

There is a considerable amount of literature, for instance, that has documented the challenge of trying to predict economic trends. The Brexit referendum vote, which took the markets by complete surprise in 2016, provided yet another example. But even after economists learned from the outcome, they proved to be no better at forecasting how it would impact growth. In fact, the Bank of England's original GDP forecast for 2017, preceding the vote, was closer to the actual number than their updated projection, when they ostensibly had more information to work with. The point is that it's not just the 'unknown' unknowns, like the Covid-19 pandemic, that make macro predictions so unreliable.

And from an investment perspective, what makes macro strategies even harder is that accurate forecasts, however rare, still offer no guarantees as to how the markets will ultimately react. In the US, one study showed that the average mutual fund investor underperformed the S&P 500 by 470 basis points for the year in 2016 following Donald Trump's victory in the general election. A flight to safety following the vote left investors underexposed to the ensuing rally that caught many unaware.

Management matters

Naturally, the inverse to relying on the 'unknowable' to inform strategy is to focus intently on the variables that are both discernible and can be quantified. This is why true value investors take a bottom-up approach to security analysis and scrutinize, in depth, company fundamentals, business momentum and catalysts for growth. What shouldn't be overlooked is the role of strong governance and capable management.

This is an area that has improved exponentially for public companies, post Enron. That's not to say that lapses in governance don't occur. The collapse of UK construction company Carillion demonstrated this back in 2018. But with greater regulatory scrutiny and the growth of the activist investor universe, directors are far less likely to rubber stamp new initiatives and will be quicker to demand accountability when companies underperform.

It's also a misconception to think management assessments are purely a subjective exercise. What can be most telling, and complements regular executive meetings, is the analysis that goes into how management deploys available cash flow. At a high level, there are generally five alternatives. From an operational perspective, it comes down to the historic 'buy versus build' question, as capital can be deployed to either fund organic capital investments or in the pursuit of mergers and acquisitions. When these paths don't offer a compelling return-on-investment, cash flows should be

used to pay down debt or can fund stock buybacks and shareholder dividends. It's in these decisions that management teams tend to betray their skillset, vision and temperance.

Games are lost, not won

Just as we expect company management teams to exhibit discretion in their pursuit of growth, the same philosophy applies to investors. Increasingly, for instance, many 'stock pickers' have shown a tendency during extended market runs to abandon fundamental analysis in favor of momentum strategies. They will pile into stocks that are already winning, and becoming increasingly expensive, in the hopes they will continue to win. The growth of ETFs and index funds has only amplified this trend, as investors, without any analysis at all, will move in and out of broad categories to gain exposure to thematic trends, and valuations be damned.

The problem with momentum strategies is two-fold: for starters, while momentum can certainly work as long as stocks keep winning, investors expose themselves to sharp reversals when fortunes turn. Witness Tesla's market cap drawdown since its peak in January this year of USD 880 billion to USD 557 billion at the time of writing. This underscores why value investors are so focused on finding a margin of safety. Plus, momentum ignores a fundamental truth about long-term investing: value matters.

Stay true to philosophy and process

Make no mistake, the period between 2017 and early 2020 wasn't necessarily easy for value investors. The monetary stimulus coming out of the great financial crisis coupled with fiscal stimulus in more recent years has driven asset prices ever higher. In this environment, investors simply need to be in the market, in any capacity or anywhere within it, to generate returns. And this is driving the more desperate fund managers to dial up the risk to justify their fees.

When we begin to hear the detractors start to screech that value or fundamentals no longer matter, this is typically a sign to double down on our philosophy, which has proven itself throughout time. We're already seeing that the next value cycle has begun to take shape and high multiple momentum-driven stocks are lagging in this pro-cyclical, value environment as the economy re-opens from the pandemic.

Our approach is, and will remain, the same regardless of the backdrop, because when we get the fundamental story right, and craft a portfolio of companies showing attractive value characteristics, strong business fundamentals and catalysts for growth, we can eliminate the uncertainty of trying to find a new path. To quote World War II general Omar Bradley, we like to set our course by the stars, not by the lights of every passing ship.

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