CORNERSTONE
INVESTMENT PARTNERS, LLC

July 2020

A Generational Opportunity for Active Value Investors

Executive Summary

Value Underperformance Exceeds The Tech Bubble

Value-oriented strategies have underperformed core and growth strategies for thirteen years (Q2 2007 – Q2 2020). The magnitude of the underperformance has exceeded what occurred in the four years from Q1 1996 – Q1 2000.

Valuation Discrepancy Alarming

As a result, value stocks trade at a greater discount to their higher growth counterparts than they did at the peak of the internet bubble in March of 2000.

A Rare Opportunity To Buy Value Stocks

The extreme discount at which value stocks trade has created an exceptional opportunity for value-oriented investors to deliver relative outperformance. Our analysis suggests that the current opportunity for our strategy is the kind that only arises a few times in a career.

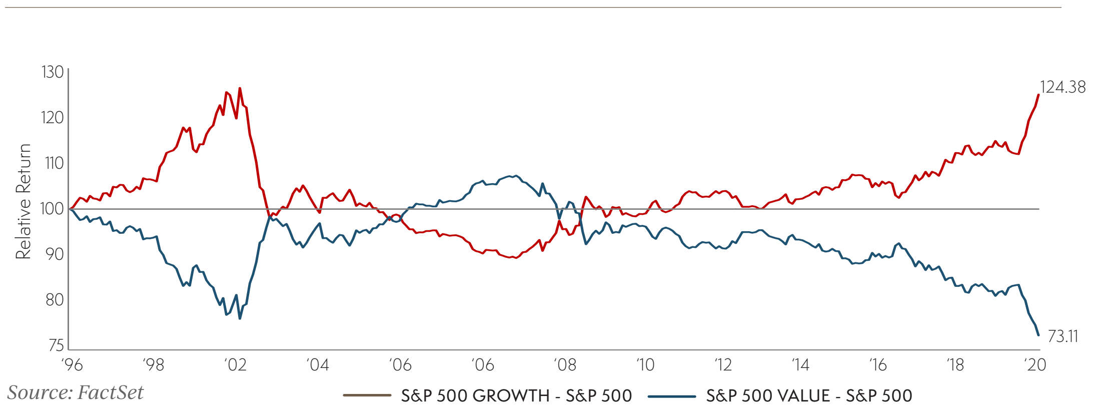
Why Value Now?

In October of last year, we wrote a thought paper explaining why we found the opportunity for value-oriented investors particularly attractive. Clearly, we were early. While value stocks held their own through the end of 2019, the global COVID-19 outbreak has led to growth stocks materially outperforming value stocks this year to date. Since growth stocks were already trading at a sizable valuation gap to value stocks, the outperformance of growth has widened the gap to historic levels. To be clear, the width of the valuation gap alone does not tell us when inexpensive stocks will begin to outperform their more expensive counterparts. Instead, it provides insight into the potential magnitude of the reversal. Ironically, the COVID-19 crisis itself suggests to us that now may be the time for value stocks to outperform. In past crises, value stocks have delivered material outperformance in the years following a crisis as the market looks through the crisis and augurs resolution. While we cannot be certain of the timing, no one can, we believe that the probability and potential magnitude of a recovery in value stocks has risen since last October.

History Rhymes

The past thirteen years have been brutal for value-oriented investors. The magnitude of under-performance experienced by value stocks has now exceeded the four years leading up to the burst of the internet bubble in March of 2000. The fact that it has taken thirteen years, rather than four, has made the experience more difficult to tolerate for value-oriented investors. It has felt like a slow drip with no abatement rather than the quickly-rectified deluge that took place over two decades ago.

Figure 1: Relative Return of Value Stocks versus Growth Stocks



Source: FactSet

The Greatest Value in Value

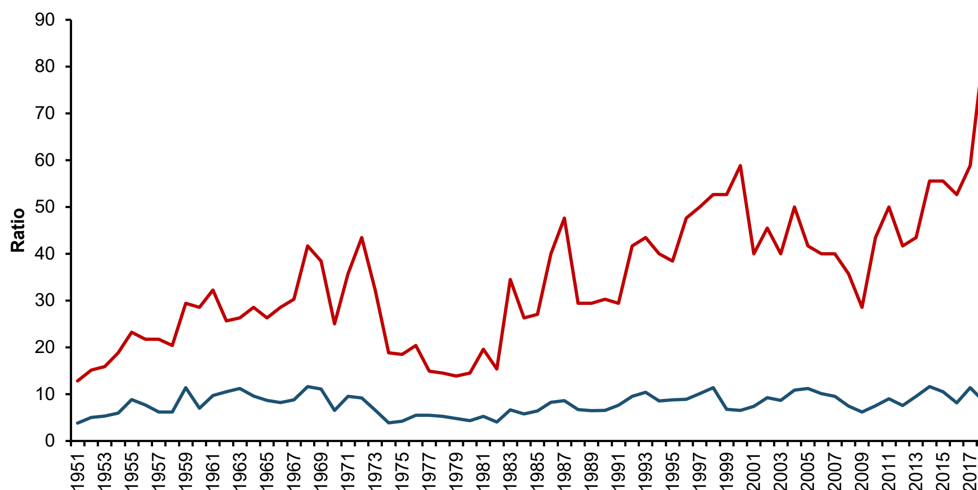
This extended period of underperformance has created a global market where value stocks now trade at a greater discount to growth stocks than they have since the peak of the internet bubble in March of 2000. The data from StarCapital support this assertion.

Figure 2: Growth Valuation Premium to Value

Market Indices May Underperform the Average Stock

For all of the talk that stock market indices are expensive, there are plenty of inexpensive stocks in the market today. That is not unusual. What is unusual is the substantial premium that expensive stocks have garnered relative to less expensive stocks. In fact, this disparity between expensive and inexpensive stocks is the widest it has been in the last several decades, including the internet bubble. We believe that allocating capital to expensive stocks, through both active and passive strategies, places investors at significant risk of permanent capital impairment. The Nasdaq 100 fell over 80% in less than three years after the internet bubble burst in 2000. It is entirely possible that the S&P 500 could decline in value over the next few years, while the average stock finishes higher.

Figure 3: Trailing Price-to-Earnings Ratio for Cheapest and Most Expensive Quintiles of the Market



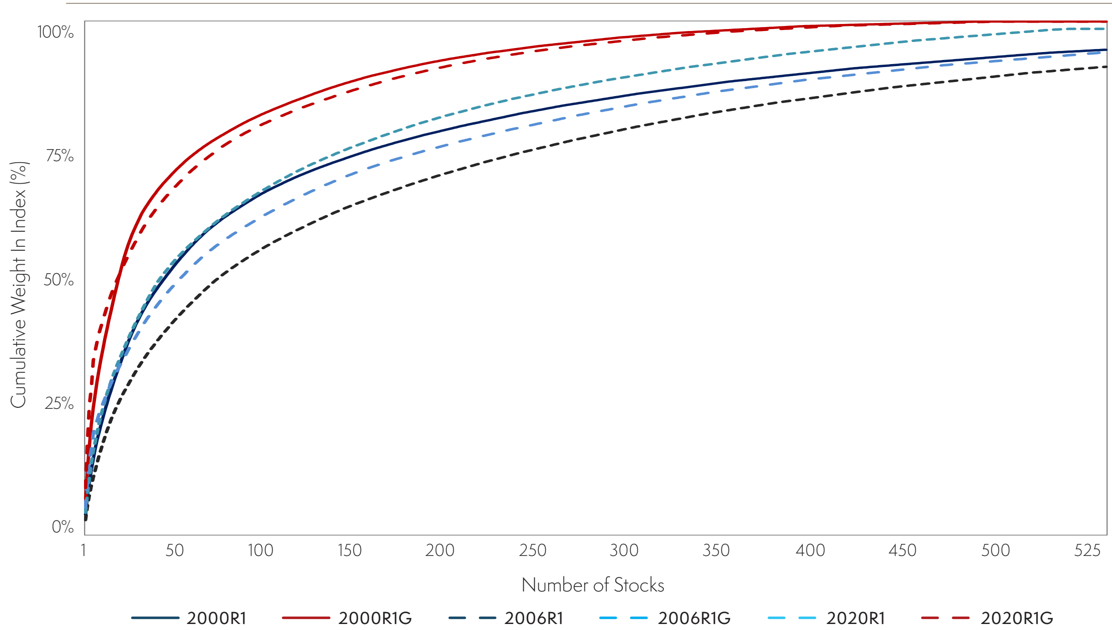
Source: Ken French Data Library, Bernstein analysis

Index Concentration at Extreme Levels

The dominance of growth stocks over the past thirteen years has generated levels of index concentration not seen since the peak of the internet bubble. The current concentration level of the Russell 1000 Growth Index is comparable to the level reached in early 2000 and a similar statement can be made for the Russell 1000 Index. As index performance continues to be driven by relatively few concentrated names, the concentration in the indices becomes greater.

Market indices are not always so concentrated. Both indices were significantly less concentrated in 2006 after a period of material outperformance for value-oriented stocks. In the late 90s and first quarter of 2000, we saw that investors allocated capital to indices dominated by small numbers of expensive stocks exposing investors to significant risk as enthusiasm for those stocks deteriorated later in 2000. With levels of concentration now looking eerily similar to 2000, we recommend that investors be fully cognizant of the underlying risks to passively investing in index funds or even active managers who do not have high active share in their portfolios.

Figure 4: Market Concentration Measured by Cumulative Percentage of Largest Names in the Indices

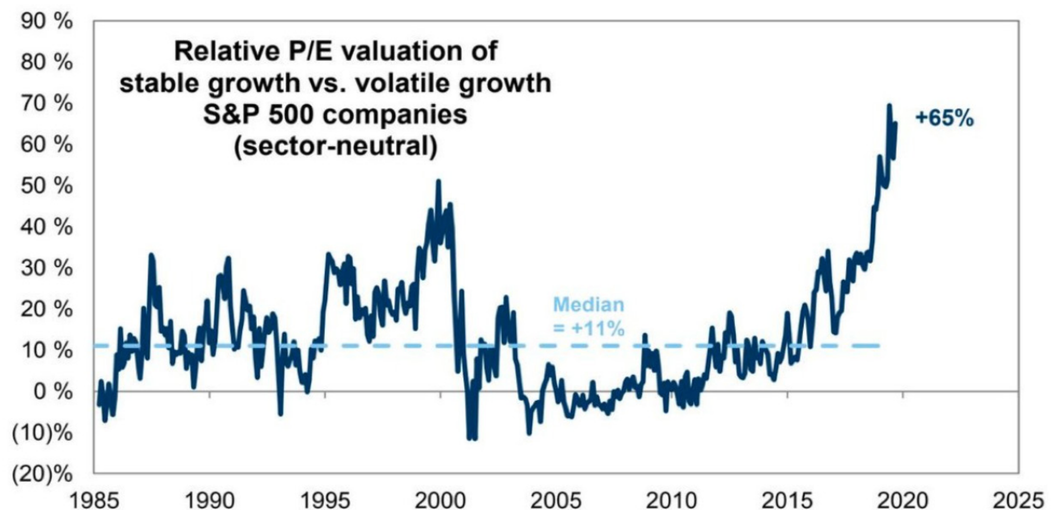


Source: Bloomberg

It's Not Just The Tech Stocks

While technology names headline the list of expensive companies, many stocks perceived to offer stability are also expensive. The below chart from Goldman Sachs suggests that stocks offering "stable" growth trade at easily the highest premium to stocks offering "volatile" growth in the last 30 years. It's fair to say that stable companies deserve a higher multiple than volatile companies. But, to what extent? Additionally, expensive companies that prove less stable than previously perceived offer significant potential for multiple compression and capital impairment.

Figure 5: Investors are Paying an Exceptional Premium for Stability



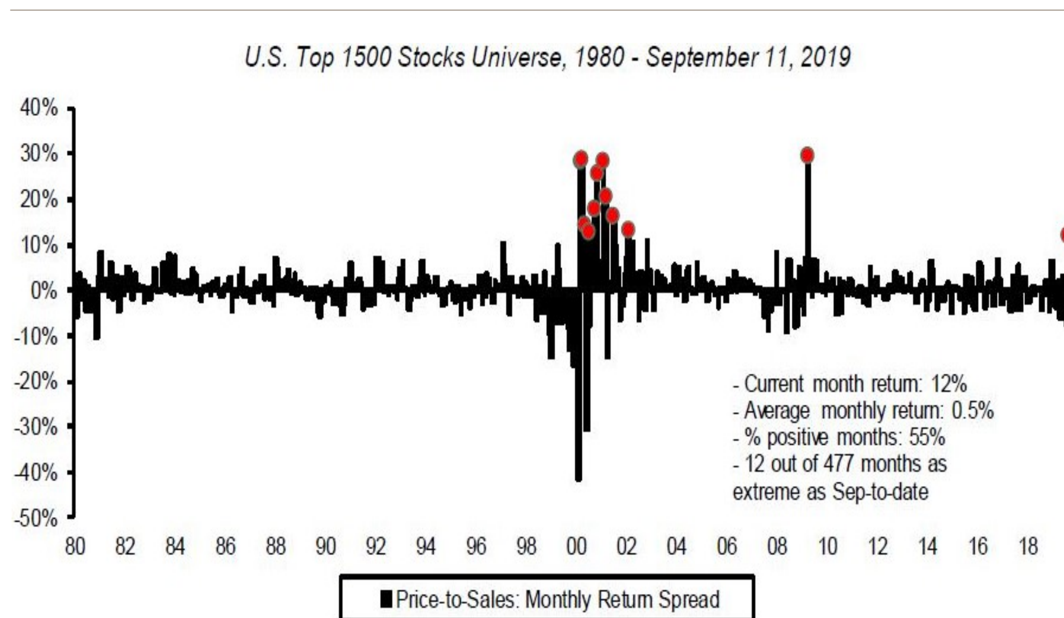
Source: FactSet, I/B/E/S, Goldman Sachs Global Investment Research

Past performance does not indicate future results. As with all investments, the possibility for profit is accompanied by the risk of loss.

The Shift Toward Value May Be Swift & Severe

In the past, value rebounds have occurred swiftly and with great severity. Last September, value experienced a period of significant outperformance, albeit short-lived. Bernstein analysis suggests that the market's behavior during September appeared similar to its behavior following the burst of the internet bubble, based on the rare width of the return spread between cheap and expensive stocks. Value-oriented stocks experienced another resurgence in May and early June which, like September, proved to be a false start. It is always unclear when the market is going to turn until after it does. Investors who wait may be holding expensive stocks that go down and have to pay higher prices for value stocks to reposition.

Figure 6: Monthly Returns Spread Between Least Expensive to Most Expensive Quintile



Source: Bernstein analysis

Value Stocks Have Historically Outperformed Following Crises

Historically, value stocks have delivered material outperformance following periods of crisis. The below data from Verdad Advisors suggest that the cheapest stocks in the market have historically outperformed their more expensive counterparts following periods when the high-yield spread has been elevated for thirty days or more. The global COVID-19 outbreak is a human and health crisis first. However, it has also created a rare opportunity to own inexpensive stocks. The 30-day moving average of the BarCap US Corporate High Yield YTW 10 Year Spread widened to nearly 9%, which is a level only seen over the past 33 year years in the Global Financial Crisis, the Dot Com Bust, and the Gulf War.

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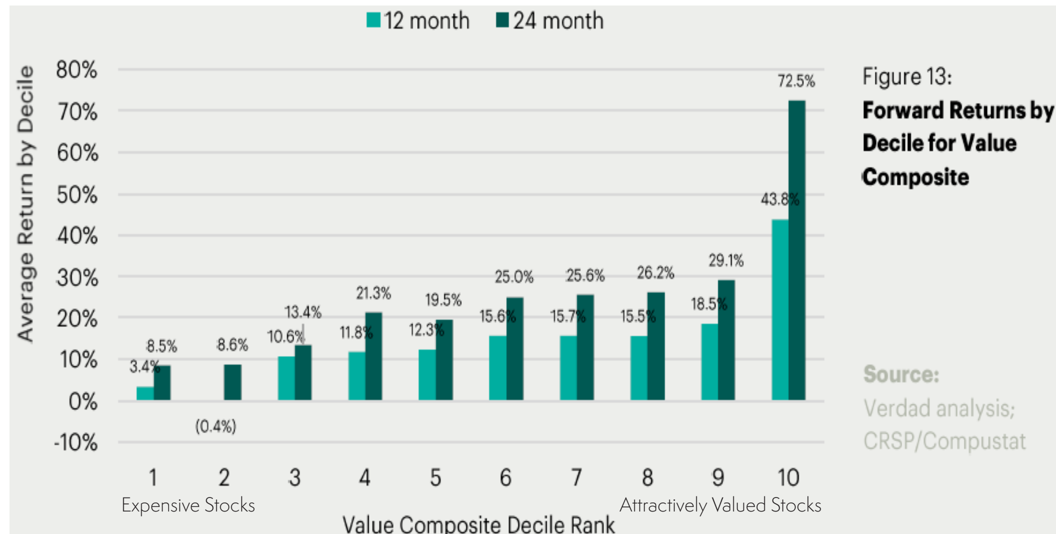
Figure 7: Cheapest Stocks have Outperformed following Elevated High Yield Spreads



Selectivity is Crucial - The Case For An Active Approach

We think it is critical to understand what you own and to understand the risk of those holdings. While the opportunity set for value-oriented investors is the most robust it has been in twenty years, it does not mean that all value stocks are set to outperform. Some stocks are inexpensive for good reason and may offer more downside risk than potential reward. Likewise, some of the expensive stocks will likely deliver strong returns going forward. Our analysis indicates that avoiding the losers among inexpensive stocks is more controllable and less risky than picking the winners among expensive stocks.

Our Promise

Our Investment Process allocates capital to high-caliber companies that trade at discounts to our conservative estimates of their intrinsic value. We believe that overpayment is the greatest risk an investor can take, as it increases the probability of permanent capital impairment. Our value orientation and our long-term investment horizon serve as our strategy's two greatest advantages, and we have designed our entire firm to ensure that we do not waver during periods of stress. Instead, we remain steadfast in our commitment to our value-oriented strategy.

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The Cornerstone Fair Value Model

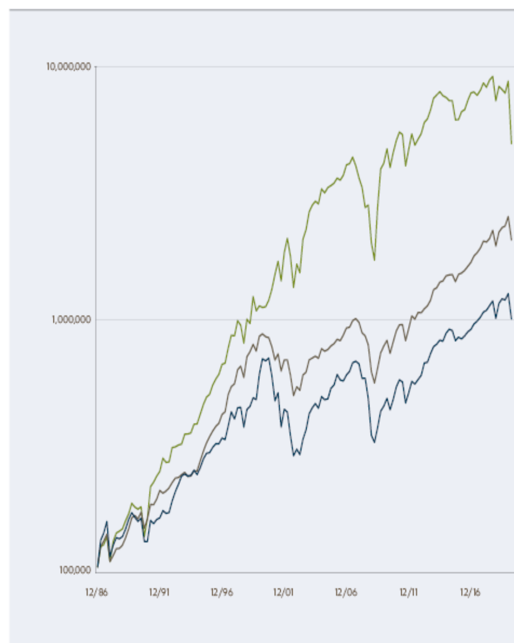
Our process utilizes our proprietary valuation tool, the Fair Value Model, to ensure that that our portfolio is composed of inexpensive stocks. Historically the most inexpensive stocks in our investable universe have delivered the highest long-term investment returns. Buying inexpensive stocks has historically been a successful investment strategy. However, it requires investors to maintain a long-term time horizon and to continue implementing the strategy during periods of underperformance. Our Fair Value Model helps ensure that we maintain our focus on inexpensive stocks regardless of what investment strategy is currently in favor in the broader market. We have recently created a client-facing version of our valuation tool and would love to provide you with access to it.

We believe that the current opportunity for our strategy is the kind that only arises a few times in a career and that we are well positioned to capitalize on this opportunity.

Fair Value Model

A proprietary system that uses rules-based, fundamental analyses to set a range of expectations as to what a stock is reasonably worth.

Our system creates an insight advantage with weekly assessments of company valuations for a broad stock universe, analyzing multiple time calculations for value to identify potential mispricings.



Cornerstone's Fair Value Model Results Spanning Decades

Most Attractive Quintile
$5,199,771
(12.6% annualized return)

S&P 500
$2,115,521
(9.2% annualized return)

Least Attractive Quintile
$1,011,889
(7.2% annualized return)

Justin Scott, CFA

Investments

Justin is a Partner for Cornerstone and is responsible for research and portfolio management. Prior to joining the firm full time, he interned at Cornerstone during the summer of 2013. Previously, Justin was an Investment Analyst on the Fund of Hedge Funds Investment Team at Neuberger Berman, where his responsibilities included manager sourcing and selection, portfolio management, and foreign exchange hedging. He graduated Magna Cum Laude from Middlebury College with a BA in Economics and a minor in Mathematics. Justin received an MBA, with honors, from the Wharton School at the University of Pennsylvania, majoring in Finance.

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