CORNERSTONE
INVESTMENT PARTNERS, LLC

November 2019

A Generational Opportunity for Active Value-Oriented Strategies

Executive Summary

Value Underperformance Similar To The Tech Bubble

Value-oriented strategies have underperformed core and growth strategies for over twelve years (Q2 2007 – Q3 2019). The magnitude of the underperformance is similar to what occurred in the four years from Q1 1996 – Q1 2000.

Valuation Discrepancy Alarming

As a result, value stocks trade at the largest discount to their higher growth counterparts that we have seen since 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.

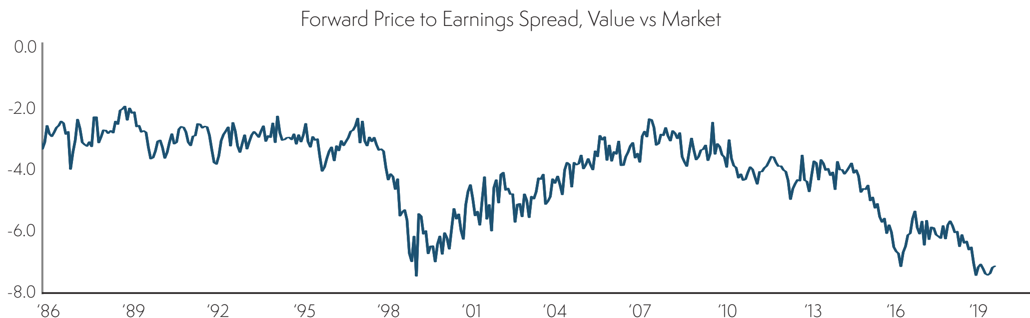
History Rhymes

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

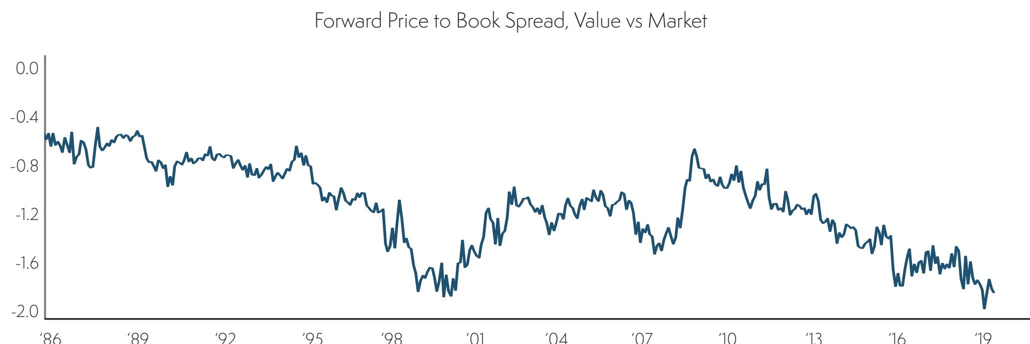
Source: FactSet

The Greatest Value in Value

This extended period of underperformance has created a market where value stocks now trade at a greater discount, on a relative basis, than they did during the peak of the internet bubble in March of 2000. The below data from JP Morgan suggest that this is the case based on both earnings and book value.



Source: JP Morgan



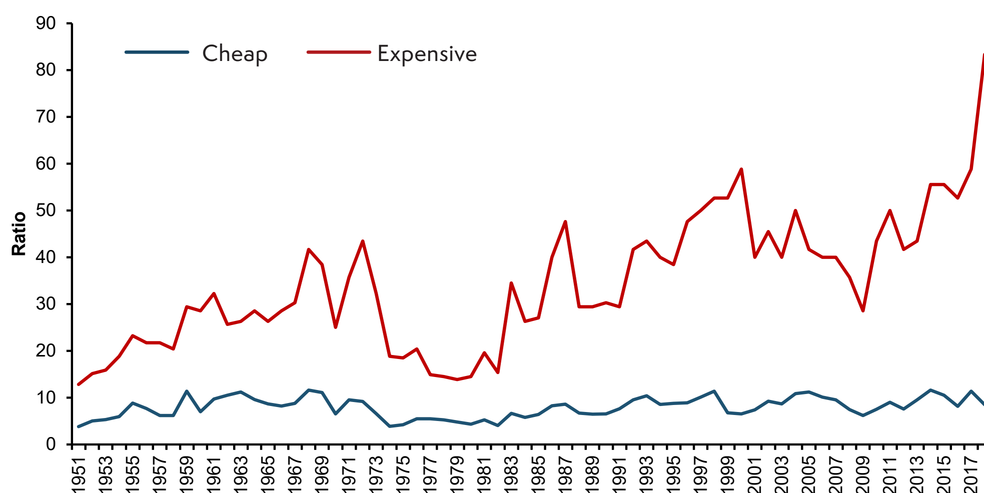
Source: JP Morgan

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

Buying Market Indices May Underperform the Average Stock

For all of the talk that stocks 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 by far the widest it has been in the last several decades, including the internet bubble. Interestingly, the expensive stocks have received this premium despite lower growth expectations, as Wall Street consensus estimates indicate higher revenue and EPS growth expectations for the Russell 1000 Value index than the Russell 1000 Growth index over the next two years. 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 a core index could decline in value over the next few years, while the average stock finishes the period higher.

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



Source: Ken French Data Library, Bernstein analysis

It's Not Just the Tech Stocks

While technology names headline the list of expensive companies, stocks perceived to offer stability are also extremely 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 more stable companies deserve a higher multiple than more volatile companies. But, to what extent? Additionally, companies that prove less stable than previously perceived offer significant potential for multiple compression and capital impairment when they trade at such lofty prices.

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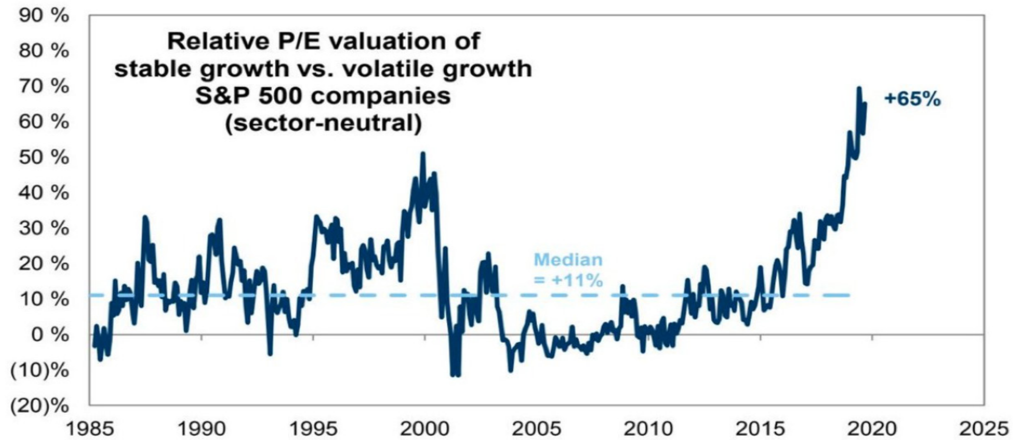
Investors are paying an exceptional premium for stability

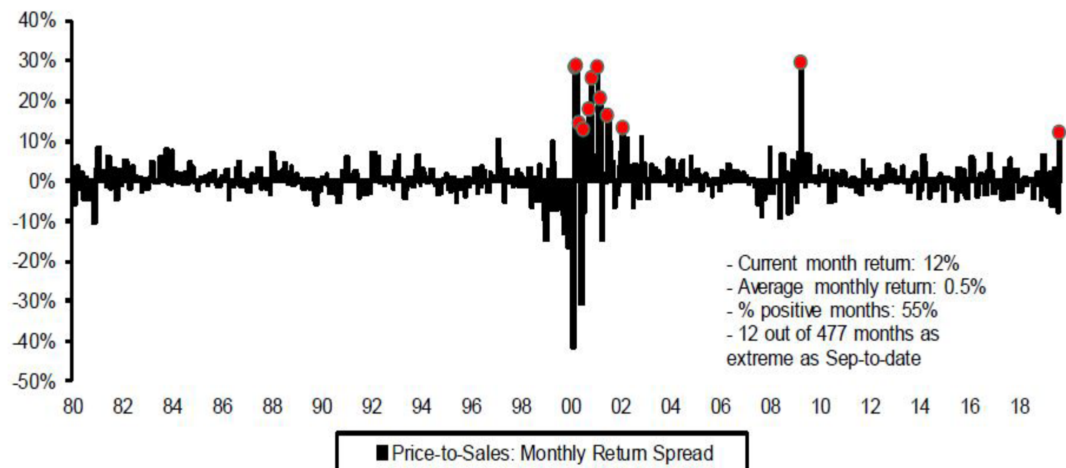


Source: FactSet, I/B/E/S, Goldman Sachs Global Investment Research

The Shift Toward Value May Be Swift & Severe

In the past, value rebounds have occurred swiftly and with great severity. During September 2019, value experienced a period of significant outperformance, if short-lived. Bernstein analysis suggests that the market's behavior during September appeared similar to its behavior following the burst of the internet bubble. Only time will tell if September was the beginning of a more pronounced market move in favor of value or a false start. However, it is often unclear when the market is going to turn until after it does, and investors who wait may be holding onto expensive stocks that go down and have to pay higher prices to reposition.

Price-to-sales factor has run up by 12% September to date, a magnitude that we have only seen 12 times over the past four decades, clustered around the tech bubble aftermath and the financial crisis



Source: Bernstein analysis

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Selectivity is Crucial - The Case for an Active Approach

We think it is critical to understand what you own. 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 easier *and less risky* than picking the winners among expensive stocks.

Our Promise

Our Concentrated 30 strategy 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. We have designed our entire firm to ensure that we do not waiver during periods of stress. Instead, we remain steadfast in our commitment to our value-oriented strategy. 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.

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