

Value investing faces some tough questions

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INSIDE THE MARKET

Judging from the 300 people who packed a ballroom in Toronto this week, value investing can still draw a crowd.

But even among the true believers who attended the Ben Graham Centre's annual conference on value investing, some doubts were apparent. Despite its long history of producing strong results, the value school of picking stocks has endured a miserable decade.

Consider Mason Hawkins, chairman of Southeastern Asset Management Inc. in Memphis, Tenn., and a keynote speaker at the value conference. A decade ago, Mr. Hawkins was invincible. His flagship offering, the Longleaf Partners Fund, had trounced the index for years by focusing on undervalued U.S. companies.

More recently, though, the Partners Fund has fizzled. Since 2008, it has produced returns of only about 5.7 per cent a year, far behind the 9.5 per cent achieved by the S&P 500.

When an attendee at the conference asked Mr. Hawkins when his style might return to its winning ways, the response was testy.

"We're very happy ... in the absolute returns we've posted," Mr. Hawkins responded. He added, "we have not been willing to stretch for the five largest market caps on the S&P 500, if that's your bogey and your benchmark, and we're unabashedly not apologetic for not participating in some of these things that are outside our circle of competence."

His answer pointed toward some of the difficulties value investors have encountered since the financial crisis. The most obvious is the rise of the tech giants. The five huge companies that Mr. Hawkins has shunned are Apple Inc., Alphabet Inc., Amazon.com Inc., Microsoft Corp. and Facebook Inc. Like Mr. Hawkins, most value investors have steered clear of these online superstars because of their expensive valuations. Just as dot-com stocks dominated the 1990s before crashing, today's tech giants are also doomed to disappoint, according to the value crowd.

History says the doubters are right. Measured by market capitalization, the seven most highly valued stocks in the world at the end of January were all technology businesses: Alphabet, Apple, Microsoft, Facebook, Amazon of the United States, and Tencent Holdings Ltd. and Alibaba Group Holding Ltd. of China. "Never before has any sector so dominated the global roster of largest market-cap companies," Research Affiliates noted in a report this week. If the past is any guide, only two of the global market-cap top

10 will remain on the list a decade later, the research firm added.

The problem is that it's not certain when today's high flyers will begin to come back to Earth. Value investors usually base their world view on reversion to the mean – the notion fast-growing companies invariably slow, while troubled companies often pick up their game. But the FAANGs and similar companies benefit from an offsetting tendency. They enjoy network effects, in which the addition of each new user increases the value of the network to every other user.

In such cases, growth can spawn even more growth. Facebook and Alphabet's Google, for instance, are now effective monopolies across much of the world, but their revenues are still expanding at double-digit clips and show no signs of stagnating any time soon.

Value investors are better at evaluating troubled companies with long track records and lots of tangible assets than they are at assessing this new breed of asset-light, network-rich business. However, the old paradigm may be shifting. Allan MacDonald, senior vice-president at Burgundy Asset Management Ltd., told the conference there are great investment opportunities in new business models.

As an example, he pointed to the impressive track record of businesses that started out as group-owned enterprises. Stock exchanges and payment systems such as Mastercard Inc. and Visa Inc. have delivered impressive returns to investors since going public as independent companies. More such opportunities may crop up, he said, pointing to possibilities such as Mountain Equipment Co-op and Realtor.ca.

Value hunters will be alert for such deals, but it's not clear how they can restore the glory days of value investing. One common theme at the conference was the threat from passive investing. Presenters took turns deploring index funds for encouraging people to invest blindly, without thoroughly researching fundamentals.

Of course, this is rather weak. The most vivid recent case of mass-market stupidity was the dot-com bubble, which occurred during the heyday of active management.

If indexing actually leads people astray and increases the amount of dumb money in the market, value investors should be applauding its rise, since widespread indexing would lead to more opportunities for value hunters.

More likely the opposite is true. Investing in broad indexes can reduce emotional decisions by individuals and funnel investors into market benchmarks that represent the collective wisdom of many participants. As a result, the rising popularity of indexing may actually be making the market smarter. If so, value investors could find the future to be just as challenging as the recent past.