

Institutional Investor

COVER STORY ■

INSTITUTIONAL INVESTOR
JUNE 1991

Has value investing lost its value?

*"Is today's stock market too complex for
traditional value investing approaches?
Bruce Jacobs and Kenneth Levy think so."*

Has value investing lost its value?

The purists say no. But after the battering they've suffered in the past few years, some value managers say the whole approach needs an overhaul.

BY JULIE ROHRER

Value investors will tell you it's all about stamina. As the long-distance runners of the money management business, they know that history shows that investment styles go in and out of favor, and that patience is required to see values realized.

But even Job would have been hard-pressed to endure silently the punishment visited on value investors during the past few years. Value managers lagged both the market and growth stock investors not just in 1989 and 1990 but for five of the past six years, according to data compiled by pension consultants Frank Russell Co. That is asking a lot of forbearance of clients, especially since they seem to be getting more short-term-oriented with every passing year.

Just how bad has it been? "Last year was a disaster," according to value manager Frederick Moran, chairman of \$450 million Moran Asset Management. In 1987, 1988 and 1989 Moran generated whopping returns, posting an annualized compounded rate of return of 42.5 percent and grabbing first place in CDA Investment Technologies' equity-manager universe. Last year, however, Moran saw the value of its assets plummet by slightly more than 20 percent. It was not alone. After chalking up a 25 percent annualized rate of return since its inception going into 1990, the vaunted \$4 billion Gamco Investors (*Institutional Investor*, March 1989) went into a 14 percent free-fall last year. "It was the worst year in our thirteen-year history," says Gamco chairman Mario Gabelli.

Part of the reason that value stocks took such a beating was that investors, spooked by looming recession, crisis in the financial system and war in the Gulf, sought comfort in



Harold Brooks

big, quality, brand-name, high-visibility stocks, the Coca-Cola Cos. of the world. The result: a two-tier market, not unlike that of the early 1970s, which left value managers in the dust.

According to Richards & Tierney, a Chicago-based pension consulting firm, in 1990 — a year when the Standard & Poor's 500 index was down 3.2 percent — large-cap growth stocks turned in a gain of nearly 2 percent, while large-cap value stocks declined 5.6 percent. And small-cap value stocks dropped 17.5 percent, a more than 19 percent differential vis-à-vis the market's favorites. "No small-cap value manager, no matter how skillful, could hope to overcome a style effect of that magnitude," says Richards & Tierney principal Maureen Culhane. Small wonder that value managers lagged the averages and other managers by the largest margins in decades; some came through 1990 with their first loss year ever.

Are value managers washed up? Hardly. In fact, some make the case that value stocks as a whole are in for a significant recovery, not unlike the one experienced in the mid- to late-1970s, as the two-tier market of the late '60s and early '70s came tumbling down. But things have been so bad for so long for so many value investors that to trumpet the "return to success" of the "old reliable 'value' style of investing," as *The Wall Street Journal* did late last month, may be a bit premature.

For one thing, the rebound in the first four months of this year did not represent a broad advance for value managers generally but was instead limited to a few sectors, most conspicuously financial and related stocks. For another, value in recent years has not behaved according to historical patterns,

and managers are hesitant to plunge back in wholeheartedly (the Windsor Fund's John Neff, for one, is still a hefty 21 percent in cash). Last year, notes Frank Russell senior research analyst Lisa Schulz, "when most of the market indexes had negative returns, value underperformed significantly. That is noncharacteristic."

Moreover, many of the value managers who have fared well in recent years have done so by deviating, to one degree or another, from the straight-and-narrow value path. Indeed, seldom has the definition of value

been more obscure, as many firms operating under the value umbrella have embraced a broader range of valuation methods. "We don't like to use the word 'value,'" says Richards & Tierney's Culhane. In any case, she adds, "it is the rare manager who falls into any one category of style."

All of which is only appropriate, argue some value investors, because classic valuation techniques may no longer be adequate to deal with today's increasingly complex market. Edgar Wachenheim, chairman of \$350 million Greenhaven

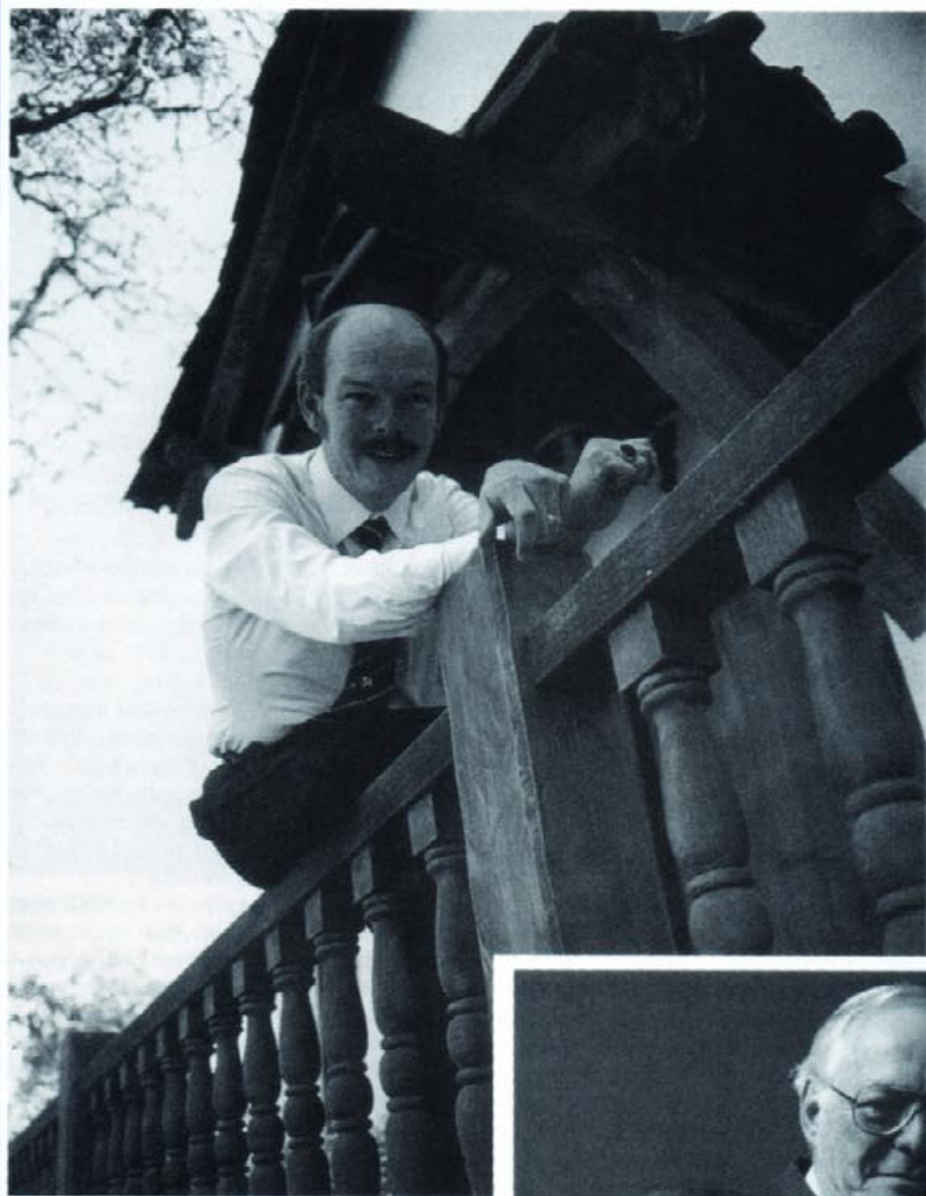
Associates, whose portfolio gained close to 4 percent last year, offers perhaps the most troubling assessment of the situation: "The problems were not in value *investing* but in value *investors*. They lost sight of what was going on in the world."

Mission impossible

To be sure, it was an unusually hostile world. Rosenberg Institutional Equity Management was another firm that suffered a down year, the first in its five and a half years of existence. Chief investment officer Barr Rosenberg notes that value managers who adhered to a fairly disciplined, systematic process, whether applied to large or small caps, were virtually stymied by the two-tier market. He says there was such a "striking difference" in performance between the 25 largest companies in his firm's universe and the 50 largest that it was impossible to incorporate the phenomenon into his firm's investment process.

"Everyone to some degree relies on risk controls to protect them from the chance that stocks that aren't naturally in accordance with a certain style won't move away from them," says Rosenberg. "But you can imagine it would be very difficult to create a systematic risk-control process that said, 'Oh, by the way, make sure you have a third of your portfolio in the 25 largest stocks.'"

The more rigorously value-committed the firm last year, the worse it did. The managers who were "more aggressive," as Trinity Investment Management Corp. chairman Stanford Calderwood puts it, kept adding to sectors that seemed increasingly attractive according to traditional guidelines — a concentration that cost them dearly: Trinity's asset value fell 19.3 percent; Sanford C. Bernstein & Co.'s composite fell 24 percent; and Neff's Windsor Fund dropped 15.5 percent. In Windsor's 1989 annual report, for the fiscal year ended October 31, Neff had warned shareholders



Bob Day

Rosenberg Institutional Equity's Rosenberg: No "systematic risk-control process" could have bailed out a disciplined value investor in last year's relentlessly two-tier market

Windsor's Neff: Ignoring the consensus and sticking with portfolio concentration can "magnify errors." But the reward can be a "high payoff for hits"

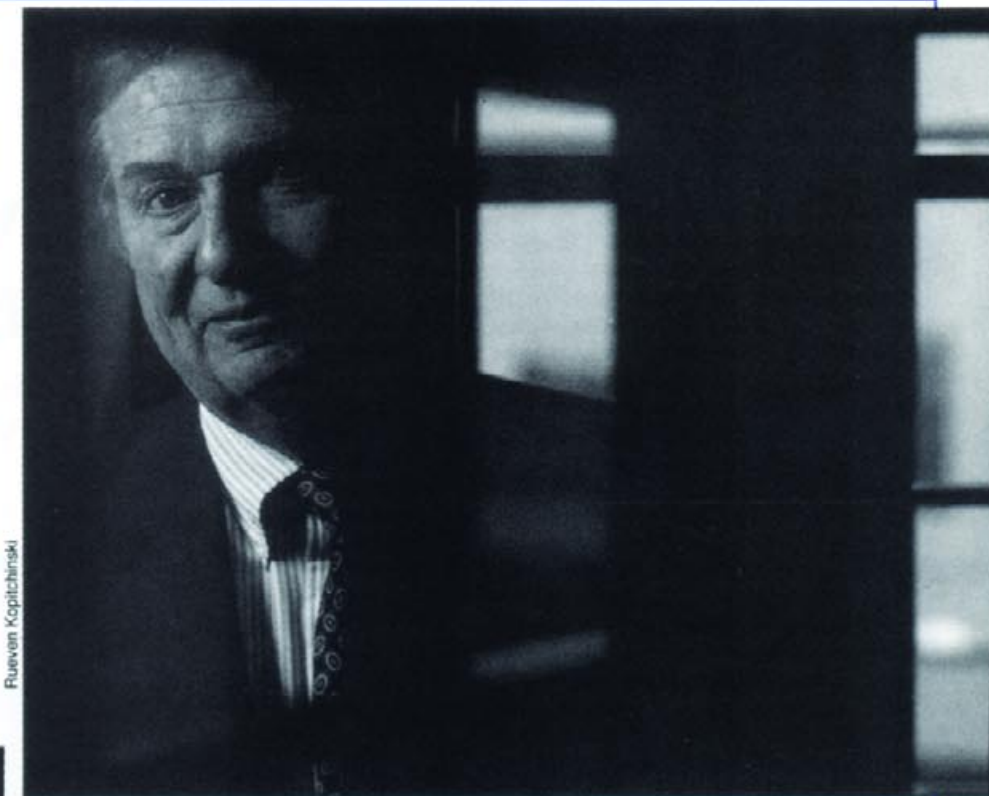


Lucy Johnson

that "the concentration manifest in 68 percent of assets in financial intermediaries and selected cyclicals does not represent your standard, garden-variety, fully diversified mutual fund" and that Windsor therefore "should probably not be your sole stock market participation."

If it was any consolation — and to some it was — 1990 wasn't much kinder to the doyen of value investors, Warren Buffett. Growth of Berkshire Hathaway's net worth last year slowed substantially from its historical rate, prompting Buffett to echo the sentiments of other value investors in the corporation's 1990 annual report by noting dryly that "Berkshire's 26-year record is meaningless in forecasting future results; so also, we hope, is the one-year record."

For their part, clients were unforgiving. Trinity lost more than half of its assets under management in the twelve months through the third quarter of last year. Mutual fund shareholders became restless, notes Windsor's Neff. Although "we've raised shareholders to expect periods when we



Rueven Koptichinski

Lord Abbot's Lynch: *To avoid troubled industries that look cheap on valuation screens, his firm's process is "built around a lot of top-down work, which separates us from most value players"*

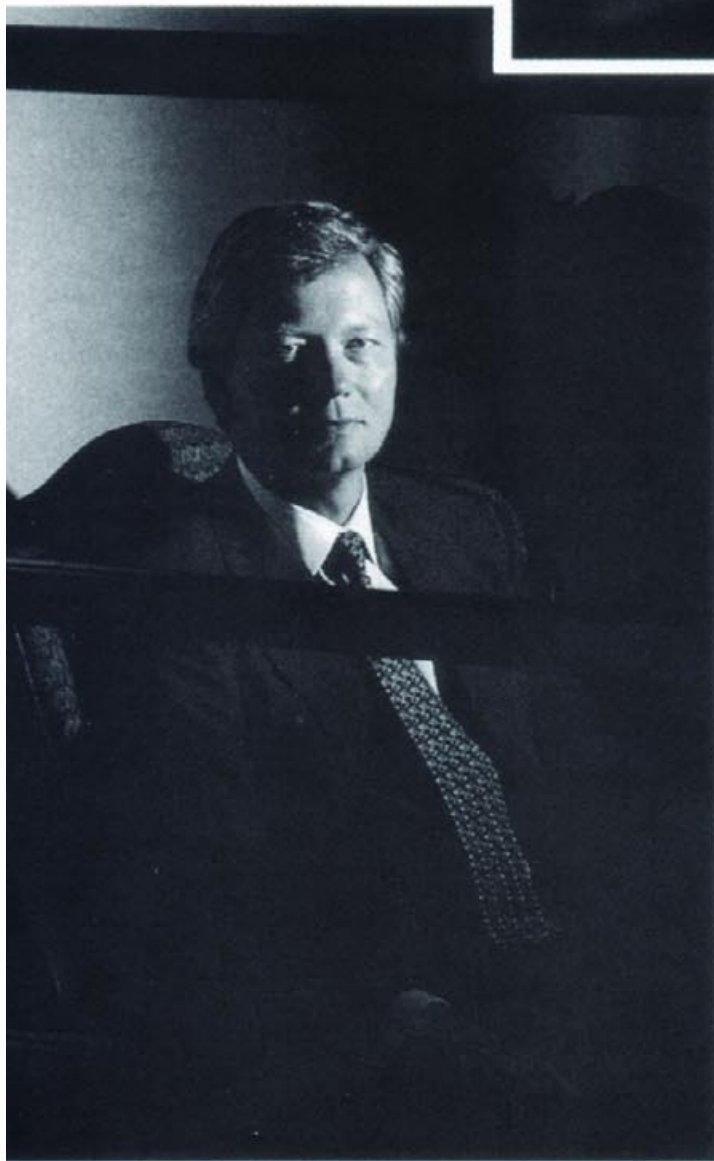
would not look well," he says, "we've gotten more mean-spirited letters in the last year or so than we've ever gotten before."

Across the board

Most consultants agree that though all value managers look for stocks that are "cheap," they can be grouped into four broad categories reflecting the major criteria they use in identifying undervaluations. (Of course, there is a fair amount of overlap in the criteria managers use.)

The first category is the low-P/E manager, who tends to own defensive stocks and industries out of favor. The second is the high-yield investor, who buys stocks with higher-than-market yields and future dividend-paying capability. The third category of managers emphasizes companies with low valuations relative to book value, often depressed cyclicals; this investor is often the most contrarian, willing even to buy companies with virtually no current earnings. The last group focuses on private- or intrinsic-value calculations, measuring the underlying assets and cash flow of companies, much as takeover specialists do.

Each of these types of manager has run into problems in the market recently. Take Brandywine Asset Management, a low-P/E specialist with \$850 million under management. When analyzing prospective investments, the firm focuses on companies that rank in the bottom quartile in terms of price-earnings multiples. But a Goldman,



Mikro Kemitz

J.P. Morgan's Cobb: *His firm, knowing the dangers of overconcentration, weights sectors neutrally against the S&P, so that "you never have a portfolio dominated by one group"*

Jacobs Levy: Unbundle and separate

Is today's stock market too complex for traditional value investment approaches? Bruce Jacobs and Kenneth Levy think so.

The two, both Wharton school alumni, worked together at Prudential Asset Management Co. and left in 1986 to form their own investment firm, Jacobs Levy Equity Management, to work on and apply their theories. In May 1990 the firm, now in Roseland, New Jersey, expanded its process to invest on the short side as well as the long. (It has about \$450 million under management, much of which is earmarked for long/short strategies.) Since then such accounts are up about 33 percent.

This record — while short-term — is impressive, given the tough environment for value managers (story). But Jacobs, 40, and Levy, 39, are not just any value managers. With a handful of academic degrees ranging from finance to computer science, they have developed a variety of valuation methods, such as anomaly-capture strategies, time-series modeling techniques and macroeconomic modeling, to sort through market inefficiencies. "You need to take advantage of all of the forces in the marketplace to make money," says Jacobs.

When many value managers were loading up on "cheap" bank stocks last year, for example,

Jacobs Levy was shorting the group. Its valuation screens showed deterioration in the industry. But the firm also tracks Street earnings revisions, surprises and sentiment, and "analysts were substantially downgrading banks," says Jacobs, which did not bode well for investor support.

Jacobs Levy also uses a dividend discount model, but apparently not in the way other firms do. Says Jacobs, "It is much more of a forward-looking model," which works best when investors are optimistic. "When markets are tanking," as they were last year, he adds, "the model works quite



Jacobs (left), Levy: Taking advantage of all the forces in the marketplace to make money

well — but you want to be short, not long."

Perhaps the most provocative notion to come out of the pair's research relates to price-earnings multiples. Their study of various market periods has convinced them that low P/Es, when isolated from other characteristics, are often insensitive to market movements. They cite the strong bull market between mid-1982 and mid-1983, when low P/E strategies hurt return—though in the mid-1983 to mid-1985 bull market, low P/Es did well. At the same time, their research indicates that high-yield approaches paid off in both periods. What is often ascribed to the low-P/E effect, they claim, may not be due to the earnings multiple at all but to the stocks' yields.

"People haven't unbundled and separated out these various effects," says Jacobs, who notes that his firm has recently received an additional commitment for \$50 million, most of which will be managed in a long strategy. "That's the true insight we've had—the notion of disentangling all the effects from one another. That way you can measure and monitor them all individually." Developing systems to incorporate the many facets of the market is, of course, an ongoing process. But, Jacobs says, "we think we're way ahead of our time."

Sachs & Co. study found that last year such stocks fell an average of 19 percent, the steepest drop for the group in two decades. Brandywine took about a 7 percent hit. Although history has shown that "it pays to invest in the lowest-P/E stocks," the firm's chief investment officer, W. Anthony Hirschler, jokes that "we're thinking of incorporating another piece into our selling discipline — to sell a stock when the P/E gets too low."

"Even high yields didn't help in 1990," says Frank Russell senior vice president and director of U.S. equity research Dennis Trittin, who reports that the median high-yield manager registered a loss of 7.7 percent last year. It could have been worse. Goldman Sachs found that stocks ranked in the top 20 percent last year in terms of yield had their worst performance since 1968, down, on average, 17.3 percent.

Yields of some stocks reached levels

that made them look better and better — in fact, too good to be true. "Our universe has yields above the market, but we don't have particular expertise in sky-high yields, and we don't buy a stock in a company that cuts its dividend," says Richard Unruh, senior vice president at \$14 billion Delaware Investment Advisers. Last year he watched the yields of Security Pacific Corp. and Manufacturers Hanover Corp. climb to enticingly high — in fact, double-digit — territory; in March of this year, however, both institutions cut their dividends. "We didn't own either of these banks," says Unruh, "because we knew they couldn't continue to pay those dividends."

Price-to-book valuations looked favorable for many stocks — basic commodity cyclicals, for example — but such stocks continued to underperform last year. As for managers focusing on private or inherent value, payoffs were big through most of the

1980s, when takeovers and leveraged buy-outs brought values to the surface. But, notes Heine Securities Corp. president Michael Price, when financing for deals — "an important cog in the machine of value investing" — began to dry up in the middle of 1989, "we began to underperform." Mutual Shares, the firm's flagship mutual fund, dipped about 9 percent in value in 1990, its first down year since 1973.

Go with the flow

Regardless of the criteria, some value managers have been buying growth stocks in recent markets. Dremman Value Management, the \$4 billion firm noted for its championing of low-P/E stocks, edged out the S&P 500 going into the third quarter of last year by, among other things, owning growth stocks like Philip Morris Cos., the firm's largest holding, and American Home Products. (It also helped that Dremman sticks

to relatively large-cap stocks, which held up better in last year's downturn.) Managing director David Dreman favored Philip Morris because it was "a company growing at 25 percent a year that was selling at ten times earnings."

Indeed, Philip Morris, a stock with a low P/E because the world regards cigarette smokers as a dwindling species, "is the stock everybody seems to be able to buy," says Fred Schaefer, vice president of research at pension consulting firm Evaluation Associates. Schaefer remembers receiving a letter early in 1989 from a value manager who wanted the consultant to know he was "starting to buy some stocks that are traditional growth stocks"; however, implored the manager, "please do not think we have changed our stripes."

Scudder, Stevens & Clark's \$1.5 billion in assets are managed in a yield-oriented value style. Lead portfolio manager Robert Hoffman points out that recent markets have created the opportunity to pick up growth stocks "at discount prices." Last year, for example, Hoffman bought Pfizer when its stock price dropped "very quickly" as investors reacted to fears of possible litigation against the drug maker related to the artificial heart valve it had developed. The price drop lifted Pfizer's yield to a level that caught the attention of Scudder portfolio managers, who focus on relative yield.

The firm considers stocks that return at least 120 percent of the market's yield as buy candidates and sells them when the price of the stock appreciates to the point where the yield drops to 75 percent of the market's. Last year Scudder accounts managed in that style outperformed the market, declining by 0.15 percent; the year before, assets gained 33.8 percent, versus a rise in the S&P of 31.2 percent.

Of course, value buyers have always hoped to find stocks with good earnings prospects as well as cheap prices, but they have usually found them among smaller, less visible companies. A relatively new product, based on a subset of the Putnam Vista Basic Value Fund, is concentrating on smaller companies. Explains Robert D'Alelio, the fund's portfolio manager, good bargains can be found among some 700 small-cap stocks, with earnings growing at moderate rates of about 10 to 15 percent a year, that fall between the cracks. The companies aren't prominent enough or their growth rates dramatic enough to draw much Wall Street or emerging-growth-stock-investor attention.

So the prices are right, and every company D'Alelio owns pays a dividend. "We get a third of our return just from that," he says. Results have been impressive. From the second quarter of 1988 through this past March, the fund's assets, which currently total \$29 million, have gained 18 percent, compounded annually, versus an increase of 8.79 percent in the NASDAQ index.

Moran Asset Management is another value firm mixing a search for unrealized "inherent business value," as Fred Moran puts it, with growth-style attributes. The chairman expects that a resumption of acquisitions — though at not anywhere near the pace of the 1980s — will help him to realize the asset values of his stocks, but he's also counting on growth (of cash flow) to take up the slack and eventually throw off earnings, in case takeovers aren't in the cards. One of his favorite picks is Telephone and Data Systems, a company that will be generating substantial earnings in a couple of years, "so people will want to own it as a growth stock and not care about a potential takeout." Similarly, Gamco's Gabelli focuses on free cash flow, which, among other things, "often foreshadows earnings-per-share growth," he says.

Delphi Management, with \$820 million, is known as a low-P/E value manager that concentrates on stocks selling at P/E multiples of 10 or below. But even with the most attractive multiples, companies have to "show consistent earnings power year in and year out," says chairman Scott Black, particularly now that the "LBO and merger mania" has waned. "I look for a higher return on equity — say, 15 percent — than most other managers. I have assets, but I look at the earning power of those assets," he adds.

Price-to-earnings valuations have been questioned for years by other managers, who say earnings are too volatile and too subject to the whim of accountants to be considered alone in making stock decisions. "I'm not a low-P/E investor," says Peter Schliemann, portfolio manager of the \$114 million David L. Babson Enterprise Fund. "I prefer to look at price to cash flow or book value. Earnings can be misleading, but a company can't do much to manipulate cash flow or book value."

Spread the risk

Value managers whose returns were punished the most during the past two years tended to have highly concentrated portfolios. At J.P. Morgan Investment Management, roughly \$12 billion in domestic equities are managed in active and structured portfolios according to various risk levels by using a standard valuation tool, the dividend discount model. But though Morgan chooses individual stocks according to the ranking of its model, sectors are weighted neutrally against S&P weightings, so that "you never have a portfolio dominated by one group," says Mor-

gan managing director William Cobb Jr.

Last year, for example, Morgan owned auto stocks but also held drug stocks. Assets in its basic structured portfolio declined by 6 percent, while the most diversified, least risky structured accounts beat the market, dropping some 2 percent. Morgan's actively managed portfolios, following a similar process, did even better, declining by less than 1 percent for the year. The risks the firm wants to take are stock-specific, an approach it feels comfortable with, given the backing of its 22-analyst stock research group. "We're not going around telling anybody we're good at sector bets," says president David Brigham.

But other value managers, arguing that such bets are precisely where most of a portfolio's performance comes from, are using top-down economic forecasting to overweight or underweight sectors —



"Value investors lost sight of what was going on in the world."

not exactly a vintage value-investing approach either. Robert Morris, vice president and manager of the investment management group at Chase Manhattan Bank, told a group of securities analysts in March, "We're a value-oriented shop, which classically means we're stock pickers." But, he added, "the economy has a big role in determining which of those stocks perform contemporaneously and which ones you have to spend time waiting for the value to be realized in the marketplace."

So, according to Morris, Chase began looking for a way to inject top-down forecasting into its essentially bottom-up methodology. It hired a Connecticut economic and sector analytical firm, Analytic Systems Corp., to do the job. "The thing that really frustrates value investors is when you know a company is cheap but its stock just sits there, particularly in a market like the one we've been through," says Morris. Chase now prefers to pick value stocks in the sectors likely to be in favor, which, says Morris, "dramatically enhances your ability to hit a home run." Adds Analytic Systems president John Moffatt, "Most value man-

agers are too early."

Lord, Abnett & Co., manager of about \$10 billion in total assets, reports that top-down research helped the fund eke out a positive return last year (0.1 percent for institutional accounts managed in the firm's large-cap value style). Lord Abnett uses a series of valuation screens, but its investment style is primarily "built around a lot of top-down work, which separates us from most value players," says Ronald Lynch, managing partner.

Last year that approach saved Lord Abnett portfolios from the trouncing in financial stocks that hurt so many value funds. As E. Wayne Nordberg, investment partner in charge of equity research, explains, the firm became concerned about deterioration of credit quality in the banking system as early as mid-1989. Given the leverage of the 1980s, as the economy slowed it became apparent that "there wasn't enough cash to support all the low-quality debt," says Nordberg. So

bank loan portfolios. Brandywine's Hirschler made the attempt. He took two real estate workout specialists with him to meet with the CFO of a Southwest bank in which Brandywine had made a significant investment. On the basis of their evaluation of the bank's construction loans, Hirschler sold at a loss, but he saved himself from a further ten-point drop.

The diehards

While some value managers took refuge in diversified portfolios, relying on top-down analysis to decide which industries could be hot and which should be avoided, and acquired some varieties of stocks they had never looked at before, others stuck to their traditional approaches. They viewed much of the turmoil as an opportunity to pick up stocks at abnormally cheap prices.

Among the more opportunistic was Sanford C. Bernstein & Co., whose president, Lewis Sanders, argues that if you are reasonably convinced that the long-term earnings power of severely battered companies hasn't changed, you needn't apologize for such a strategy. As for financial companies, Sanders concedes that "if I had to do it over, I might have bought them slower." But, he adds, "it's a good thing to buy stocks when prices are depressed. That's what value managers

do. They play these cycles."

Indeed, Sanders thinks his firm's analysts may actually have underestimated the long-term earnings potential of some of the financial stocks in its portfolios, that the stocks are still undervalued, despite their recent run-up. After all, in periods of adversity, managements usually try to improve profitability.

Bernstein uses a dividend discount model, but unlike J.P. Morgan, it doesn't weight sectors neutrally. "That's fine," says Sanders. "You'll never vary much from the S&P, but it leaves return on the table. It's just not what we do." About 35 percent of the firm's assets were in financial issues at the end of last year.

Windsor's Neff is of the same persuasion. His portfolio at the end of the fund's 1990 fiscal year was 33 percent in financial stocks — insurance companies and some savings and loans as well as banks — because portfolio concentration, as Neff pointed out in the fund's annual report, can greatly "magnify errors," but it can also yield a "high payoff for hits." It is, he wrote, "hard to take a line against the consensus," but that is what creates opportuni-

ties "if you hang in. Fortunately, we've been able to do that."

Windsor may have been down 15.5 percent last year, but it was up 19.2 percent in just the four months through April of this year, versus a 14.8 percent gain in the S&P, and the strong rebound in financial stocks was a prime reason. Bernstein's \$5 million-and-up equity accounts rose by 26 percent. Trinity's accounts, similarly overweighted in financial stocks, rose 33 percent in the same period and 46.7 percent off the bottom reached last October.

Other value managers, less concentrated, have also done well. Dreman points out that in the first rally off the bottom in November, some stocks advanced as much as 60 percent in six trading days. "We had a very strong comeback," he says, with returns close to 1,000 basis points ahead of the market from the end of October through the first quarter of this year. Mutual Shares, with a 14.4 percent gain in the four months through this past April, made up the ground lost last year.

Shortly before the market topped the 3,000 threshold in April, Neff looked back at history. "Three times previously we've faltered," he says. In 1971, 1972 and 1973 there was "the same phenomenon, only in a different form. It was the classic growth stocks then, and for the three years, we were 26 percent behind the S&P. Then in 1974, 1975 and 1976 we were 63 points better." The next time the Windsor Fund "faltered" was in 1980, "when we were ten points behind, and in 1981, when oil tanked, we got 22 points back. Again in 1987, despite the fact we had some pretty good cash going into October 19, we were four points poorer, but the next year we were twelve points better.

"You can ask," Neff continues, "Are you going to be 56 points better over the next two or three years? We've always done about twice as well on the other side. So it will be interesting."

If the two-tier market abates, value managers could shine for some time, outperforming growth-stock managers as they did for much of the 1970s. In Bernstein's 1990 annual report, Sanders and chairman Zalman Bernstein wrote, "We see more potential in our stock portfolios than [we have] in almost twenty years."

But the road back may be a long one. Recent improvement in some value sectors could be the result of a temporary "feeding frenzy," says Delphi's Black, whose own firm's assets were also beating the market through April of this year. However long a stretch of favor value investing enjoys, some managers have no doubts about their traditional methods and will stick to their guns. Others, though, will continue to reevaluate and modify their approaches. As Black says, "There is still a lot of pain in the system." ■



**"Even
high yields
didn't help
value investors
in 1990."**

the firm sold the money center banks (with the exception of Morgan Guaranty Trust Co.). Indeed, the fact that bank stocks got cheaper and cheaper seemed more of a warning than a lure. "A big, visible stock rarely declines more than 50 percent unless there is something wrong with the business," notes Lynch.

Any economic analysis that led to skepticism about the financial sector provided a plus for value managers last year. As Brian Rogers, executive vice president and co-portfolio manager of T. Rowe Price Associates' \$1.17 billion equity income fund, notes, how badly "whipped" you were was largely determined by how much exposure you had to the financial sector. T. Rowe's value fund didn't exactly get whipped; on a relative basis, its 6.7 percent decline didn't look bad. But it didn't wholly escape the lure of the financials either, concedes Rogers.

Managers trying to identify sound banks being pounded down with the whole group found that it is difficult to analyze