BUSINESS

Road to Retirement: Why value investing still isn't working

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If you yearn for the days when you could buy good companies on the cheap, get a big dividend, and watch the price rise as the rest of the investing world recognizes you found a diamond in the rough, you may have to wait a long time.

Value investment strategies had another poor year in 2020. The Russell 1000 Value Index (a list of the largest value companies in the market) produced a total return of about 3% in 2020 compared to over 18% for the S&P 500. Value has trailed the S&P 500 for the past 13 years. Why doesn't value work like it used to?

Photograph by Ellen Jaskol

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It's because 30 years ago markets were less efficient. With some hard work and patience, value investors could find companies that others had overlooked. Then they could sit back and wait until the rest of the market recognized their genius.

The value investment advantage lasted roughly through the early 2000s, but then information technology began to erode the edge. Today, there are few public companies that have great numbers that nobody knows about.

Think about it this way. Let's say you like to walk the beach with a metal detector in hopes of finding something valuable in the sand, like a piece of jewelry (Fun fact: The beach is one of the top places to lose an engagement ring).

Now assume someone develops a piece of satellite technology that scans all the beaches in the world and pinpoints every piece of jewelry that is lost in the sand. It wouldn’t be long before beach hunters picked them all up. Then anytime a new piece of jewelry gets buried in the sand, the satellite broadcasts it to everyone in the world. Within a few seconds, someone runs down to the beach and picks it up.

Once this new technology exists, how much jewelry do you think you will find scouring the beach with a metal detector? Not much. Rarely would a piece of jewelry sit there for months or years until you happened to walk by with your metal detector.

That’s sort of what has happened with financial information over the past few decades. Today, when companies report their financial results, hundreds of financial metrics about those firms are quickly uploaded to investors. Everybody knows at the same time where the “diamond rings” are located in the market. Investors quickly chase those companies with good numbers and bid up their prices.

That’s not to say there aren’t some deals out there. Every so often you can find a company that has been ignored for any number of reasons. The hard thing is finding an entire portfolio of companies (30 to 50). Many companies are cheap for a reason, meaning they are having problems. Those problem companies often weigh down the performance of the few gems a value manager might have in their portfolio.

I know many value advocates believe the situation will reverse, and companies that are cheap will one day shine. That could happen for a period of time, but it’s unlikely with today’s access to financial data that cheap companies will outperform over the long term. You need an information advantage to find something that is valuable that no one else knows about. And there are few information advantages left for publicly-traded securities.

Hunting for a new home is another example of the lack of an information advantage. What are the odds that you could find a nice house in a desirable neighborhood in the Denver area for 30% below fair market value? Slim to none. Why? Because all you have to do is go to Zillow and look up the value of the house.

Sellers know what their homes are worth and won’t let them go for 30% below market. This is similar to the financial markets. If your goal is to buy a quality company that is cheap, you need someone to sell you that stock for a discount. These days, not many investors will make that mistake given the widespread access to all that financial data about any particular firm.

I used to be a big value advocate because it made sense. I wish it still worked as well as it used to. But technology changes everything, including markets and investment strategies. That doesn't mean you chase every crazy idea out there. But it does mean the odds favor the "wisdom of the crowd" in the public markets.

As long as financial data is ubiquitous and instantly available, investors will likely do better with a portfolio that tracks broad-based stock market index returns like the S&P 500, instead of contrarian strategies that require information advantages that are getting harder to find.

Charlie Farrell is a CEO of Northstar Investment Advisors LLC. This article is for information and education purposes only. Past performance is no guarantee of future returns, and all investing involves the permanent risk of loss. Consult your individual financial adviser for guidance specific to your circumstances.