Navigating Value

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The growth versus value dynamic is an age-old saga with a new life. Equity style has been a conceptual distinction since the 1950s and with quantifiable yardsticks since the 1980s. The dozens of recent papers on the subject have been triggered by the reversal of the value premium over the last decade after 40 plus years of confirming data (anointed market premiums being academic finance's version of knighthood). A few say it is temporary, while others say it represents an evolution—we say it is both.

White papers are not a regular occurrence at Sapience; however, we think we have a perspective on this topic, which might not be necessarily unique but certainly different from conventional wisdom. In addition, we wanted to discuss where we fit among value investors and how that influences our recent activity in our Small and SMID Cap Value strategies. Recently, we discussed our "value origins" and thought a good way to begin would be to identify some foundational principles. Below are a few quotes by investors we admire and who have been instrumental in guiding the investment philosophy at Sapience:

> *Know what you own, and know why you own it*.
>
> Peter Lynch

> *Investing is most intelligent when it is most businesslike*.
>
> Warren Buffett

> *If you spend your energies looking for and analyzing situations not closely followed by other informed investors, your chance of finding bargains greatly increases.*
>
> Joel Greenblatt

> *It turns out that value investing is something that is in your blood. There are people who just don't have the patience and discipline to do it, and there are people who do. So it leads me to think it's genetic.*
>
> Seth Klarman

> *Casual commitments invite casual reversal, exposing portfolio managers to the damaging whipsaw of buying high and selling low. Only with the confidence created by a strong decision-making process can investors sell mania-induced excess and buy despair-driven value.*
>
> David Swensen

> *Most analysts feel they must choose between two approaches customarily thought to be in opposition: "value" and "*growth*". We view that as fuzzy thinking (in which, it must be confessed, I myself engaged some years ago). In our opinion, the two approaches are joined at the hip. Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive.*
>
> Warren Buffett

Is Value Investing a concept, a sector play or a factor?

The *concept of value investing* centers on three inputs: identifying the criteria you seek in businesses you wish to own, effectively valuing these businesses, and owning the stocks when the current market price for these companies is at a sufficient discount to your estimate of intrinsic value. There are two important variables at play here. The criteria you select may be broad or very precise. Ben Graham, for example, was quoted on the back cover of an early edition of *The Intelligent Investor*, "I want the reader to recognize that 99% of public companies would be a good investment if purchased at right share price*."* Many equity investors, including Sapience, look for above average quality. The second variable is how intrinsic value is calculated. There is a variety of methods in use, but the main message here is that most investors in the value camp eliminate businesses from consideration that they believe cannot be valued with confidence. This frequently eliminates businesses in high-growth markets because a trait of value investing is to use conservative estimates and that is why high P/E multiple stocks rarely find their way into value portfolios.

While few observers would consider value investing to be a *sector play*, the impact of sector exposures is generally underemphasized. By this I mean, style performance differentials are frequently sector differentials misinterpreted. To use a few recent examples within the large-cap markets, if you suggested:

2017 was a growth year (Russell 1000: 22%, Russell 1000 Growth: 30% and Russell 1000 Value: 14%), I could point out that Tech was 38%, Energy was -1%, and Utilities were 6%.

2016 was a value year (Russell 1000: 12%, Russell 1000 Growth: 7% and Russell 1000 Value: 17%), because Health Care was -3%, Energy 25% and Materials and Utilities 20%.

2009 was a growth year (Russell 1000: 26%, Russell 1000 Growth: 37% and Russell 1000 Value: 20%), because Tech was +4%, Finance 20%, Energy 17% and Utilities 11%.

As you review the sector performance for similar periods between Growth and Value Indices, the differences are surprisingly small. Yet the sector weights between Indices and the performance differentials between sectors are quite dramatic. You recognize that a meaningful percentage of what is chalked up to style is simply aggregating the results of the idiosyncratic economics of the key sectors. Given the importance of the past decade in creating this growth-value deliberation, the annualized mid-teen returns of Tech and Health Care, contrasted with the negative returns of Energy and the volatility in performance of Financials and Industrials, are a big part of the story.

While the sector aspect is a useful muse, the *value factor* approach is a major issue. In the late '80s when Wilshire and Russell were seeking to create and commercialize their style Indexes, and shortly thereafter, when Fama and French published their models to explain stock market returns, a significant change occurred. Their need to create a simplified method for identifying value that could be broadly applied, modified the traditional qualitative or subjective assessment (value is in the eye of the beholder) to a set of objective metrics. This method, which could be termed systematic value or quantitative value, or what Aswath Damodaran (professor at NYU Stern School of Business who is known as the Dean of Valuation) frequently refers to as "lazy valuation," basically identifies what is cheap based on simple methods and are therefore a collection of lower expectation businesses. The impact of value factor thinking is pervasive—the related Indexes mark the dominant arbiter of which style is outperforming and they are the basis around portfolio construction for many value managers (though not at Sapience), and it drives the holdings or returns-based style analysis used to label individual managers. This is somewhat disconcerting for firms like Sapience who are engaged in the level of research required to contrast intrinsic value of a business with the current market price.

To illustrate the point, many stocks in the Russell universe have perpetually scored as pure value. These stocks are perpetually low expectation businesses and are always cheap on a relative basis. While cheapness and the concept of value frequently overlap, we hope the reader will embrace that these terms are not synonymous or interchangeable.

Differentials in active value management

As the above commentary describes, value investing is not a commodity or a homogenous endeavor. In addition to the systematic analysis, a few sophisticated consultants have provided insights that have helped us identify additional relevant variables. We share these reflections on value peers, along with where we fit, below.

1. Selection criteria: Some investment managers will buy shares in any business as long as it is priced at a discount—the Ben Graham mindset. Others focus on very specific quality metrics or criteria. Our approach at Sapience is nuanced, as we are clearly a price-driven investor in that a discount and a margin of safety are a requirement. However, we do seek businesses that are above average in quality, which we define as having high returns on capital and projected durability of cash flows over our investment time horizon. We have the flexibility to own four different categories of value stocks: *Discounted Franchises, Value with Drivers, Undervalued Growth, and Undervalued Assets*. These categories of stocks differ in level of quality, growth trajectories, and source of returns—whether our returns are expected to come from closing the valuation gap or a combination of increasing the intrinsic value and closing that gap. Therefore, the four categories offer disparate return streams and differ in terms of their expected investment time horizon.
2. Contrarian: Some managers classify themselves as contrarian investors and others avoid the moniker. Certainly not all businesses that are out of favor will be assessed as potential "value" opportunities, but they can be a useful source for some of our idea generation.
3. Quantitative versus qualitative: In terms of the methods of research and decision-making, consultants tell us that quantitative firms manage the majority of value equity allocations. That percentage grows dramatically if you include smart-beta and style-indexed mandates. Sapience is 100% qualitative in our work, as we are skeptical of formulaic investing and relying on consensus estimates.
4. Depth of research: We aim to go deep, but consciously avoid paralysis of analysis. We seek to know the 2-4 key aspects about a company that will move the dial, and to solidify our confidence level regarding where our views and those of the market differ. One of the reasons we have chosen to focus on the small/mid cap segment of the market is based on narrower coverage and less efficient pricing—the marginal benefit on a per hour basis of research within our universe is much greater than research in the large-cap space.
5. The primary definition of risk: We believe there are two dominant perspectives in how managers view risk—tracking error and the probability of a permanent loss of capital. Our focus is completely on the latter metric which means in portfolio construction we are benchmark indifferent while seeking to effectively diversify our holdings among macro and micro variables.
6. Assessing results: We frequently refer to our investment mindset as having a private equity orientation. The bottom line distinction is that our recognition of franchise value, a longer investment time horizon, and frequently modeling our return assumptions based on expectations of improving operating results are the primary differentiators between Sapience and many other public equity investors. Therefore, assessing results emphasizes operating performance above quarter-to-quarter stock price performance—emphasizing the "weighing machine" over "voting machine" aspect of the market. Our objective is to generate excess returns over the benchmark while employing an absolute return mindset. This is a nuanced though crucial differentiation. Absolute return is a term frequently used to refer to an objective of providing positive returns regardless of the benchmark results. As a long only equity manager, we are not claiming this objective or capability. Our absolute return approach focuses on generating returns by compounding cash flows to increase

franchise value and closing the gap between the market value at purchase and our estimate of the intrinsic value. On a security level, we apply an absolute return approach. However, we combine this with relative considerations at the portfolio level as we avoid making outsized sector allocations.

7. Level of investment conviction: This manifests primarily in the level of portfolio concentration. We have looked across our Small and SMID Cap Value peers and observed a range of owning 300 stocks all the way down to 10 stocks. Although we avoid targeting tracking error, we are middle of the road in holding 40-50 stocks in our SMID Cap Value strategy and 60-70 stocks in our Small Cap Value strategy.

Observations over the past decade

We are well aware that over the past decade two major detractors to the overall investment performance for many institutions have been their exposure to international equity and value equity. For the 10 years ended June 30, 2020 (on an annualized basis), the S&P 500 (+14%) has outperformed EAFE (+5.7%) for an 8.3% spread, and the Russell 3000 Growth (+16.9%) has an annualized spread of 6.7% above the Russell 3000 Value (+10.2%). It should be noted that in our markets (Russell 2000 and Russell 2500), the absolute returns were below the Russell 3000 but the spreads between Growth and Value Indices were moderately less (5.1% and 5.6%, respectively). Our concern is, of course, the value shortfall and thinking through what might be learned from this experience to improve results going forward. Our goal is not to burden you with statistics you are probably aware of; however, we do want to share a few observations:

- Back-tests had estimated the long-term value premium at 2% to 3% per year. We have seen a profound reversal since mid-2007.
- While we recognize that risk cannot be fully captured in studying volatility, we do think it provides a useful input. Value stocks demonstrated significantly lower volatility than growth stocks for the 30 years ending 2008. However, for the last 12 years, this risk metric between the two styles has neutralized (for large and small cap stocks).
- In addition to the value premium, the small cap premium was one of the earliest anomalies uncovered in the '70s. A 3.5% annual premium can still be observed if you look at studies going back to 1927; however, small caps have returned about 10 basis points less than the average stock between 1980 and 2019. Our draw to smaller company investing is rooted in gaining a superior research edge as opposed to any perceived beta advantage.
- We have experienced a long running bull market with value gaining the upper hand over growth in only 3 of the past 11 calendar years. Many value adherents postulated that their style would better protect capital in a downturn. As we now know, this occurred in the first half of 2020 in the most dramatic fashion in lockstep with the escalating Covid-19 pandemic; however, the same stocks that had been leaders in the bull market were also the best performers in the market meltdown. While some observers conclude this is a further sign of a deteriorating value proposition, we consider the result logical given that such a high proportion of the value universe depends on yields (Financials) and industries that rely on human interaction (manufacturing, service, and retail/airlines/lodging). On the other hand, many of the growth businesses, especially Technology and Communication Services are unaffected, or even thrive, in a stay-at-home environment.

The tactical case for the value factor

> *Value investing works in the long term precisely because sometimes it doesn't work in the short term.*
>
> Joel Greenblatt

While we are not factor-based investors, having invested in the public markets for over twenty years, we do agree that the spread between growth and value is currently at historic levels and seems overextended. In March 2000, value had never been cheaper relative to growth. That was the all-time, world-record low by a wide margin. Today we are close to that record. The third-place candidate was the end of the Nifty-Fifty period in December 1974. If growth managers failed to recognize the most speculative market in history back in 2000, can we expect them to recognize future vulnerabilities? Not to say value managers have a better record. In 2007, when we were facing the greatest credit excess in history, many value managers had 30% to 45% positions in banks and other financial institutions that were crushed in the Great Financial Crisis (GFC).

Inertia has been a powerful force since the GFC and especially in the last five years in the U.S. equity markets. The tepid economic recovery, low rates, and late cycle fear were drivers for multiple expansion in defensive businesses as well as in mega-cap growth stocks. The theory behind the value premium is twofold: that value businesses are more risky and deserve a "risk" premium (pure academic) and that growth stocks are systematically overpriced (a behavioral phenomenon). One of the reasons investors say growth has outperformed is that growth companies have delivered in spades on their promise over the past decade.

Much has been written about the S&P 5 (FAAMG: Facebook, Apple, Amazon, Microsoft, and Google) and we have nothing unique to add. These wonderful businesses with optionality for growth have practically become monopolies. They are not cheap today but are also not as expensive as the Tech leaders in the early 2000 and they generate strong profitability and free cash flow. We need to acknowledge that these companies have done a remarkable job in deferring current earnings in favor of investing in their operations, compounding their intrinsic value, and further widening their moats. At the same time, they have also used their vast financial resources to acquire companies with the sole objective to eliminate competition. The tail risk of increased regulatory scrutiny is currently not reflected in valuations. Just like Nifty-Fifty, the S&P 5 have become one-decision stocks. With that said, we have less of an issue with the S&P 5 as they have wide moats, but there are plenty of other crowded stocks—both defensive and momentum—that could come crashing down once the Covid-19 pandemic subsides and the economy opens up. Not every Software as a Service (SaaS) business is created equal and deserves to trade at 15x revenues. Merely altering the sales model to a subscription basis should not lead to a tenfold increase in the market cap of a software business. A subscription model in itself does not improve the quality of a business or make it more defensive.

If there is a bubble in large-cap growth stocks, we might need the real interest rates to trend higher to prick the bubble. Bill Gross recently commented that the Fed intervention and their implicit guarantee has caused the real interest rates to decline by 150-200 bps in the last few years. The decline in real rates has had a much greater impact on the prices of mega-cap growth stocks than for value/cyclical stocks. An increase in real yields could act as gravity on the multiples of these growth stocks. Once the Covid-19 pandemic starts to recede and the recovery begins to unfold in the 2-3 years that follow, we see an attractive opportunity for returns in the value segment, especially small- and mid-cap value stocks. While cyclicals versus defensives and growth versus value have gone through various fits and starts over the last two years, it is only now that fundamental expectations are really backing up a rotation in leadership that favors under-owned cyclicals.

In 2000, the spread between large-cap growth and small-cap value was being driven by how expensive large-cap Tech stocks were. Today, the same spread is being driven by how cheap small-cap value has become. For the Value style and small caps to truly gain momentum and for the cycle to extend beyond the initial recovery phase, similar to what took place in 2000-2002, we would need to see a pick-up in inflation expectations and the upward pressure on yields. The 3 D's: De-Globalization, Deficits, and Dollar weakness are causal factors that we envision could become the sparks to ignite this fire. As equity investors in small- and mid-cap companies, we are especially focused on the underlying dynamics in these segments of the market. The table below highlights the reversal that took place in value versus growth in small caps over the three years starting 2000:

	Russell 2000 Value	Russell 2000 Growth
2000	22.8%	-22.4%
2001	14.0%	-9.2%
2002	-11.4%	-30.3%

Source: Russell Investments.

The Covid-19 crisis and how we have modified our portfolios

> *Yet if the security were truly a bargain when it was purchased, the rational course of action would be to take advantage of this even better bargain and buy more.*
>
> Seth Klarman

In our Q1 letter, we wrote that the best investments are often undertaken in an environment when the outlook is circumspect to panicked. It is difficult to ascertain the magnitude of the economic damage that will be caused by the Covid-19 pandemic and the trajectory of the eventual recovery. Our view is that it will inflict more serious damage than a typical transitory shock but less severe than what transpired after the 1930s depression or the GFC. We believe that investors should make realistic and conservative assumptions about the near term, but this does not mean that they should be pessimistic regarding the return opportunities over the medium term. Investor comfort is a poor gauge for evaluating risk exposure.

In the equity markets meltdown in March, we saw the best opportunity set since the GFC in small- and mid-cap companies based on our absolute return criteria. We took advantage of the select dislocations by establishing new positions in businesses that we deemed to be of high quality and adding to our existing investments that we believe were unjustifiably oversold. Since the start of the year, we have increased our exposure to our *Discounted Franchises* and *Undervalued Growth* categories (remember, growth and value can be "joined at the hip") and added to existing investments where their management teams are executing well (and may be even better positioned after the Covid-19 pandemic subsides). In addition, we took advantage of the market rebound in the second quarter and exited and/or reduced exposure in select investments in industries such as aircraft leasing, lodging, and restaurants where fundamentals have deteriorated and could remain challenged for a few years. We also maintained an underweight stance in the Financials and Real Estate sectors.

The tactical case for the Sapience portfolio

> *You don't get rewarded for taking risk; you get rewarded for buying cheap assets.*
>
> Jeremy Grantham

The performance of the large Tech and growth stocks has driven the S&P to +3% return and NASDAQ to nearly +23% return on a year to date basis. However, the S&P and NASDAQ paint a dubious picture of the broader market's health because the results have been highly bifurcated. The equal weighted S&P Index trails the S&P by a wide margin and Russell 2000 Value Index was down close to 20% on a year to date basis. This historical divide has led to several investments in our portfolios that we believe offer attractive upside.

The current environment reminds us of 2009 and we continue to see an opportunity to outperform over the next few years. Even in the recovery since March 23, the spread between small cap value and large cap growth has largely remained intact. We believe Covid-19 became the catalyst that ended the last economic cycle that was elongated but tepid in nature. Even with the potential of an effective therapeutic treatment and/or the likelihood of a vaccine by year end, it could take up to two years for the economy to normalize. The recovery will likely be uneven and different types of businesses and industries will be operating at widely disparate levels over the next couple of years. Of course, as bottom-up investors we will need to discriminate between above average businesses that are trading at depressed valuations due to their exposure to any one or all of the three factors: value, cyclicality, and leverage, from businesses that are structurally challenged and look cheap but are value traps. True price discovery should take place in the next 6-18 months when liquidity risk will be differentiated from the solvency risk and we could see a pick-up in M&A activity in small/mid cap companies as the bid-ask spreads should narrow.

Like many price-driven investors, we are often early in repositioning our portfolios. While it's early days, we are pleased that our conviction in our existing holdings along with our new investments (underwritten in the last 5-6 months) started to pay off in the second quarter. The last 5 years were a more favorable time for passive investing; we believe the next few years should be a better environment for skill-based investing over market-based investing.

Sapience conclusions

The past decade has been too dramatic, in terms of length, relative performance, and a changing economic perspective, to chalk it up as just another anomaly. Our objective will be to identify and adjust to secular change, while maintaining the key principles of value investing that should remain at the center of our beliefs and methods.

We could complain about how overvalued some of the momentum growth stocks have become and how that has skewed the perception of broad market returns. However, this type of thing happens every decade or two and should be considered "a given". The key is to think through how to do Value investing better—what has changed in businesses and the economy and what remains intact. That is the worthy challenge at hand.

Is today a re-run of 1999? Although there is an even greater concentration of total market cap in the largest companies which is troubling, we do not view our current scenario as being quite that extreme or vulnerable. Between August 1995 (Netscape IPO) and the peak of the internet bubble in February 2000, earnings growth for the Russell Growth Index lagged that of the Value Index by more than 3% per annum. The extreme outperformance of growth during that period was clearly based on considerations outside of reality. That said, this remains a market extreme and we like what we own far better than what we see in growth portfolios or in many value portfolios that are crowded with overpriced businesses in the name of safety and "high quality".

As you have likely gathered, we have a natural skepticism to the academic modeling of factors and market premia. Similar to our prior statement that the small cap premium is highly in doubt, we question the validity of a value premium. It is certainly time dependent. At the end of February 2000, value had lagged growth by 220% cumulatively over the prior 21 years. Given that both Russell (2011) and Fama and French (2014) have modified their style screens, the skeptic in us would consider that the value premium is more of a mirage conceived around poor index construction.

These views, however, do nothing to dissuade our belief in the power of knowing the companies we own well enough to effectively assess their value and hold them when they might be out of favor and at times trade at a significant discount. This includes owning healthy franchises that are misperceived by the markets and investing in select troubled businesses where we are confident in our underwriting assumptions of improving rather than static operating results. Understanding the value of a business continues to represent the best defense against a permanent loss of capital.

Back in the '90s it became clear that valuation had become less of a balance sheet and asset-based computation, and much more related to cash flow and the income generating capabilities of all assets including intangibles. This notion takes another step forward today. The market should not pay us for identifying stocks that are cheaper than average, but it will pay us for superior insights.

Part of the theory behind the value premium has been that growth stocks are systematically overpriced and value stocks will therefore win by default. Innovation, technology, and disruption are facts more powerful today than they have ever been. In our view, this opens up an equivalent shortcoming for the value universe—there are more buggy-whip companies than ever. Just as the growth universe has a segment that is overvalued, the value universe has a growing number of businesses that cannot be assessed based on their past and have a highly suspect future. Consider two points: the average lifespan of S&P 500 companies has shrunk from 50 years in 1950, to 30 years in 1985, to 18 years today, and the length of time it takes a new business to scale operations and achieve mid-cap status today is a fraction of what it was even a decade ago. Having said that, most software or ecommerce firms flame out and it takes disciplined analysis to separate the sustainable winners.

In our efforts at Sapience to "do Value better", we have intensified specific aspects of our research lens, including:

- A recalibration of what constitutes a competitive advantage or a sustainable moat.
- The value of fixed versus intangible assets and the network effect in its ability to impact incremental margins and cash flows.
- A heightened assessment of changing customer preferences, ease of price discovery in the internet age, and competitive forces.

Value investing works because its core principles are logical and timeless. As students of value investing for over three decades and practitioners for over two decades, we at Sapience constantly strive to learn and improve in our craft. Every pursuit we undertake at Sapience, from investing to client communication is a team endeavor. We thank you and appreciate your interest in our firm.

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