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David Stevenson: value investing's comeback may never arrive

By **David Stevenson** / 16 Sep, 2019

Investment anoraks like me love to witter on endlessly about different equity styles such as value and growth. We tend to take on an almost evangelical tone when we enthuse about our chosen investment style, ignoring hard facts as we choose.

By nature, I am more of a value investor, having lapped up the collected works of Ben Graham, Warren Buffett and Joseph Piotroski. Yet the contrarian in me is always looking for evidence that I might be wrong, and my attention is currently focused on Japan, which should be the greatest value market on earth – but has consistently under performed for as long as I can remember.

The challenge here is the awkward, hard facts: value stocks have underperformed for many years now. Amongst the pointy-head quantitative types who follow this stuff, the numbers are fairly well known. During the current upswing cycle, value has become so unpopular that many institutions have dumped active managers in this space, to chase growth orientated tech stocks. Alternatively, more sensible types have made a sideways move into what are called quality stocks – slightly less racy, well managed companies with strong balance sheets and sensible levels of growth.

Yet in the last few weeks there has been some evidence that value stocks might be becoming a tad more popular, especially as worries about a global slowdown become more pronounced.

This week for instance analysts at Societe Generale reported the single largest value stocks bounce-back on record. That said, we shouldn't get too carried away. Since the turn of the year, value stocks – as monitored by those analysts – are still down in relative terms by around 10% in Europe and the US.

Ground zero for many value investors worldwide is Japan. It has the largest collection of dirt-cheap stocks on a developed world stock market. And don't just take my word for it. Value fiend Michael Burry, who featured in the film The Big Short, recently observed that: 'It is not hard in Japan to find simple extreme undervaluation -- low earnings multiple, or low free cash flow multiple. In many cases, the company might have significant cash or stock holdings that make up a lot of the stock price.'

Mobilising that value is the issue. 'There is tremendous opportunity here for re-rating if companies would take governance more seriously,' says Burry.

'Far too many companies are sitting on massive piles of cash and shareholdings. And these holdings are higher, relative to market cap, than any other market on Earth.'

More and more value-oriented hedge fund managers are now running their slide rules over Japan. Over here in the UK we have a small bevy of specialist Japanese small- to mid-cap equity fund managers, many of them with cracking track records.

We even have a dedicated Japanese value focused shareholder activist investment trust, **AVI Japan Opportunity Trust** (AJOT) run by the experienced team at Asset Value. In its short life span this trust has already achieved some big wins. But these are isolated examples. Overall Japanese stocks remain cheap, and small cap stocks even cheaper.

The managers behind the Samarang Japan Value fund – a small, specialist mutual fund in this space – cite the example of two reasonably well-known broad-based trading companies called Kanematsu and Yuasa.

Both are small- to mid-cap in size, with market caps of around $1 billion. Kanematsu currently yields 4.8% and trades at 5.9 times earnings despite having grown book value per share by 76% in last five years. Yuasa yields 4.8% and trades on 7.6 times. Crucially both have little direct exposure to China, where investors worry that the tariff war could wreck profit margins.

Corporate governance is steadily improving in Japan and the Bank of Japan has been aggressively buying equities through a huge exchange-traded fund (ETF) purchase programme involving the direct purchase of private sector shares via pooled funds.

Logic suggests that the unloved, and under researched small-cap Japanese sector should start to bounce back. And what goes for these minnows might go for the whole market.

Japanese equities are now only trading at a small premium above book value: (1.1 times versus 3.3 for the US S&P 500) while some sectors look especially unloved. Japanese banks for instance have underperformed the broader market by 46% since the peak of the Abenomics reflation program – in fact their share prices haven't changed much since the beginning of the massive monetary experiment.

And despite all the talk about Japanese corporates handing back some of their spare cash, the S&P Japan buyback index (which focuses on stocks with big buyback programmes) has been sharply underperforming since the third quarter of 2017 and is now below pre-Abenomics levels.

Intriguingly the one sector that has shown some sign of life is the Japanese real estate investment trust sector, an important part of the Bank of Japan portfolio, where prices have perked up noticeably.

It's easy as a value investor to get carried away with the gloomy, contrarian message. Some value managers in Japan have been making good money in this difficult market. That Samarang Japan Value fund I mentioned earlier made an 18% gain in the first half of this year, after an 11.9% loss in 2018.

But the hard numbers suggest that Japanese value stocks should be posting much bigger gains. This I think raises an interesting prospect which is that value investors looking for Japanese adventures simply can't ignore basic macroeconomic facts, despite low valuations on individual equities.

Japan’s demographic crisis is deeply embedded in the psychology of its consumers now and I think we’ve seen in effect a form of collective surrender before the altar of economic growth. Growth rates have been so low for so long, that they’ve also pushed down interest rates.

Collectively, a new attitude has arguably emerged. Smaller, more vulnerable companies see a low growth economy and they in turn become more and more cautious. They hoard cash, they become careful about investing for growth and generally shun too much dangerous corporate innovation.

The government may try and shake confidence into the corporate sector and while there is some evidence that this is working with the bigger businesses, amongst the bedrock of smaller firms a kind of fog of caution has emerged. With no fabulous opportunities for growth, smaller businesses turn into value traps.

And where Japan leads, the rest of us may follow. Many of the leading G7 economies are contending to varying degrees with similar demographic crises, some more deep seated than others.

The globalised financial economy has encouraged investors to send their cash abroad in search of growth, neglecting domestic value-driven sectors which increasingly fall off the radar of big institutions.

Under researched and struggling with anaemic domestic growth, many value stocks in key developed world economies are going nowhere. Evangelists for value may spot opportunity but maybe these unloved stocks really are the first big corporate victims of a decades-long economic stagnation in the West.

Low growth rates, low interest rates, low stock market returns, low demographic growth. Add this all up and value small caps will always be doomed to stagnate. Maybe value’s day will never come?