Within Style Diversification- The Value in the CEP Value Strategy

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"Be fearful when others are greedy, and greedy when others are fearful."
- Warren Buffett

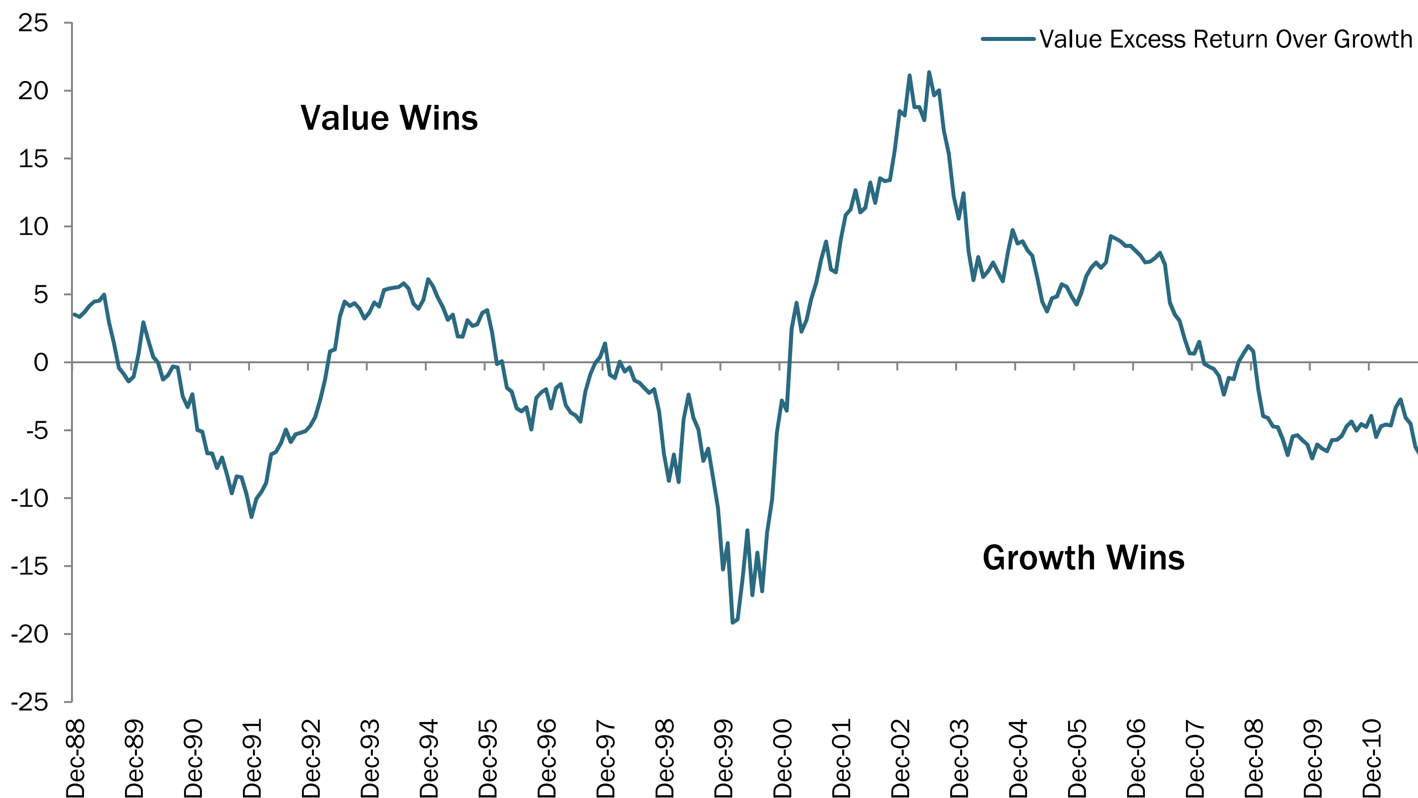
Value investors look for stocks they believe will outperform in the long run, because their prices are too low (undervalued) relative to a certain fundamental metric, such as book value, earnings or cash flow. As such, value investing essentially involves bearing a risk when the market does not want to bear that risk, as indicated by the undervalued stock's low relative price. Not surprising, the rewards of value investing are often tied to economic cycles and cycles of risk aversion in the capital markets. Therefore, the efficacy of value investment management tends to move in cycles, similar to growth investing at the opposite end of the spectrum.

Remember the supposed death of value investing and the dawn of a 'new era' approximately a decade ago, which led to the demise of many well-respected value shops? That supposed paradigm change came crashing down with the bursting of the technology/internet bubble. Moreover, the value of the growth and value styles is not necessarily correlated with the outperformance of the underlying growth and value benchmarks. In other words, if a passive value benchmark is beating its growth counterpart, this does not mean most active value managers are outperforming the benchmark during the same timeframe.

Investors seeking to diversify their portfolios often own growth and value stocks. As the growth and value styles move in and out of favor, cycles also emerge within each style. For example, many investors seek higher-tracking-error, 'deep value' and 'deep growth' strategies to complement lower-risk active or passive core strategies. We know there are stages of value cycles when deep-value investors have performed exceedingly well, but there also are value-cycle stages that have not been favorable for these approaches. Many investors may be unaware there are value portfolios offering pure exposure to the underlying value benchmark while providing lower risk and less-volatile return potential. Admittedly, these portfolios may underperform deep-value funds (while still beating the Russell 1000 Value Index) during strong value phases, such as the early-recovery surge that typically favors a 're-risking' trade. These lower-risk strategies tend to perform better during the later stages of economic expansion and often when the value-style itself is out of favor.

It is useful to review the relative three-year rolling return of the value style versus the growth style, shown in Chart 1. The biggest relative outperformance of the value benchmark came during the deflating of the internet/technology bubble in the post-2000 period. Yet, value also outperformed growth on a rolling-return basis during the normal economic expansion phase of 2003 to 2007, both in the early stages and as the cycle matured. Conversely, the value benchmark has underperformed on a three-year trailing basis throughout the latest recovery phase, which began in 2009.

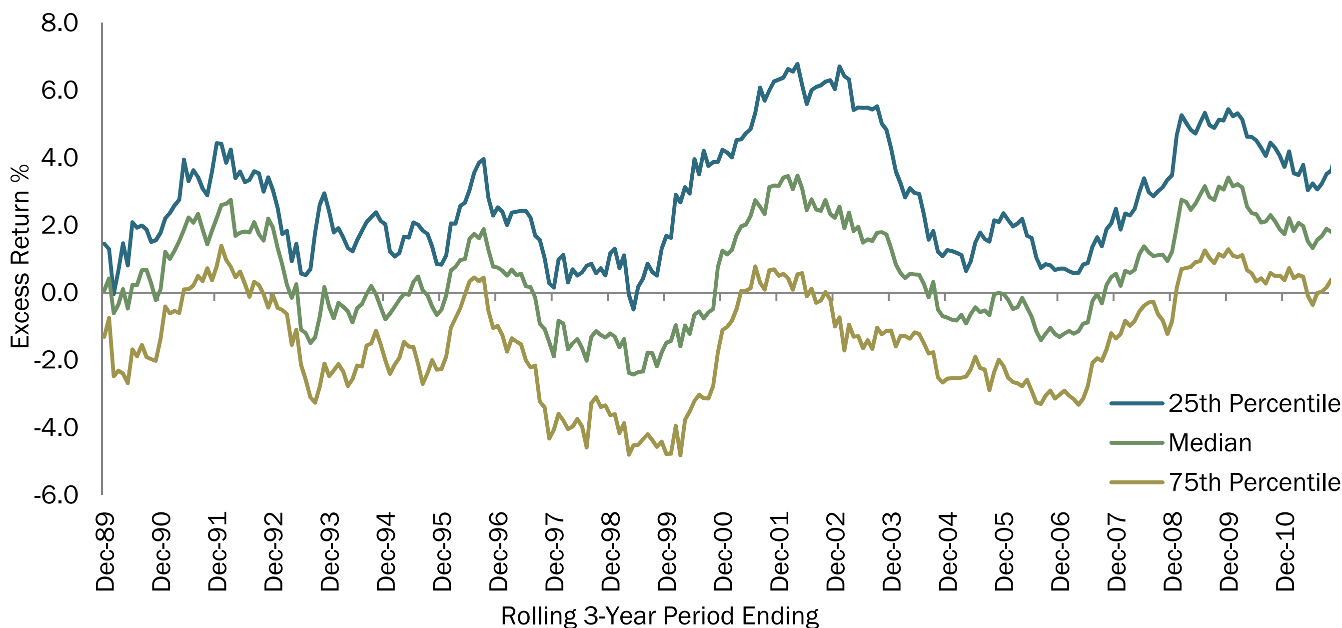
Chart 1 – Russell 1000 Value Index Minus Russell 1000 Growth Index (Rolling 3-Year Difference)



Source: eVestment Alliance

Chart 2 shows the excess returns for the large-cap value managers in the eVestment Alliance database during the last 10 years. Comparing Chart 1 with Chart 2 demonstrates the cyclical nature of the excess returns shown for the median, 25th and 75th percentiles. The pattern seems to fit well with the general performance of deep-value strategies. The median manager outperformance was strong during the bubble collapse and during the early stages of economic expansion in 2003 and 2009. All of these periods tend to favor the stocks with the highest book value-to-price ratios. This pattern holds whether the underlying value benchmark outperforms, as in 2003, or underperforms, as in 2009. The early stages of recovery still favor the cheapest, most beaten down stocks and the most cyclically depressed sectors, which also tend to exhibit the highest volatility. Those who favor quality metrics often refer to such periods as “junk rallies.”

Chart 2 – Rolling 3-Year Excess Returns vs. Russell 1000 Value Index

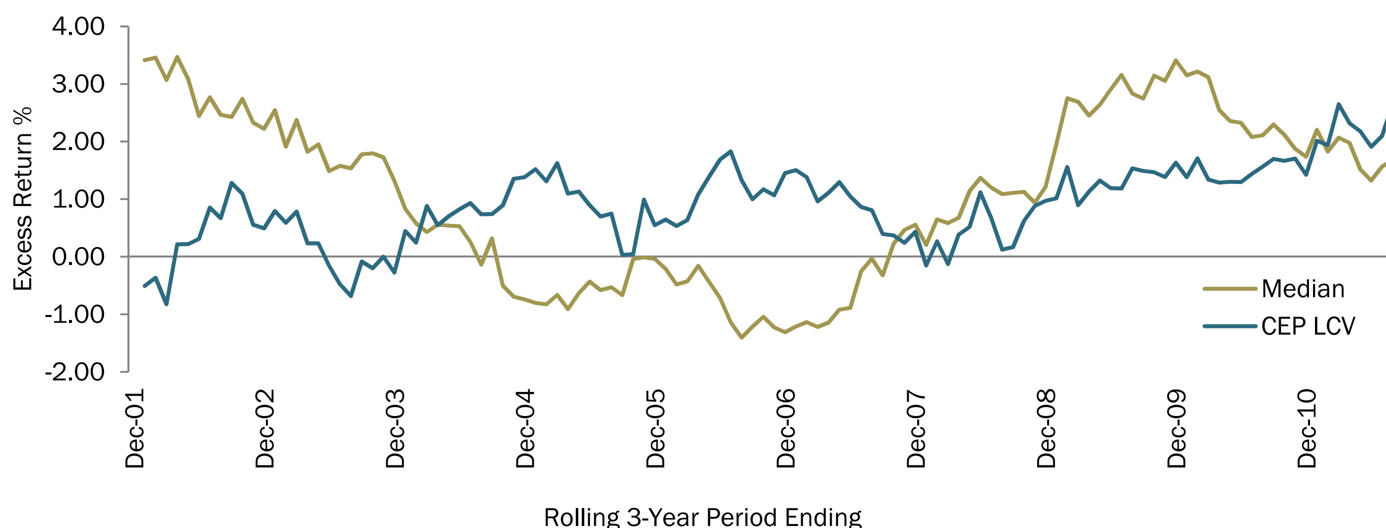


Source: eVestment Alliance

On average, this same manager group did not perform particularly well during the latter stages of economic expansion from 2004 to 2007. A similar pattern appears to be emerging now during the more mature phase of the economic expansion, as evidenced by the rollover in the quartile manager returns. The early 'rising tide lifts all boats' phase of the rally, which favors simple price-to-book strategies, gives way to a phase that favors a balance of diversified factors. Such phases tend not to favor the deep-value approaches.

The CEP Large Cap Value strategy provides consistent exposure to the underlying value benchmark. Although the portfolio emphasizes traditional value metrics, it also focuses on other factors, including cash flow, earnings quality, capital discipline, expected growth and earnings momentum. The strategy's broad factor-intersection approach seeks to provide less-volatile excess returns and consistent outperformance versus the Russell 1000 Value benchmark. The CEP Large Cap Value portfolio outperformed the benchmark but didn't do as well as its deep-value peers during the strong value periods (2002-2003, 2008-2009). Nevertheless, the CEP Large Cap Value strategy outperformed deep value peers during other stages (2004-2007, year-to-date through September 2011), despite its consistently lower risk profile, as shown in Chart 3.

Chart 3 – Rolling 3-Year Excess Returns vs. Russell 1000 Value Index

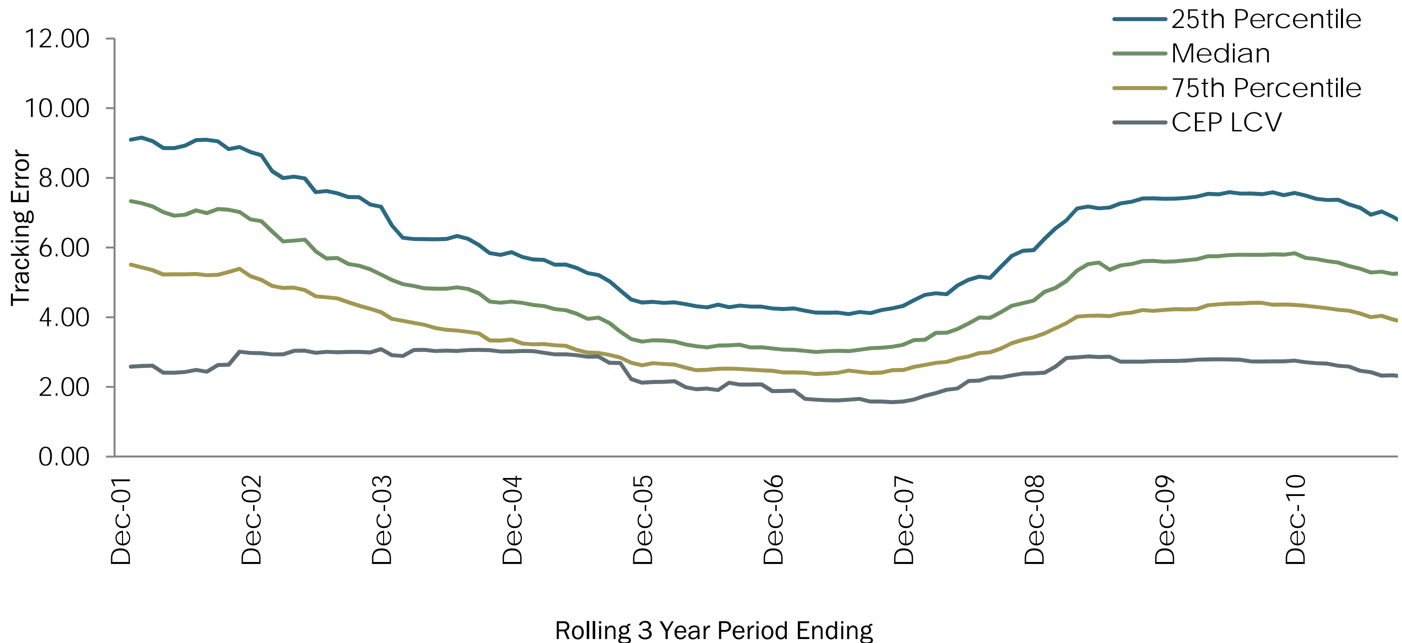


Source: eVestment Alliance

The returns in the charts above demonstrate the different approaches to value investing and suggest some diversification within broader style investing can be beneficial. There are clear benefits to adding a manager with a broad intersection approach to a mix of managers with deep-value exposure. The manager with more moderate factor tilts may consistently outperform the Russell 1000 Value benchmark and perform best when other managers within the style are struggling. From an excess-return correlation standpoint, there may be benefits to diversifying away from pure deep-value strategies, even if there is no particular aversion to high-risk strategies.

While deep-value managers may earn good excess returns during certain stages of the cycle, such performance does not come without risk. Chart 4 displays tracking errors for the same time period and the same set of managers as displayed in Chart 2 (excess returns). Not surprising, the tracking-error cycle is highly correlated with the excess-return cycle. Most deep-value managers do not attempt to manage either systematic or specific risk factors, and in many cases, they attempt to cyclically amplify them. In general, the median manager in the large-cap value group has an average tracking error of approximately 5.0%. While these strategies certainly have their place, provided the risk/reward trade off is appropriate, they do not represent the only approach to value investing. Specifically, a lower-risk strategy that actively manages systematic risk exposure and minimizes stock-specific exposures may consistently deliver excess returns. On average, Chicago Equity Partners' tracking error has been 2.5%, or half the tracking error of the median manager. Our approach, which emphasizes risk control, has provided an attractive diversifying return pattern. In general, most managers within the value asset class do not attempt to manage risk in this way.

Chart 4 – Rolling 3-Year Tracking Error vs. Russell 1000 Value Index

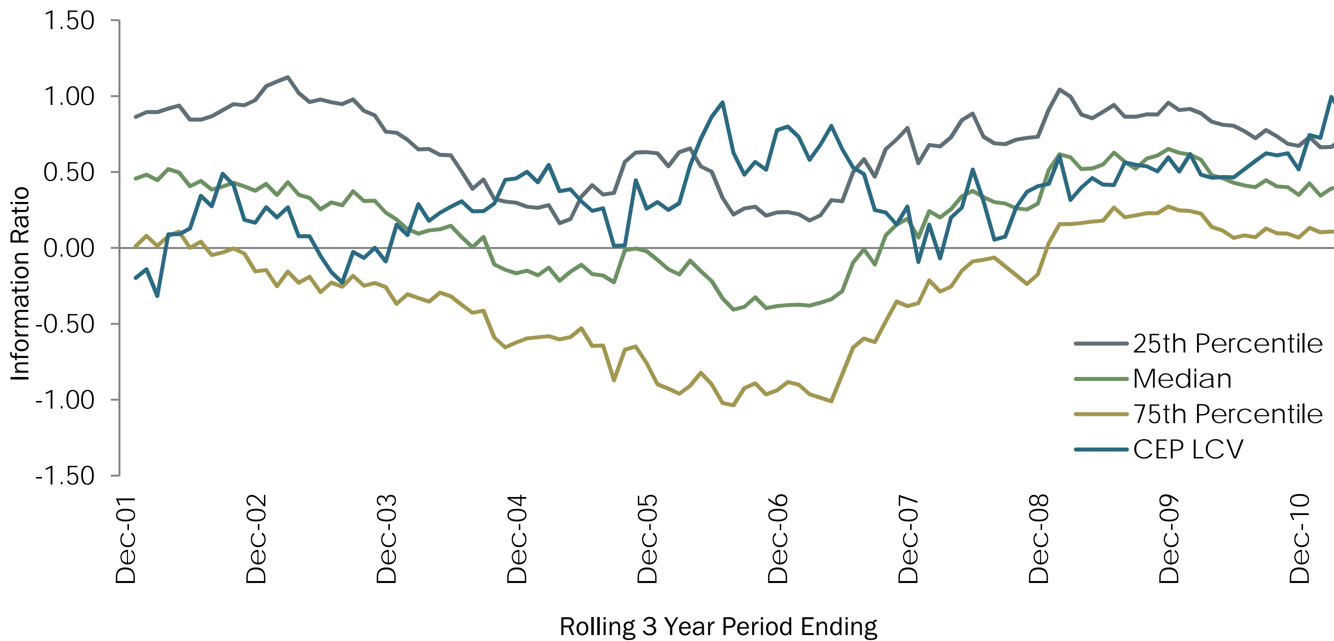


Source: eVestment Alliance

It is helpful to examine return and risk in conjunction, even for investors who are less concerned about risk. In particular, it is useful to assess manager value-added by measuring excess return per unit of risk (tracking error), known as the information ratio (IR). Combining excess returns and tracking errors is one way of statistically evaluating the certainty of value added. Risk can result in excess return, either through skill or luck, and IRs are a means of risk-adjusting those returns.

This is demonstrated in Chart 5, which looks like a more muted version of the excess returns shown in Chart 2. As evidenced, the CEP Large Cap Value strategy performs even better on a risk-adjusted basis, outperforming the median value manager from 2004-2008 and placing in the top quartile in 2006-2007 and for the year-to-date period through September 2011.

Chart 5 – Rolling 3-Year Information Ratio



Source: eVestment Alliance

CONCLUSION

Deep-value investing likely will continue to perform in a cyclical fashion, much as the underlying value benchmark will cycle through periods of underperformance and outperformance. The majority of funds in the value universe fall within this cyclical value category. Such managers should provide strong excess returns during particular stages of economic and market cycles, but not during others. While there certainly is a place for such cyclical value strategies in an overall equity allocation, they do not represent the only approach to value investing. Under the broad "value umbrella," investors should consider holding a deep- value, high-risk component in conjunction with a low-tracking-error, structured-value portfolio. As a complement to deep-value funds, a lower-tracking-error value strategy provides diversifying stability while simultaneously providing consistent and pure-value benchmark exposure.