

# Positioning Value in Portfolio Construction



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**R**isk factors and their relationship with different macroeconomic environments are well understood. But in recent years these factors have not behaved as expected.

This is the case for value stocks. Buying cheap stocks in the expectation of their prices improving over the long term is a well-established strategy. Investors select value stocks according to specific financial metrics, such as low price-to-book ratios or price-to-earnings ratios.

These discounted stocks tend to be higher risk companies, often with high levels of debt. Over time, however, investors expect to be rewarded for investing in these higher risk companies with greater potential returns than would be achieved by investing in the overall market.

This stock characteristic has been heavily researched by academics. But despite its well-established credentials, this strategy will sometimes experience unexpected behaviour.

## Value stocks tend to perform when economies are expanding

As value stocks tend to be risky investments, these companies are likely to outperform when there is a favourable economic outlook, and to outperform other factors when there is an improvement in GDP growth.

Typical outperformance of a value index compared with a market-capitalisation weighted index is around 1% when GDP growth is increasing. For example, during economic expansion from mid-2003 to mid-2007, value indices outperformed blended benchmarks by roughly 2.5% a year.<sup>1</sup>

Value stocks tend to perform best in the early stages of a recovery. During this period, there is sharp relaxation of investors' risk aversion. The early stages of expansion are also a return to normality – it is essentially a “mean reversion”. And investing in value stocks is a mean reversion strategy – the price of a stock is expected to revert to a price comparable to its competitors.

Over the second and third quarters of 2003, there was an economic recovery following the bursting of tech bubble. During this period, value

indices outperformed standard indices by around 4–5%.<sup>2</sup>

Similarly, in the recovery after the financial crisis, value outperformed standard indices in second and third quarters of 2009. Global value indices outperformed by 4–5% during this period while European value indices outperformed by 10%.<sup>3</sup>

While value indices tend to outperform during times of economic recovery, they will underperform standard indices by around 1% when GDP growth is contracting. During economic crises, investors shun these riskier stocks in favour of those with safer characteristics.

## But the normal rules haven't applied to value in recent years

Although many regions experience economic growth, during the last five years this macro-economic expansion has been anything but normal as it has been driven by ultra-loose monetary policy. While monetary policy has underpinned stock market performance, its transmission to the real economy has been less successful. That's been reflected in the low level of business investment.

This monetary policy has also re-shaped investment behaviour. As bond yields have fallen, investors have instead turned to high-quality equities to provide them with income.

In addition, the economic recovery has been very fragile and its longevity has been uncertain. As a result, investors have remained risk averse, preferring low-risk to high-risk equities.

But over the past few months the mood has lightened considerably. An increase in fiscal spending looks more likely under a Trump presidency. In addition, the US Federal Reserve has started to raise interest rates, signaling a move to a more normalised macro-economic environment.

In Europe, where interest rates remain very low, sentiment about economic conditions has improved. Should this more positive economic outlook persist, value investment strategies are likely to look attractive to investors, again.

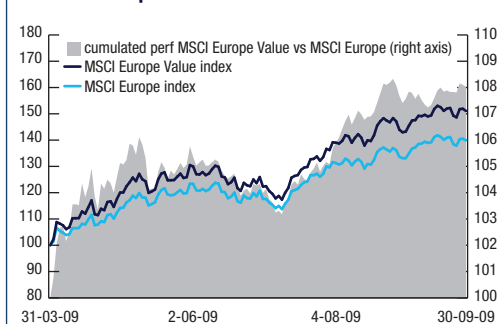
## Why combining different factors makes sense

Another way to potentially optimise performance is either to identify those periods when value stocks will underperform or to hedge against these periods by also investing in quality stocks, as these two strategies are negatively correlated.

For example, when value indices outperformed during the second and third quarters of 2003 and 2009, quality stocks underperformed the standard index by 5% and 13% respectively.<sup>4</sup>

By contrast, quality stocks can provide a good hedge during periods of deceleration and recession as they tend to be less volatile than value

**Value outperformed standard indices in second and third quarters of 2009**



Source: Amundi ETF, Indexing & Smart Beta/Bloomberg. Performance comparison MSCI Europe Value Index vs MSCI Europe index between April 2009 and September 2009. Past performances cannot be regarded as a reliable indicator for future results, nor can they guarantee future returns.

stocks. For example, when value stocks underperformed during the financial crisis from mid-2007 to early-2009, quality stocks outperformed by an impressive 20%.<sup>5</sup>

## No single way to invest in value stocks

Investors now have a plethora of value investing options at their fingertips. They can, for instance, opt for a cost-effective exchange-traded fund which has been demonstrated to capture most of the potential value outperformance.

A more sophisticated solution allows investors to use more specific parameters to limit certain biases present in value indices.

For example, not every company with a low price-to-book ratio will outperform – some are badly run companies that will never recover, known as ‘value traps’.

These more actively managed strategies also can prevent the investor from having too high a proportion of their index exposed to a particular sector, for example, the financial sector where price to book is low, compared with sectors like information technology – where this one is a less meaningful metric.

It's clear that investors care about how risk factors are defined and constructed. To generate returns, investors need to challenge how weightings are determined in order to limit bias and overexposure and efficiently combine different factors throughout the market cycle.

1 Source: Amundi/Bloomberg performance monitor, Q3 2003 – end of Q2 2007

2 Source: Amundi/Bloomberg performance monitor, Q2 and Q3 2003

3 Source: Amundi/Bloomberg performance monitor, between June 2007 and Q1 2009

4 Source: Amundi/Bloomberg. Performance monitor between 01/04/2003 and 30/09/2003 and year 2009

5 Source: Amundi/Bloomberg. Performance monitor between June 2007 and Q1 2009

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