DISTILLATE CAPITAL

# Value Failed Because It Was Expensive

## When "Value" Isn't Value

The sharp underperformance of common value benchmarks in recent years has led to commentary that value investing is either dead or very near death. Value's disappointing performance is evident in **Figure 1** which plots the relative gains of the popular Russell 1000 Value Index against those of the broader S&P 500 Index. The value index's inflection from outperformance in the wake of the dot-com bubble to underperformance since 2006 is marked with a vertical black line.

*After outperforming the S&P 500 Index significantly from 2000 to 2006, the Russell 1000 Value Index has underperformed sharply thereafter.*

**Figure 1: Russell 1000 Value Index vs. S&P 500**


Source: FactSet

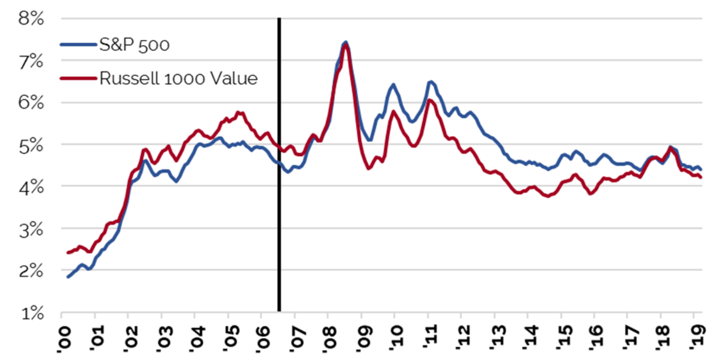
Defenders of value investing sometimes respond to its recent performance woes by blaming monetary policy or a spattering of individual stocks. Other times, no explanation is offered, but value is still emphatically described as poised for a robust recovery. Such hopes are often pinned to little else than to the longevity of value's underperformance.

We are value investors at our core and do not find any of these explanations or assertions particularly compelling. Instead, we believe that there is a much simpler explanation available: **"value" underperformed because it was expensive**.

Because of accounting rule changes and the economic evolution from physical production-based businesses to asset-light ones, many traditional valuation metrics like price-to-book (P/B) or price-to-earnings (P/E) no longer correlate with what we believe to be the truest measure of valuation—free cash flow generation. We discuss these accounting issues at great length in our paper on valuation and accounting as well as why we believe free cash flow-derived measures are more valid. Consequently, an index that is labeled value may not offer attractive price-to-worth if it is constructed using definitions that have lost their relevance.

*The Russell 1000 Value Index had a higher free cash yield and was cheaper when it outperformed, but was more expensive when it lagged.*

**Figure 2: Free Cash Flow to Enterprise Value Yield**

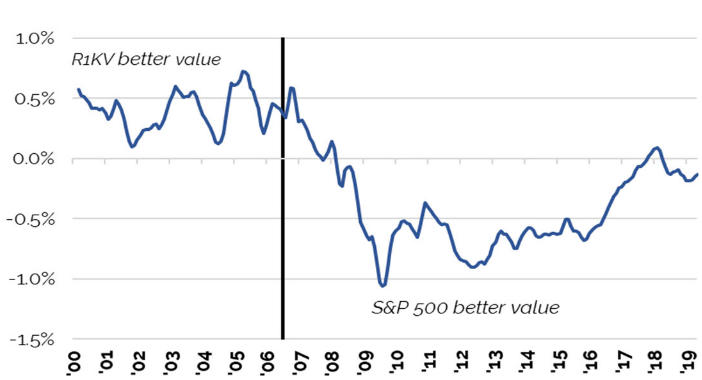



Source: FactSet, Distillate Capital

By comparing the valuations of the S&P 500 and Russell 1000 Value indexes on the basis of free cash flow to enterprise value, as we do in **Figure 2**, a different story emerges. The chart highlights that the value index was cheaper and offered a higher yield over the period of its outperformance, but was then the more expensive index when it lagged. **Figure 3** shows the difference in the two free cash yields and similarly highlights that the underperformance of the value index coincides with when it began to get more expensive and remained so. **So rather than indicating a problem, the underperformance of the traditionally-defined value index at a time that it was expensive supports the efficacy of value as a style – when it is accurately and rationally defined!** Most recently, the valuations of the two indexes did narrow considerably, though the value index remains slightly expensive and so to us still does not truly provide what is advertised in its name.

*Despite being labeled a "value" index, the Russell 1000 Value was more expensive than the S&P 500 Index on the basis of free cash flow.*

**Figure 3: Free Cash Yield Difference**




Source: FactSet, Distillate Capital

# Why Buffett Said Book Value "Has Lost the Relevance It Once Had"

While many traditional valuation metrics now suffer from the combined distortive impacts of accounting changes and the economic evolution to asset-light businesses, price-to-book (P/B) looks particularly flawed. Critically, it is also the exclusive valuation metric used to determine the constituents of the Russell 1000 Value Index, the most commonly used value index.

Because book value measures a company's balance sheet assets less its liabilities, what gets counted as an asset is of tremendous importance. When the economy was dominated by companies that engaged primarily in physical activities, this was not so much of an issue as plants and equipment showed up on balance sheets and financial statements were generally comparable to one another. But today, many companies derive their value not from physical assets, but intangible ones based on extensive investments in research and development, branding, and other non-physical activities. Even though these intangible assets are very valuable and can generate substantial free cash flow, they generally do not count as balance sheet assets and so do not create any book value. This makes balance sheets and book values significantly less comparable and useful today than they were in the past.

Apple, for example, has very little in the way of assets that count as book value even though it generates enormous amounts of free cash. Apple therefore looks chronically expensive on P/B and currently trades at a lofty 15x P/B compared the Russell 1000 Value Index's 2x average. But on the basis of free cash to enterprise value, Apple looks inexpensive versus the overall market at a yield of around 5%. This is a significant disconnect between two measures of value and means that even though Apple looks inexpensive on free cash flow, it is unlikely to ever be added to the value index. Importantly, this is not an issue for just Apple, but for any company investing heavily in non-physical assets, which is now the majority of the market.

In another example of how book value has become less meaningful, there is over $1.1 trillion in market capitalization in companies in the S&P 500 that have negative book values as a result various accounting issues. The list of negative book value stocks is wide ranging and includes major companies like Home Depot and McDonald's. A valuation assessment for such companies based on book value is obviously nonsensical and further highlights the issues with the metric.

These issues are why Warren Buffett said in his 2018 Berkshire Hathaway annual letter that book value "is a metric that has lost the relevance it once had." We consider those significant words from an extraordinary investor. It is remarkable to us that despite this statement and the struggles of many value indexes, the general reliance on P/B has not been met with greater skepticism.

# Investment Implications

Rather than indicating a problem with value as an investing style, the underperformance of a P/B-defined index at a time it was expensive on a free cash flow basis actually supports the validity of value investing when it is defined in a logical and accurate way.

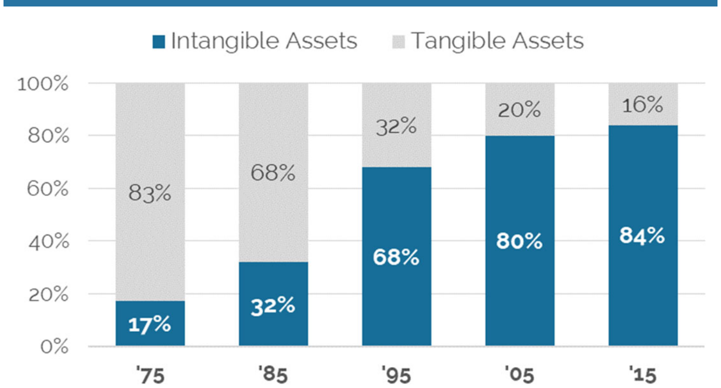
This explanation for the underperformance of "value" also makes much more intuitive sense than the explanations that are typically offered (or not) since human nature has not changed and neither have the behavioral biases that help to explain why pricing opportunities are persistently available in equity markets. Instead of asking when value is going to outperform again, we think the better question investors should ask is whether there is truly any value in their value indicies.

Waiting for a recovery in a P/B-based methodology based on its efficacy in the distant past also does not strike us as very logical. Since accounting rules have changed and companies are dramatically different than they used to be, it should be of little consequence that a metric worked as an indicator of value nearly a century ago if it has little relevance today. The economic evolution and the steady decline in the importance in physical assets that count towards book value is well captured in **Figure 4** which shows the tangible versus intangible share of overall S&P 500 Index market value over time from Ocean Tomo's "Intangible Asset Market Value" study. In a world that is now dominated by intangible assets, it makes little sense to us to rely on a valuation metric that largely ignores today's most valuable assets.

As an alternative to accounting-based measures of value that have become distorted over time, we believe free cash-based ones offer a truer picture as they remain comparable across companies regardless of whether profitability is driven by intangible or tangible asssets. Free cash-based measures of value have also continued to perform well even through the period when traditionally-defined measures of value have suffered.

*Physical assets have become steadily less important as a determinant of overall market value over time.*

**Figure 4: Tangible vs. Intangible Components of S&P 500 Market Value**




Source: Elsten & Hill "Intangible Asset Market Value Study" Ocean Tomo

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*__Book Value__ refers to the balance sheet value of a company's assets, less its liabilities.*

*__Price to Book Value__ is a traditional valuation measure that compares a company's market price to its balance sheet book value. For example, this can be calculated by dividing a company's stock price by its book value per share.*

*__Free Cash Flow__ refers to a company's operating cash flow, less its capital expenditures. Data excludes the real estate sector.*

*__Enterprise Value__ refers to the market value of a company's equity, plus the value of its outstanding net debt.*

*__Free Cash Flow to Enterprise Value Yield__ refers to a company's free cash flow, divided by its Enterprise Value. Data excludes the real estate sector.*

*The __S&P 500 Index__ is an index of roughly the largest 500 U.S. listed stocks maintained by Standard & Poor's. The __Russell 1000 Value Index__ is a stock index, managed by FTSE Russell, representing large capitalization U.S.-listed stocks that appear inexpensive on FTSE Russell's valuation criteria.*

***Indexes are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses, such as management fees and transaction costs, which would reduce returns.***

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