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A Framework for Value Investing

As providers of an active value strategy, our team has built an investment framework through study and experience that we believe can lead to persistent outperformance. In this memo we outline this investment process based on a compilation of insights published by our investment team.

"Buy wonderful businesses at fair prices"

Charlie Munger advised Warren Buffet, "Forget what you know about buying fair businesses at wonderful prices; instead, buy wonderful businesses at fair prices."[1] In factor terminology, we interpret this advice as focusing on quality together with valuation. In our previous Breton Hill Quant Library article "Why We Believe Quality Is a Good Guide for Value Investing", we provided a short literature survey in support of focusing on high-quality value stocks, and provided more recent out-of-sample data. This evidence supports higher quality as the most fertile area for value investing. Other names may be trading at exceptionally low multiples, but we believe the investment opportunity is not attractive if impairment issues justify those valuations. In our view, quality considerations can help avoid these value traps.

Drop the Sector Baggage

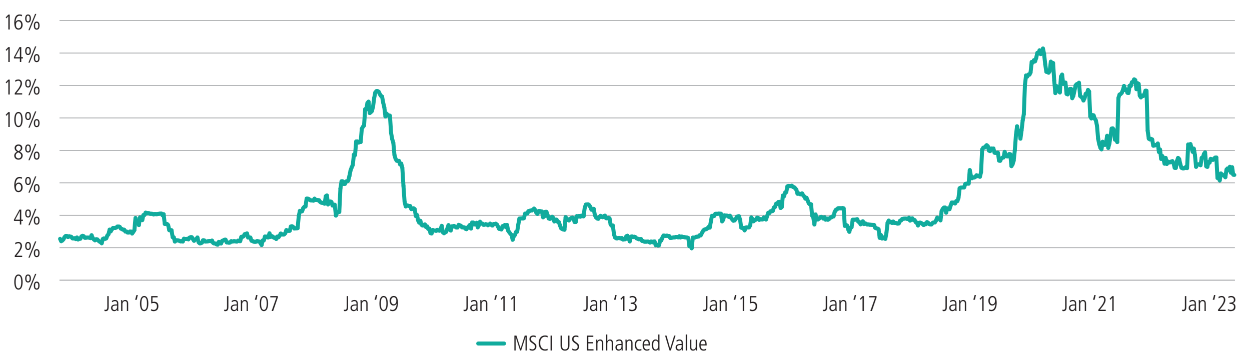
Effective sector management improves the expected information ratio by appropriately sizing within-sector and across-sector relative valuation opportunities. In our Breton Hill Quant Library article "Value Without the Sector Baggage", we explain what we see as a common pitfall of using valuation ratios to take large sector bets that can dominate the style bet. We believe it is a stronger risk/reward proposition to take moderate sector and industry tilts, which can be achieved without materially compromising on portfolio-level valuation ratios.

Consider Portfolio Risk

In spite of proliferation of index methodologies (over 175,000 factor/smart beta indexes),[2] we are not aware of any commonly used value benchmark that directly considers any portfolio risk metric. We believe this provides active managers with two avenues to potentially outperform over time:

- Point-in-time risk/reward optimization: The MSCI Enhanced value methodology, for example, is based on three standardized value factors: Forward Price/Earnings, Price/Book and Enterprise Value/Operating Cash Flows. The benchmark portfolio is built by choosing the highest scoring names up to a target number of names, without considering a portfolio risk metric such as volatility. To assess the opportunity cost of ignoring portfolio risk, we conducted a simple test. The current MSCI USA Enhanced Value Index has a tracking risk of 6.1% (as of October 31, 2023) tilt versus the MSCI USA Index. However, we estimate that equally strong value tilt can be achieved with a risk budget of only 4.9%.[3]
- Steady risk budgeting over time: The tracking risk between value benchmarks relative to market cap benchmarks varies dramatically through time. For example, the realized tracking error for MSCI USA Enhanced Value Index versus MSCI USA Index, ranged from 2.0% to 14.3% over the last 20 years (January 1, 2004 – December 31, 2023).[4] In other words, value benchmarks are much more aggressive in some periods than in others, which means that their active bets are concentrated at specific points in time. We believe that a more risk budgeted approach through time has the effect of increasing the breadth of active risk and thereby improves the long-term Sharpe Ratio.

TRACKING ERROR (26 WEEKS ROLLING)



Source: Bloomberg.

Add "Craftmanship" Alpha

Finally, we believe that value investing is best done actively. "The Fine Print of Indexation"[5] series highlights structural issues with benchmarks, but we believe those issues are magnified in value index products. For example, both MSCI and Russell value indexes use a two-dimensional value/growth methodology that has a perverse impact: companies with the poorest growth are pushed into the value index, even if they are not particularly cheap. On the other hand, cheap companies are pushed out of the value index if they demonstrate strong growth. We believe this is exactly the opposite behavior that value investors should seek.

In addition to avoiding such issues, we believe that active value managers can focus on areas where they have an additional edge. For our team, that includes for gaining an edge with alternative data, ESG and fundament insights (see Breton Hill Quant Library article "Integrating Fundamental Insights").

Conclusion

Based on our experience in quantitative value investing, we believe these are key repeatable components that can lead to outperformance.

[1] Buffet, Warren. 2014 Shareholder Letter. Berkshire Hathaway, 2015, p 26.
[2] Skypala, Pauline. "Index Proliferation adds choice but fuels confusions". *Financial Times*, November 5, 2018.
[3] Our calculation is focused on tracking risk. Substantial improvements can be achieved for investors focused on absolute risk as well.
[4] For comparison purposes, during the same period, the tracking error ranged from 1.7% to 11.3% for MSCI US Value Index versus MSCI US Index.
[5] Kramer, Doug. *The Fine Print of Indexation.* Neuberger Berman, June 2023.

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