VanEck®

Value

A timeless approach

ASX: VLUE — ASX: HLVU

VALUE INVESTING

Premised on identifying stocks whose prices seem to understate their intrinsic value.

The observation that cheaply priced stocks outperform pricier stocks in the long term is the foundation of value investing. Cheaply priced stocks are those that are trading lower than their 'intrinsic' or book 'value'. Value investing, therefore, is like bargain hunting, it is about buying companies that appear to be cheaper than they are worth. This often means buying companies that are out of favour with investors. In some cases, these companies may have been oversold and investors can benefit when they return to their intrinsic value.

It's worthwhile understanding how the value of a company is measured. Common valuation metrics, such as earnings or price-to-book value ratios have traditionally been used to measure value. Those with low metrics are considered value.

Value investing has been around since before the Great Depression. Over that time it has faced criticism, been finessed and different value investors have employed different ways to calculate value.

A history

1920s

Value investing identified

Economists Benjamin Graham and David Dodd formally developed the concept of value in the 1920s. Their book, *Security Analysis* (1934) and Graham's later work, *The Intelligent Investor* (1949) introduced investors to methods that could be used to identify value.

Graham and Dodd believed that the true value of a stock could be determined based on its assets, future earnings, dividends and prospects. The lower the price of the security, relative to this intrinsic value, the higher the 'margin of safety'. Behind this concept of value investing is the belief that 'cheaply' valued assets tend to outperform more expensive stocks over the long term.

This has proven to be true. One of the world's most successful investors, Warren E. Buffett, who got an A+ from Graham at Columbia in 1951, has made his fortune using the principles of Graham and Dodd as the CEO in Berkshire Hathaway Inc.

1970s

Further research

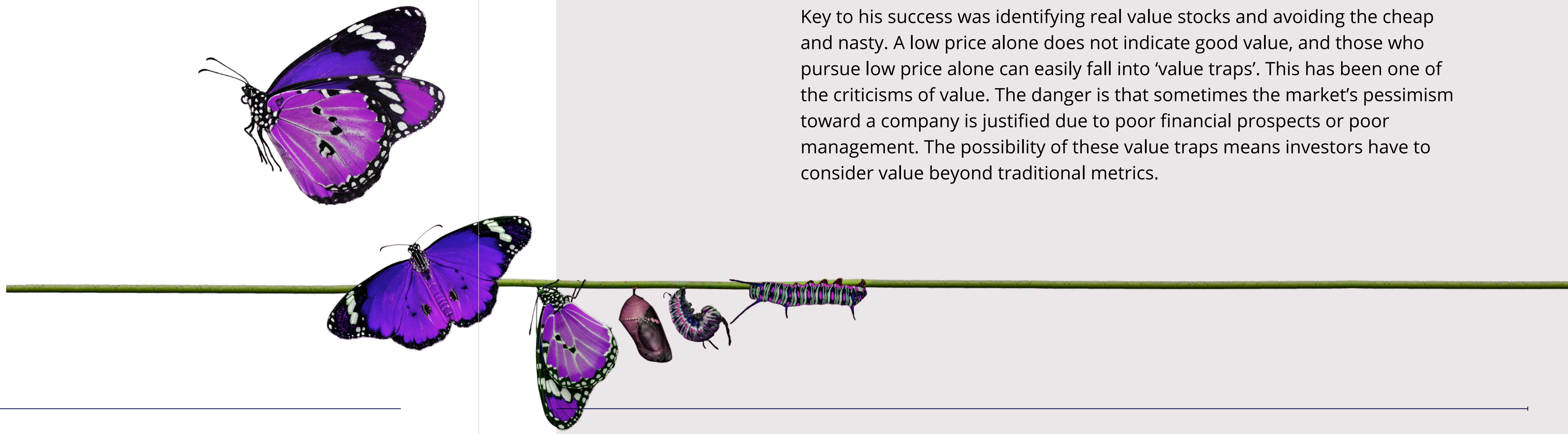
Academics too have studied value. Early research done by Basu (1977), Stattman (1980), and Rosenberg, Reid, and Lanstein (1985) shows that valuation ratios such as price-to-book and price-to-earnings are indicative of future returns, and that low value stocks tend to outperform high value stocks over a long time horizon. This led to Fama and French developing the Three-Factor Model as an extension of the Capital Asset Pricing Model (CAPM) to account for size and value factors. Fama and French's Three-Factor (later Five-Factor) Model changed the way investors considered and measured risks and returns. It paved the way for research into the persistent and identifiable drivers of stock returns, resulting in the rise of 'factors'. According to index provider MSCI, there are six main investment factors: quality, size, value, momentum, dividend yield and volatility.

1970s – 2000s

Value investing flourished

It was during the 70's, 80's and 90's that value investing flourished. According to the commentary of the 2003 edition of Graham's *The Intelligent Investor*, at the time, prominent value advocate and active manager Peter Lynch had the best 20-year return of any mutual fund ever.

Key to his success was identifying real value stocks and avoiding the cheap and nasty. A low price alone does not indicate good value, and those who pursue low price alone can easily fall into 'value traps'. This has been one of the criticisms of value. The danger is that sometimes the market's pessimism toward a company is justified due to poor financial prospects or poor management. The possibility of these value traps means investors have to consider value beyond traditional metrics.



VALUE: A TIMELESS APPROACH

LOOKING BEYOND INCOME

Earnings stability and dividends were two of the seven fundamental measures Graham cited in *The Intelligent Investor* when assessing a company's value. This led many value investors to look at these backward measures to determine future value. However, value investors should consider what a company's potential is, so forward earnings may be a better guide.

> The use of forward earnings estimates can help mitigate the potential for investing in those companies whose valuation might appear favourable, but where earnings growth is low or even negative, causing book value to stagnate.

REDUCING THE RELIANCE ON PRICE-TO-BOOK

According to a paper written by MSCI in 2015, a big part of the value underperformance is the mis-definition of value by relying on price-to-book in a world where intangibles are increasingly important.

To overcome this many value managers now place greater emphasis on enterprise value, a measure of the company's total value (typically based on debt plus equity market cap less cash). It also serves as the basis for many financial ratios that measure the performance of a company. Firms with high enterprise multiples have high expected cash flows relative to operating income, implying high growth opportunities and a relatively lower discount rate than firms with low multiples.

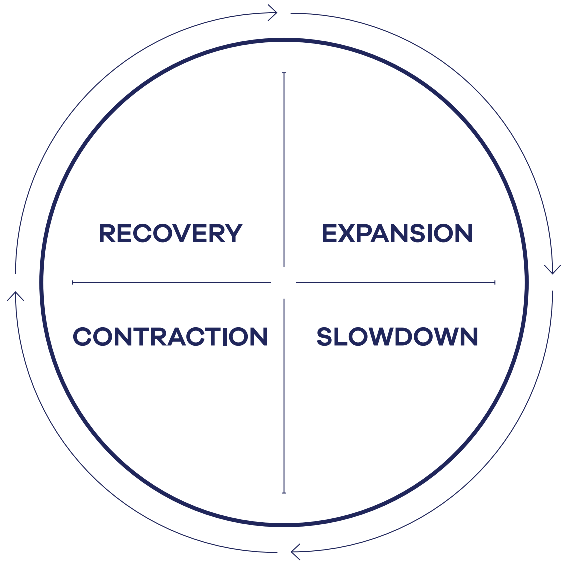
MSCI's analysis also found that forward earnings has helped protect against 'value traps', and that whole-firm valuation measures, such as enterprise value, have reduced concentration in highly leveraged companies, meaning those that have borrowed heavily. Therefore, MSCI developed its Enhanced Value Indices, which apply three valuation ratio descriptors on a sector relative basis:

- price-to-book value;
- price-to-forward earnings; and
- enterprise value-to-cash flow from operations.

Compared to a traditional value approach, MSCI's Enhanced Value overcomes many of the criticisms of value investing because it puts less weight on price-to-book as a metric and removes backward-looking dividend yield. It uses a whole-firm valuation measure in enterprise value that could reduce concentration in leveraged companies. An analysis of historical performance supports MSCI's Enhanced Value approach.

THE PERFORMANCE OF VALUE THROUGH THE CYCLE

Four identifiable stages make up the economic cycle. These are **recovery, expansion, slowdown, contraction.**



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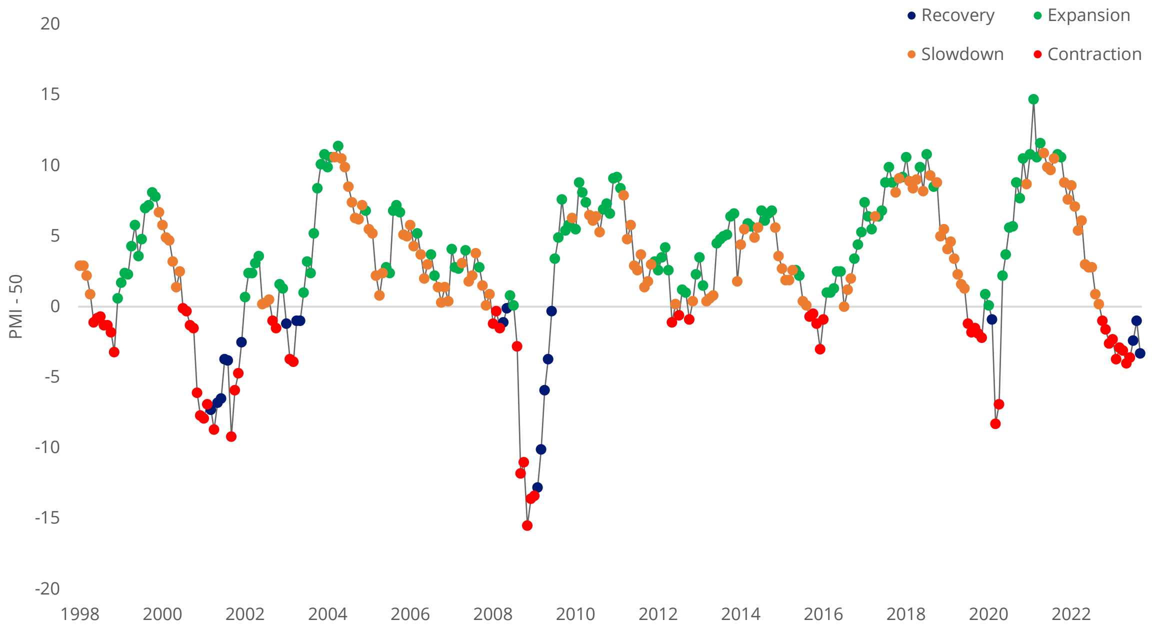
- An expansionary environment is when growth is expanding and at a faster rate than usual;
- A slowdown occurs when economic activity is slowing down after an expansion;
- A contraction occurs when economic growth is negative and it is still falling; and
- A recovery is an environment in which the economy, after the trough of a contraction, starts to head toward growth.

The Purchasing Managers' Index (PMI) is an index used to measure the prevailing direction of economic trends in the manufacturing and service sectors. It measures the change in production levels across the economy from month-to-month so is considered a key indicator of the state of the economy. The chart below shows the three-month rolling PMI changes since 1997, highlighting the stage of the economic cycle at that time.

VALUE: A TIMELESS APPROACH

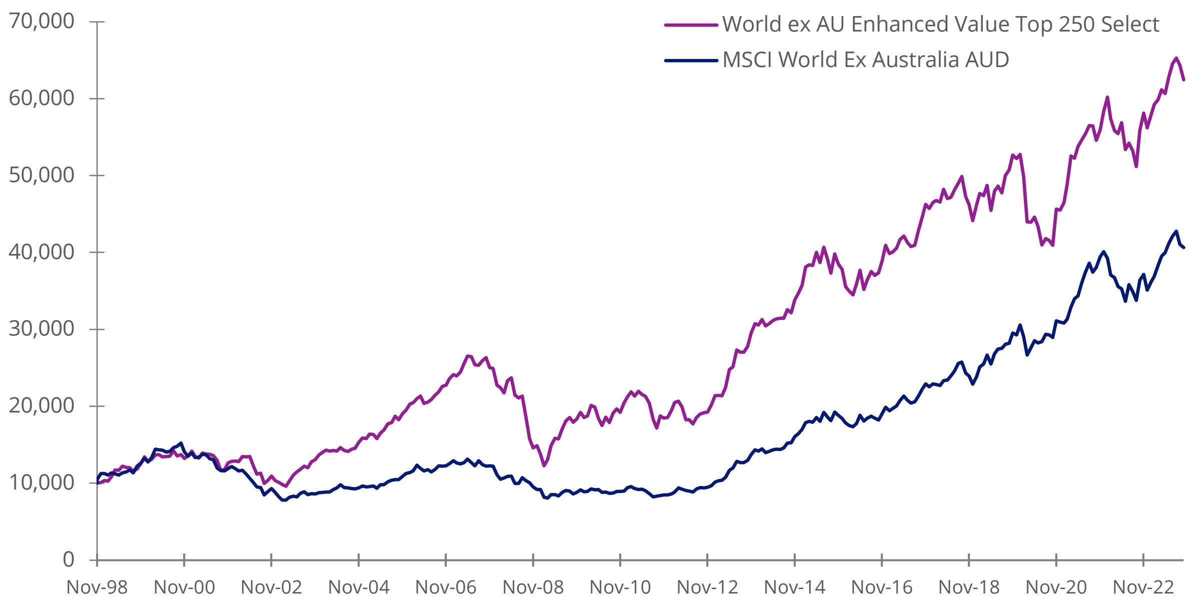
Chart 1: ISM Manufacturing PMI Index



Source: VanEck, Bloomberg. November 1998 to October 2023.

Over that same period (1998 to current) the value factor, as represented by the MSCI World ex Australia Enhanced Value Top 250 Select Index, has outperformed the MSCI World ex Australia Index.

Chart 2: Growth of 10,000: MSCI World ex Australia Enhanced Value Top 250 Select Index vs MSCI World ex Australia Index



Source: Morningstar Direct, as at 31 October 2023. Past performance is not a reliable indicator of future performance. The above graph is a comparison of the performance of MSCI World ex Australia Enhanced Value Top 250 Select Index (VLUE Index) and the parent index, based to 10,000 from the VLUE Index base date 30 November 1998. Results are calculated to the last business day of the month and assume immediate reinvestment of all dividends and exclude fees and costs associated with investing in VLUE. You cannot invest in an index. VLUE's Index base date is calculated at 30 November 1998. VLUE Index performance prior to its launch on 15 February 2021 is simulated.

The MSCI World ex Australia Index ("MSCI World ex Aus") is shown for comparison purposes as it is the widely recognised benchmark used to measure the performance of developed market large- and mid-cap companies, weighted by market capitalisation. VLUE's index measures the performance of 250 international large- and mid-cap companies selected from the MSCI World ex Australia Index with high value scores relative to their peers at rebalance. Exclusions apply for weapons and tobacco. Consequently, VLUE's index has fewer companies and different country and industry allocations than MSCI World ex Aus. Click here for more details.

Value outperformed over the long term, but as was observed in the decade following the GFC, value also had periods of underperformance. These tend to correlate to the economic cycle. The following table represents the returns of the value factor through the cycle compared to other MSCI factors.

Table 1: Total performance (% per annum) during different economic regimes

Period	Quality	Momentum	Growth	Enhanced Value	Benchmark
Recovery	2.78%	-0.17%	-2.55%	5.53%	-3.38%
Expansion	14.75%	21.21%	17.69%	18.64%	15.84%
Slowdown	1.65%	3.33%	-1.77%	0.16%	-0.55%
Contraction	10.18%	-4.56%	3.45%	1.89%	2.25%
Since Inception	8.27%	8.28%	6.45%	7.79%	5.98%

Source: VanEck, Bloomberg. November 1998 to October 2023. Past performance is not a reliable indicator of future performance.

You can see from the above that value was among the top two returning factors during the recoveries and expansions, but it underperformed during contractions and slowdowns. Another way to look at this is performance relative to the index as shown in the chart below. You can see that value's relative underperformance during slowdowns and contractions dwarfs its strong relative performance during recoveries and expansions. This is important because expansionary environments are the most common environment occurring more than 40% of the time during period analysed.

Table 2: Performance differential (% per annum) compared to MSCI World ex Australia benchmark during different economic regimes

Period	Quality	Momentum	Growth	Enhanced Value
Recovery	6.16%	3.21%	0.83%	8.91%
Expansion	-1.10%	5.37%	1.85%	2.80%
Slowdown	2.20%	3.88%	-1.22%	0.71%
Contraction	7.93%	-6.81%	1.20%	-0.37%
Total	2.30%	2.31%	0.47%	1.82%

Source: VanEck, Bloomberg. November 1998 to October 2023. Past performance is not a reliable indicator of future performance. Performance differential is calculated by subtracting the total return from the return of the benchmark.

Because the impact of rising inflation and rising rates is less for mature, value companies, those companies tend to perform better during recoveries and expansions. The reasons for this is that many investors calculate the value of companies using a net present value (NPV) model. This is important when valuing high-growth stocks, which have little or no earnings yet, so investors assess expected earnings. This means they discount projected earnings back to the present using a discount rate, typically the yield on 10-year US treasuries. Therefore, when this rate goes up, as it does during recoveries, valuations tend to go down.

In this type of environment, expensive stocks in areas like new-technology underperform value companies, which tend to be cyclicals such as financials and energy. The forward price-to-earnings (PE) multiples of the most expensive stocks therefore become inversely correlated with 10-year yields during rate hiking cycles. The reverse is true for value stocks during these periods.

VALUE: A TIMELESS APPROACH

USING VALUE IN A PORTFOLIO

Identifying companies that appear underpriced using fundamental analysis.

The value factor, as represented by MSCI World ex Australia Enhanced Value Top 250 Select Index, has demonstrated long-term outperformance relative to the global benchmark, MSCI World ex Australia Index. While the value factor will have periods of underperformance, it comes to the fore during recoveries and expansions.

During slowdowns and contractions, when the value factor performs relatively weaker compared to other factors, investors may want to consider a 'quality' approach, which tends to do well during these periods. For more information on MSCI's quality approach and VanEck's range of quality ETFs see our booklet *Quality: An all-seasons investment approach*.

Australians investing in international equities seeking exposure to the value factor can do so via the VanEck MSCI International Value ETF (VLUE) or VanEck MSCI International Value (AUD Hedged) ETF (HVLU) on ASX. VLUE tracks MSCI World ex Australia Enhanced Value Top 250 Select Index and HVLU tracks the MSCI World ex Australia Enhanced Value Top 250 Select Index AUD Hedged.

In addition to applying MSCI's Enhanced Value approach, it also employs a sector neutral approach that MSCI has found mitigates some of the drawdown inherent with the value investing style.

Value investing has come a long way since the days of Graham and Dodd, but the underlying principles remain the same: identifying companies that appear underpriced using fundamental analysis.

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