THE VALUE OF VALUE FUNDS: WHY YOU SHOULD ALWAYS HOLD THEM

By John Markese

Over long-term periods, value and growth stocks run nearly neck-to-neck in terms of performance, but the returns from value stocks are more stable, and they tend to perform better than growth during down markets, with the year 2000 being a perfect example.

When markets soar, value funds are ignored.

When markets fall back toward earth, value funds get deserved attention.

The trick is to pay attention to value funds all the time. Why? It's simple really: Value funds offer high risk-adjusted returns, as well as industry diversification that dampens the variability of the returns on your total portfolio.

VALUE CHARACTERISTICS

While it's hard to argue against getting value for your investment, just what are the characteristics of a value fund?

It is useful to describe value funds by comparing them to growth funds, the other general approach in the universe of stock funds.

Value stocks tend to have higher dividend yields, annual cash dividends divided by share price. Far more value stocks pay dividends—and dividends that are significant— than growth stocks.

However, dividend yields are in a long-term decline, as firms opt not to initiate dividend payments or to increase existing dividends. For investors dividends can be taxable, and for corporations dividends are not tax-deductible. Dividends are scarce among firms that have high earnings growth rates and high returns on reinvested capital. For corporations, dividends represent cash not reinvested in the firm.

Another distinction of value stock investments is a lower relative price-earnings ratio, market price per share divided by annual earnings per share. In other words, value stocks tend to have a lower price per dollar of demonstrated earnings, and growth stocks a higher price per dollar of earnings. Why? Growth stocks have greater expectations of future earnings growth than do value stocks.

However, future earnings are of course less certain than current earnings, and lower growth expectations may be more often met than high earnings growth expectations.

There are other possible value stock characteristics: assets carried on the books far below value, strong industry position, mature and more predictable product markets, and financing power, to identify a few. But the basic lower-risk foundation for value stocks exists primarily from the higher dividends, which provide a steady source of annual return, and lower growth expectations, which means less severe earnings shock possibilities.

WHAT ABOUT RETURNS?

The case for much lower returns on value stocks than growth stocks would seem to follow the lower-risk profile.

But hold on. Over long-term periods, including market corrections, value and growth stocks run nearly neck-to-neck in terms of return. But the returns from value stocks come in a lot more stable, performing well in down markets although relatively less well in up markets.

And if you are still not convinced that a value fund might have a place in

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your portfolio, look at the impressive performance of some top value funds in Table 1, ranked by their performance for 2000. Funds tracked in AAII's *"Individual Investor's Guide to Low-Load Mutual Funds"* were considered to be value funds, no matter what their name implied, based upon how well their performance tracked a value benchmark.

Of course, 2000 was the sort of year value funds would be expected to shine, so don't fail to note the three-year and five-year performance figures.

The stock market capitalization that each fund tends to concentrate in—large cap, mid cap, small cap, or some combination—is provided just before the returns for each fund. You can see the effect on performance that concentrating on a particular market capitalization

TABLE 1. TOP VALUE FUNDS FOR 2000

Fund (Ticker)	Market Concentration: Large Cap	Mid Cap	Small Cap	Avg Annual Return (%): 1 Yr	3 Yrs	5 Yrs	Bull* Market Return (%)	Bear* Market Return (%)	Yield (%)	Avg P/E** (X)	Risk Index (X)	Expense Ratio (%)
Clipper (CFIMX)	X	X		37.4	17.0	20.1	16.6	31.4	2.1	17.7	0.76	1.10
Wasatch: Core Growth (WGROX)		X	X	37.3	18.5	19.8	51.8	19.8	0.0	22.7	1.26	1.38
Vontobel U.S. Value (VUSVX)	X	X		35.1	10.0	16.7	2.7	27.6	0.0	20.4	1.12	1.87
PBHG Mid Cap Value (PBMCX)		X		32.5	28.3	—	76.8	6.8	0.6	22.0	1.20	1.44
Schroder Cap: U.S. Sm Co/Inv (SCUIX)			X	31.2	10.4	15.8	29.8	0.1	0.0	25.8	1.17	1.35
Ariel (ARGFX)	X	X		28.7	10.0	17.5	16.9	23.0	0.6	17.8	1.07	1.24
Meridian (MERDX)		X	X	28.2	14.4	14.7	37.5	4.4	nmf	30.3	1.03	1.09
Dreyfus Gr & Val: Mid-Cap Val (DMCVX)		X		27.4	16.0	22.4	63.5	5.5	0.0	21.1	1.51	1.27
Mairs & Power Growth (MPGFX)	X	X		26.4	14.0	19.2	32.1	18.0	0.9	23.4	0.89	0.79
Oakmark Select (OAKLX)	X			25.8	18.7	—	50.9	10.5	0.3	20.6	1.23	1.17
PBHG Large Cap Value (PLCVX)	X	X		23.9	23.8	—	56.1	13.7	0.5	22.0	0.95	1.11
T Rowe Price Cap Apprec (PRWCX)		X	X	22.1	11.4	13.4	14.8	13.4	3.0	16.9	0.54	0.88
Amer Cent: Eqty Income/Inv (TWEIX)		X		21.9	11.1	16.8	19.3	14.7	2.7	16.4	0.77	1.00
Dreyfus Gr & Val: Agg Val (DAGVX)	X	X		21.3	13.0	19.5	36.6	4.4	1.3	23.6	0.98	1.34
Weitz Partners Value (WPVLX)	X			21.0	24.0	26.1	41.8	10.4	2.1	19.7	0.84	1.19
Longleaf Partners (LLPFX)	X			20.6	12.0	16.9	17.4	21.4	0.6	19.6	1.02	0.92
Weitz Srs: Value (WVALX)	X	X		19.6	23.1	25.2	37.7	10.4	1.2	20.1	0.83	1.19
Ariel Appreciation (CAAPX)	X	X		18.8	10.9	18.4	23.8	16.9	0.3	19.5	0.99	1.31
Mosaic Eq: Mid-Cap Growth (GTSGX)	X	X		18.4	11.4	11.4	36.7	12.7	0.3	22.6	0.97	1.25
Oak Value (OAKVX)	X			18.1	10.8	19.3	19.0	15.2	0.0	33.0	1.09	1.13
Royce: Premier (RYPRX)			X	17.1	11.7	14.2	31.7	3.9	0.2	19.1	0.93	1.23
Dodge & Cox Stock (DODGX)	X	X		16.3	13.7	18.2	42.4	6.8	1.8	19.7	0.98	0.55
Large-Cap Value	X			7.2	10.4	16.5	36.3	1.6	0.9	—	0.96	1.04
Mid-Cap Value		X		28.8	10.2	14.1	28.2	12.1	0.8	—	1.10	1.13
Small-Cap Value			X	14.9	3.6	11.8	17.8	2.7	0.3	—	1.02	1.33
All Value Funds	X	X	X	**15.1**	**7.7**	**14.4**	**26.2**	**5.7**	**1.1**	**—**	**1.00**	**1.19**
All Growth Funds	X	X	X	**–9.7**	**19.0**	**17.7**	**113.4**	**–22.2**	**0.1**	**—**	**1.50**	**1.17**
Vanguard Idx: Value/Inv (VIVAX)	X			6.0	11.0	16.6	40.2	0.6	1.5	24.4	0.98	0.22
Vanguard Idx: Growth/Inv (VIGRX)	X			–22.2	12.5	19.1	71.2	–21.7	0.4	40.6	1.16	0.22
Vanguard Idx: 500 Idx (VFINX)	X			–9.0	12.2	18.3	56.3	–11.5	1.0	31.2	0.97	0.18

**Bull Period: 9/1/98 to 3/31/00; Bear Period: 4/1/00 to 11/30/00.*
***From Morningstar.*
Source: "The Individual Investor's Guide to Low-Load Mutual Funds," 20th edition, by AAII.
Returns are through 12/31/00.

nmf = no meaningful figure

would have by comparing the fund's returns to the market capitalization benchmarks at the bottom of Table 1. The effect of concentrating within a particular market capitalization is evident in year 2000 performance: Mid-cap value funds did the best by far, followed by small-cap value funds and then large-cap value funds, but large-cap value funds prevailed over the last five years.

BENCHMARK COMPARISONS

Several other comparison benchmarks are provided near the bottom of Table 1.

First, statistics are given for all value funds and all growth funds covered in the Low-Load Guide, and there are no surprises here—they play to character: The longer the time period, the more the returns converge. But the value funds, on average, performed better during the bear market periods, while the growth funds, on average, performed better during the bull market periods. Also, the value funds provided a higher yield.

But focus for a moment on the risk index. This measures a fund's total monthly variation in return over a three-year period (using standard deviation as the measure), and then compares it to the average value fund, with the risk index equal to 1.00. The average growth fund has a risk index of 1.50, which means it has 50% more return volatility than the average value fund—essentially erasing any return advantage of growth funds for this period after adjusting for risk.

The final benchmarks at the bottom of Table 1 are Vanguard Index Funds: Value, Growth, and 500. These funds are passively managed—no stock selection or timing adjustments, whereas the other benchmarks, as well as all of the value funds, are actively managed. The Vanguard Value and Growth Index Funds are an even split of the Vanguard 500 Index, a very large-cap index, so buying the 500 Index gets you both growth and value, an important point of diversification. Not surprisingly, the average value fund expense ratio is about 1.00% higher than these passively managed indexes.

As for industry weightings, these value funds tend to be heavy in financials and services, whereas growth funds have been concentrated in technology and health.

And some of these value funds, in a tribute to value manager Warren Buffett, hold Berkshire Hathaway, Mr. Buffett's value vehicle, which is classified as a financial stock.

THE RATIONAL APPROACH

Value managers have been saddled with a variety of behavioral descriptions attempting to capture the essence of their value approach: contrarians, out-of-favor stocks, growth-at-a-reasonable-cost, overlooked stocks, equity-income, low price-earnings ratio, bargain-hunters. If you think about it, these may all simply describe a rational, effective investment discipline.

Value funds work better at different points in the investment cycle than growth funds, complementing, but not substituting for, growth performance. Think of the tortoise and the hare fable—you probably want both on your team.❖