INVESTMENT APPROACHES: PICKING A VALUE-ORIENTED ADVISER

By Mark Hulbert

The advantage to adopting a value approach is well-known: Value stocks have outperformed growth stocks over the long term. But putting the value approach theory into practice is easier said than done.

When it comes to being a value investor, there is a huge gulf between theory and practice. In theory, at least, value investing appears to be quite straightforward, and exploiting it ought to be simple.

In practice, however, being a successful value investor is anything but straightforward and simple. This article will alert you to some of the major pitfalls you may encounter when taking the road that leads out from theory into the real world.

The advantage to adopting a value approach is well known: Value stocks significantly have outperformed growth stocks over the long term, and, even better, they have provided more downside protection in bear markets. The icing on the cake is that value investing can trace its roots back to legendary investor Benjamin Graham and has an impressive number of prestigious academic studies behind it.

PITFALL #1: WHAT IS VALUE?

However, you can't rely simply on names when trying to find a value-oriented adviser, and that applies equally to investment newsletters. If you were to choose on this basis, for example, you might be drawn to a newsletter named The Pure Fundamentalist. After all, fundamental analysis searches for out-of-favor value stocks; you'd think that a letter that practices a "pure" form of this analysis would be a good candidate. Yet the average stock pick of The Pure Fundamentalist is quite close to being a "pure" growth stock, at least according to one standard definition.

Ironically, in fact, the stock picks by another newsletter, Growth Stock Outlook, are closer to the "value" end of the spectrum than those from The Pure Fundamentalist.

The problem is that every adviser recommends stocks that he/she believes represent "value." To that extent, therefore, every adviser is value-oriented. Yet academics have a specific definition of value in mind when they report that "value" approaches have outperformed "growth" approaches. Advisers who don't adhere to that definition, but who nevertheless say they are value-oriented, either are unaware of the definition or are cynically exploiting the public's sense that value approaches are to be preferred.

The definition of value that most often is used in academic circles is based on the price-to-book-value ratio [a stock's market price per share divided by book value (tangible assets less all liabilities) per share.] Though some advisers, like Benjamin Graham, have insisted on an absolute level below which a company's price-to-book-value ratio must fall in order to be considered a "value" stock, most investment advisers today define "value" in relative terms. Thus, given two companies, the one that is trading at the lower price-to-book-value ratio is considered to be more of a "value" stock than the other company.

Mark Hulbert is editor of the Hulbert Financial Digest, a newsletter that ranks the performance of investment advisory newsletters. It is published monthly and is located at 316 Commerce St., Alexandria, Va. 22314; 703/683-5905; www.hulbertdigest.com.

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PITFALL #2: STYLE DRIFT

This is straightforward enough, you might be thinking: Just pick a mutual fund or investment newsletter that defines "value" in terms of the price-to-book-value ratio. But you still aren't out of the woods because of a phenomenon known in this business as "style drift." It turns out that many advisers who start out in life as value-oriented tend to shift over time into being more growth-oriented. Listen to Arnold Wood, president of Martingale Asset Management, after analyzing a large pension fund that intended to employ seven growth managers and seven value managers: "We discovered that in fact it employed 13 growth managers and only one value manager."

Why does style drift happen? Because it's not easy being a value investor. It requires buying stocks that the market has all but given up on and for which the current news seemingly is all bad. It's far easier to buy growth stocks because they currently are looking good and are very popular. Another way of saying the same thing: Though it's more comfortable being in a group than being a loner, value investing requires you to be a loner. Most advisers would rather fail conventionally than succeed unconventionally.

One measure of style drift comes from a major study recently completed by Harvard Economics Professor Andrew Metrick. He exhaustively analyzed the Hulbert Financial Digest's database of every U.S. common stock owned between mid-1980 and the end of 1996 by any of the newsletters the HFD has tracked. Utilizing data obtained from the Center for Research on Security Prices at the University of Chicago, Metrick was able to classify precisely where each newsletter falls on the value vs. growth continuum. Metrick graded every letter on a 1-to-5 scale: If its stock picks fell within the 20% of New York Stock Exchange stocks with the lowest price-to-book-value ratios, then Metrick gave it a grade of 5.0, indicating a pure value approach. Conversely, if all of its stocks came from the quintile with the highest price-to-book-value ratios, then it would be given a grade of 1.0, indicating a pure growth approach.

Listed in Table 1 are the newsletters followed by HFD that have a value tilt to their portfolios, however slight. You'll notice that only 12 appear. And as you furthermore can see, no newsletter received a Metrick grade close to 5.0. In fact, only one letter earned a grade above 4.0. Consider what this means: In a ranking of all NYSE stocks from most to least value, the average stock recommended by a newsletter with a 4.0 grade would fall between the 60th and 80th percentiles (with 100th percentile being the best value). Yet only one letter had a grade above 4.0.

Another way of appreciating the significance of this: a grade of 3.0 would mean that a letter's stocks fall in the middle of the range between value and growth. But even the most value-oriented letters have Metrick grades that are not all that far from 3.0. In fact, the average Metrick grade of all newsletters the HFD tracks is 2.41 (with 1.0 representing pure growth and 3.0 being the midpoint).

The lesson to learn from this: A genuinely value-oriented adviser is

TABLE 1. VALUE-ORIENTED NEWSLETTERS AMONG THOSE TRACKED BY THE HULBERT FINANCIAL DIGEST

Style Grade: (Pure Value = 5 Pure Growth = 1)	Newsletter	Size Grade (Large Cap = 5 Small Cap = 1)	HFD Data Begin Date	Average Annual Return (%)	Wilshire Annual Return (%)	Relative Risk-Adjusted Ranking (Wilshire = 100)
4.02	Utility Forecaster	4.16	1993	8.0	15.9	37.4
3.70	F.X.C. Newsletter	3.03	1988	13.1	15.9	101.3
3.63	Investors Intelligence	2.46	1987	10.4	14.6	82.5
3.50	Contrarian's View	3.18	1991	3.4	17.2	–5.4
3.49	Turnaround Letter	1.99	1988	11.2	15.9	41.9
3.48	Prudent Spectator	3.05	1980	15.8	15.4	71.4
3.29	Insiders	2.14	1985	13.9	16.0	70.1
3.26	Personal Finance	4.36	1984	9.2	15.0	53.3
3.23	Investor's World	2.92	1982	13.3	15.8	77.9
3.16	Investment Quality Trends	4.36	1986	13.6	14.8	111.8
3.03	Addison Report	3.64	1983	10.0	15.6	50.3
3.01	Margo's Small Stocks	2.56	1984	8.8	15.0	38.3

Source: Hulbert Financial Digest, and "Performance Evaluation With Transactions Data: The Stock Selection of Investment Newsletters," by Andrew Metrick, forthcoming in the Journal of Finance.

hard to find, even among those who use the standard definition to define themselves as value oriented. Judge an adviser not only by what he says, but also by what he does.

PITFALL #3: THE SIZE FACTOR

The next pitfall awaiting the value investor is that value investing does not work equally well for all stocks. Historically, it has been most profitable among the smallest caps. Take the famous study from earlier this decade by then University of Chicago Professors Eugene Fama and Ken French (French now is at MIT): They found that the performance advantage enjoyed by value over growth is relatively small (about 2% per year) for the 20% of stocks that have the largest capitalizations. Yet, they also point out that 20% comprises the bulk of the market value of all U.S. equities (73.9%, to be exact).

Modest as this 2% annual advantage may appear for 73.9% of the U.S. stock market, there's even less here than meets the eye. Upon investigating this 2% advantage for value among the large caps, University of Iowa professor Tim Loughran discovered that it is not very robust. Value outperformed growth in just 15 of the 28 years covered by the Fama-French study. Furthermore, the 2% annual advantage is highly dependent on just three of those 15 years, during the mid 1970s. Without those three years, according to Loughran, large growth stocks actually have outperformed large value stocks by more than 1% per year on average.

The lesson to draw from this seems straightforward enough: To achieve the greatest profit from value investing, you should focus on smaller-cap stocks. However, this may turn out to be more difficult than you think. It turns out that most of the value-oriented newsletters do not focus on small-cap stocks.

Take another look at Table 1. In addition to reporting each newsletter's value vs. growth rating, the table also reports grades assigned by Metrick according to the average market capitalization of their recommended stocks. Metrick used all common stocks on the New York Stock Exchange as his benchmark. If a letter's average recommended stock was small enough to put it in the range of the smallest 20% of all NYSE stocks, then it would be rated 1.0. Conversely, if a letter's average recommended stock was so large that it fell among the 20% of the NYSE's largest, it would be given a rating of 5.0.

Notice from the table that none of the value-tilted newsletters come close to a size grade of 1.0. The newsletter in Table 1 whose average recommended stock is smallest is the Turnaround Letter, with a grade of 1.99. This grade means that the newsletter's average recommended stock falls in the second-to-the-bottom quintile among all NYSE stocks ranked from largest to smallest.

PITFALL #4: PERFORMANCE

The last pitfall that will sabotage the value investor: Many value advisers have dismal performance. Table 1 also lists each newsletter's performance, as calculated by the HFD, along with the Wilshire 5000's performance over the same period. Each newsletter's risk-adjusted performance is also indicated in the last column. The risk-adjusted returns are measured using the Sharpe ratio, which relates the average return to the volatility of returns, providing a measure of the return per unit of risk undertaken. These risk-adjusted returns are ranked relative to the Wilshire 5000's risk-adjusted return; a relative-risk-adjusted return of 100 indicates a risk-adjusted return equal to that of the Wilshire 5000, while a figure below 100 indicates a risk-adjusted return less than the Wilshire 5000. Notice that only two of the dozen newsletters in Table 1 have risk-adjusted returns above the Wilshire's. That means that they are the only ones that did a better job than the market itself in exploiting risk.

When choosing an adviser, needless to say, you should favor those with the best long-term risk-adjusted performance.

CONCLUSION

Don't be scared away by these pitfalls that await value investors—no one said it would be easy!

For those with the patience and discipline, value investing can be rewarding, but make sure that you choose your adviser—whether it be a mutual fund or an investment newsletter—carefully.