

VALUE INVESTING

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Broadly speaking, there are two major approaches to investing in the stock market, Value investing and Growth investing. The idea of Value investing is to buy companies at prices below what the companies are worth. The most important indicators of good value are a low price/earnings ratio and a solid balance sheet. The idea of Growth investing is to buy companies based on the belief that they will grow even if their prices may be high from a value perspective.

Northwest Criterion Asset Management has three main strategies for investing. All three are based on some measure of value.

Equity Select strategy. This is based primarily on earnings. By looking at the current level of earnings and the recent rate of earnings growth, we project a path of future earnings. We then calculate the present discounted value of the projected earnings. We buy only companies that trade at prices below the calculated present value. We also take into account the level of debt relative to equity, the business model, and general economic conditions.

Dividend strategy. This is based primarily on dividends. We look for companies that pay a dividend which is high relative to the share price, that have a history of paying steadily increasing dividends, and that have sufficient earnings and cash flows to make it likely that the dividends will continue to be paid.

Mutual Fund Mix. Choosing mutual funds is not a matter of choosing stocks but fund managers. We use a rigorous selection process to find managers with a history of producing strong, relatively stable returns. Although we do not look explicitly at the value of the companies owned by the mutual funds, as it happens, the managers who satisfy our criteria are usually Value managers. (This reinforces our belief in Value investing.)

Does Value investing work?

First, Value investing makes good common sense. If you were looking to become the owner of an ongoing business, you would want to buy one that has earnings or at least the prospect of earnings. The price you would be willing to pay would be based on the level of earnings you would expect to achieve. Also, you would want to avoid taking on too much debt. If after owning the company and building up the business you decided to sell, you would tout the level of your earnings and the soundness of the business. You would expect to get a price that compensated you for the future earnings that you would be giving up. There would be a minimum price that you would accept. There would not, however, be a maximum! You would like to get as high a price as possible. If you were lucky, someone might pay more for your company than you thought it was worth.

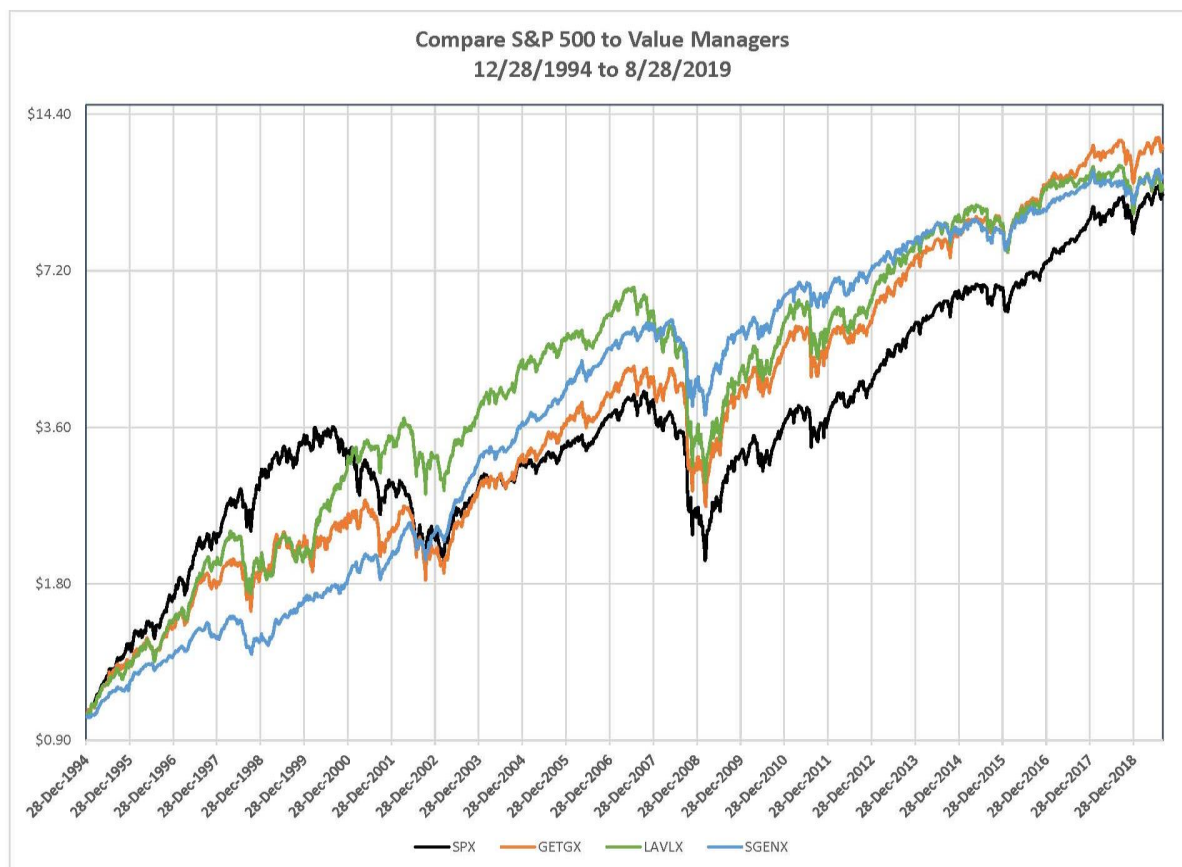
Buying shares in a publicly traded company is similar, but there are some differences. For one thing, you don't negotiate the share price; it is determined by the competing actions of many buyers and sellers. For another, shareholders don't benefit directly from the company's earnings. A shareholder may benefit in two ways, either from dividends or from buying at one price and selling at a higher price. Both of these ways are influenced by earnings. Dividends are paid from earnings, and companies with growing earnings tend to go up in price. It is possible, however, for a company's earnings to increase and its price to go down; and it is also possible for a company with meager or no earnings to have a high and

climbing price. During the tech bubble of the late 1990's many companies traded at higher and higher prices without good earnings to support them. Presumably, the reason that can happen is that investors anticipate high earnings in the future. If anticipated high earnings are not realized, the price of the stock will eventually fall. From 2000 through 2002 the tech bubble deflated. On the other hand, if a company's earnings grow over a long period, the price of the shares will eventually rise.

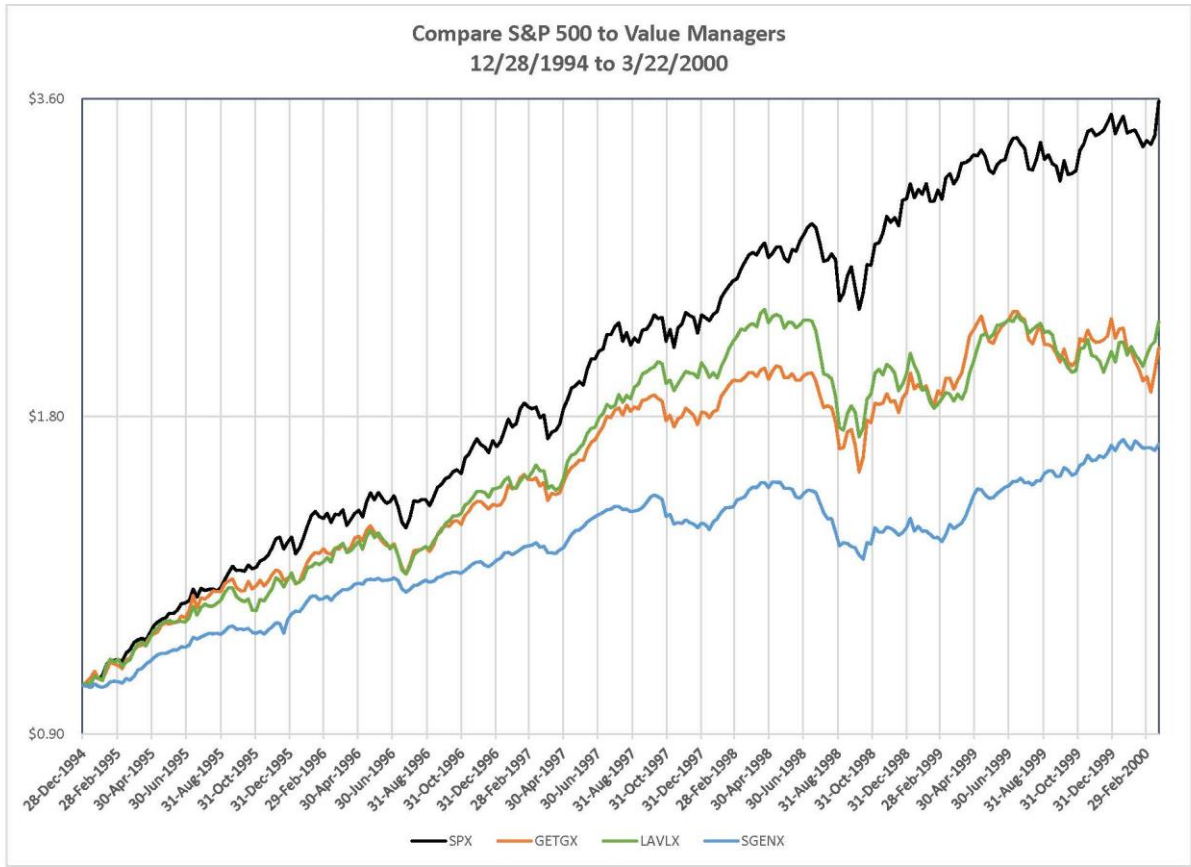
That is a theoretical answer to the question. Empirically, we can ask How have actual Value managers done relative to the S&P 500?

To answer this question we look at three Value-oriented mutual funds: Victory Sycamore Established Value Fund (GETGX), Lord Abbett Mid-Cap Stock Fund (LAVLX), and First Eagle Global Fund (SGENX). We picked these funds because they have long, solid records of performance. We also look at the Russell Midcap Value Index (RMV), which was established on March 20, 2000. We compare these to the S&P 500 Index with dividends reinvested. We choose the S&P 500 because it is well known, generally accepted index of the general stock market. Many people invest in it through index funds. We make the comparisons graphically, starting at the end of 1994 for the mutual funds, and at the end of March, 2000, for RMV. The graphs represent the growth in value of \$1 from the start date in each case. The vertical axis is on a log scale in order to represent equal percentage changes as equal distances.

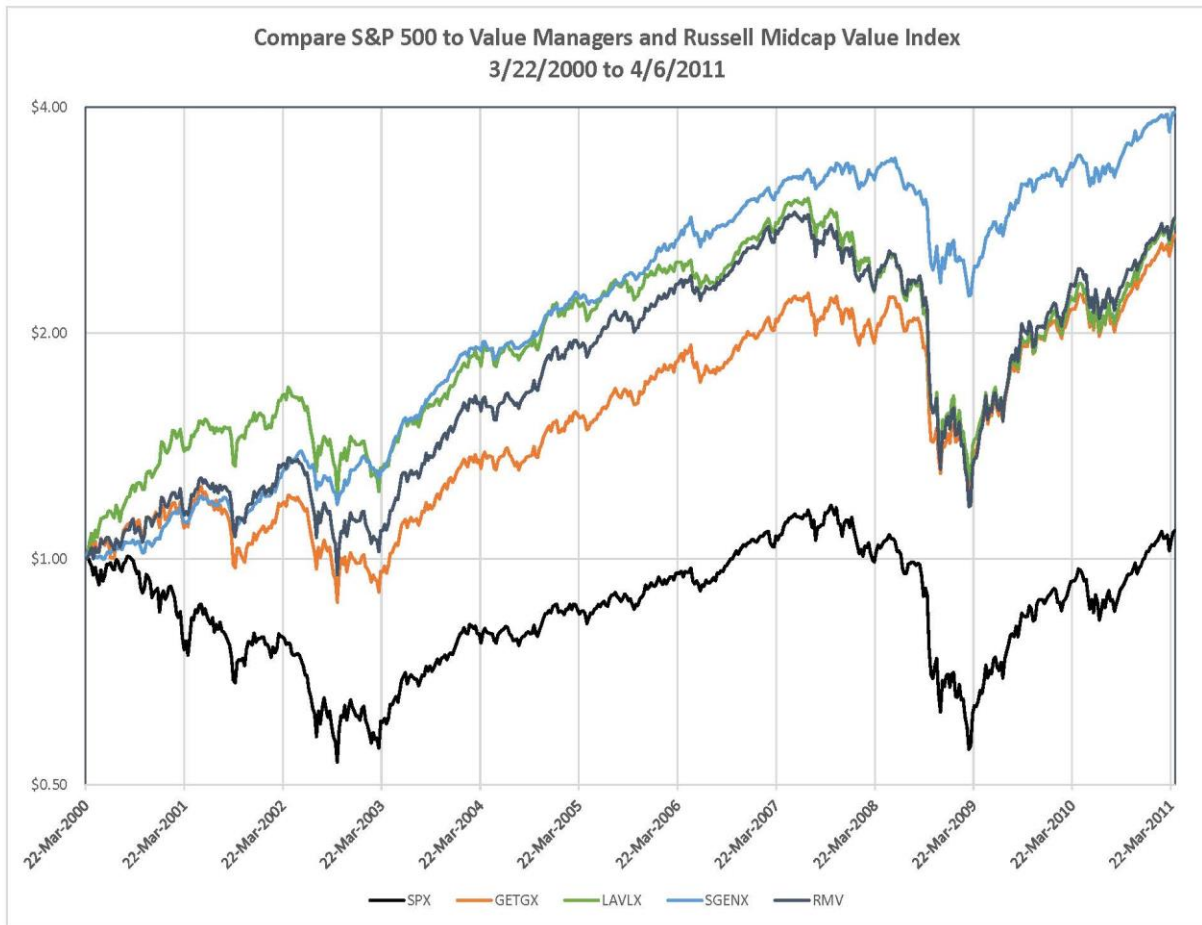
The first graph represents the whole period of almost 25 years. We see that the Value managers actually outperformed, albeit narrowly, the S&P 500. While the S&P 500 returned 9.81% annually, GETGX returned 10.74%, LAVLX 9.92%, and SGENX 10.17%. The performance of the Value funds was steadier than that of the S&P 500. Despite falling considerably behind at the beginning, by September, 2004, all three Value managers had a lead over the S&P 500, never to lose it.



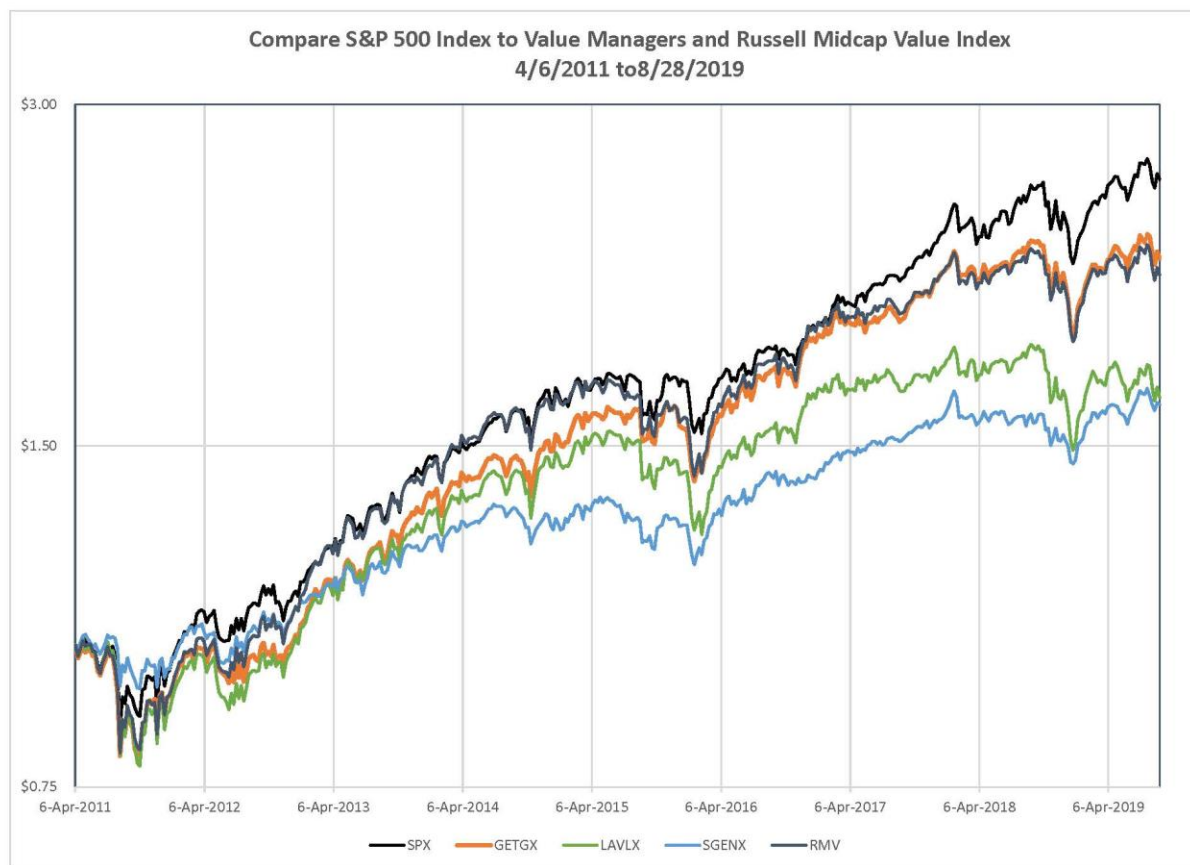
The second graph concentrates on the period in the late 1990's, up to the end of March, 2000. This was the time of the "tech bubble," the "new paradigm," or "irrational exuberance," depending on your point of view. Near the end of this period people who had invested in tech stocks must have felt they couldn't lose, while Value investors must have had doubts about their strategies. Very good Value managers were unable keep up with the S&P 500 Index (let alone the NASDAQ). In business terms, it was a very hard time for Value managers as clients took assets away from them.



The next period we look at extends from March, 2000, until April, 2011. During this period the S&P 500 made almost no progress while the value managers did quite well. As the tech bubble burst from 2000 through 2002, the S&P 500 took a big hit, but the Value managers held their own, or better. By July 10, 2002, all three had pulled ahead of the S&P 500. From December 28, 1994, through April 6, 2011, GETGX was ahead of the S&P 500 by 44.4%, LAVLX was ahead by 59.6%, and SGENX by 71.3%.



The final period we look at runs from April, 2011, through August, 2019. In this period all three Value funds were up substantially but they fell behind the S&P 500, particularly from November of 2016 on. From November 30, 2016, through August 30, 2019, GETGX gave up 13.7% against the S&P 500, LAVLX gave up 26.6%, and SGENX 15.7%. (Annualized, these amount to 5.4%, 11.3%, and 6.2%, respectively.)



A detailed look at a single year, August 31, 2018, through August 30, 2019.

To gain some insight, we looked at the stocks that made up the S&P 500 from August 31, 2018, through August 30, 2019. Due to changes in the index, there were only 498 such stocks that were present for the entire period. For each stock we found its market cap and P/E on August 31, 2018, and its total return for the following year. The S&P 500 Index is a weighted average of 500 large corporations. The exact weights used by Standard and Poors to compute the index are proprietary, and we are not privy to them. However, we can get a pretty good approximation to the index by weighting each stock in proportion to its market capitalization. To do this we divide the market cap of each stock by the sum of market caps for all 500 (or in our case 498) stocks in the index. The sum of the weights for all stocks is 1. To calculate the return for the index we multiply the return for each stock by its weight. Therefore, each stock makes a contribution to the total return of the index equal to the stock's weight times its total return. It turns out that the total return for the S&P 500 was 2.92% while the sum of contributions for the 498 stocks was 2.83%. The slight difference is due to the fact that we used only 498 stocks, and we don't have the exact weights used by Standard and Poors.

To see how return on the S&P stocks varied by P/E and market cap, we defined five ranges for P/Es and three ranges for market caps. Using these we constructed several two-way tables with 15 cells each. The first table below shows the ranges. The second shows the number of stocks that fit into each cell. The third shows the sum of weights for each cell, the fourth the average return for each cell, and the fifth the contribution of each cell to the total return for the S&P 500 index.

We see that the stocks are pretty evenly distributed among the 15 cells, but the weights are concentrated in the large cap stocks. That probably would happen for any year we might have chosen. For the year in question Small Cap stocks with P/Es over 35.4, Mid Cap stocks with P/Es between 25.0 and 35.4 and Large Cap stocks with P/Es between 19.1 and 35.4 showed the highest average returns. Looking at the row averages, we see that stocks with P/Es under 14.7 (this is the category that would contain Value stocks), had an average return of -8.5%, the worst of any P/E range. Because Large Cap stocks had most of the weight, Large Cap stocks with P/Es between 19.1 and 35.4 dominated the total return for the S&P 500.

Levels used to define P/E and market cap categories					
P/E percentile			Mkt Cap percentile		
80%	35.4		67%	35,651	
60%	25.0		33%	15,580	
40%	19.1				
20%	14.7				

Number of companies in each category					
		Small Cap	Mid Cap	Large Cap	Row Sum
P/E	over 35.4	36	40	24	100
	25.0-35.4	36	29	34	99
	19.1-25.0	31	29	40	100
	14.7-19.1	32	31	36	99
	under 14.7	31	37	32	100
	Column Sum	166	166	166	498

Weight of market cap in each category					
		Small Cap	Mid Cap	Large Cap	Row Sum
P/E	over 35.4	1.6%	3.5%	11.9%	17.0%
	25.0-35.4	1.7%	2.5%	16.3%	20.4%
	19.1-25.0	1.3%	2.6%	24.5%	28.4%
	14.7-19.1	1.3%	2.9%	13.4%	17.6%
	under 14.7	1.3%	3.2%	12.1%	16.5%
	Column Sum	7.2%	14.7%	78.1%	100.0%

Average return for each category					
P/E		Small Cap	Mid Cap	Large Cap	Row Average
		over 35.4	10.4%	5.6%	1.0%
	25.0-35.4	-0.7%	14.5%	11.5%	7.9%
	19.1-25.0	1.3%	5.4%	10.1%	6.0%
	14.7-19.1	-10.3%	-0.4%	-0.8%	-3.7%
	under 14.7	-16.6%	-4.6%	-5.3%	-8.5%
	Column Average	-2.8%	3.7%	3.8%	1.6%

Contribution made to the return of the S&P 500 Index					
P/E		Small Cap	Mid Cap	Large Cap	Row Sum
		over 35.4	0.186%	0.188%	-0.342%
	25.0-35.4	-0.002%	0.328%	1.861%	2.19%
	19.1-25.0	0.019%	0.165%	1.484%	1.67%
	14.7-19.1	-0.142%	0.025%	-0.083%	-0.20%
	under 14.7	-0.211%	-0.149%	-0.492%	-0.85%
	Column Sum	-0.15%	0.56%	2.43%	2.83%

The table below shows the ten companies that made the largest contribution to the return of the S&P 500 Index for the year ending August 31, 2019. In aggregate, they contributed just over 3% to the return. Since the return for the index was actually under 3%, without these ten companies the index would have been down for the year. All ten of these companies fall into the large cap category. Only one had a P/E of less than 19.1.

	Market Cap August 2018 \$MM	P/E ratio	Return for year ending August 2019	Weight	Contribution to S&P 500 return for the year
Microsoft Corp	861,000	31.4	24.7%	3.3%	0.820%
Procter & Gamble Co	206,000	20.0	49.4%	0.8%	0.394%
Visa Inc.	327,000	35.3	23.9%	1.3%	0.301%
Mastercard Inc	224,000	38.3	31.2%	0.9%	0.270%
Walmart Inc	283,000	20.1	21.7%	1.1%	0.237%
Starbucks Corp	72,000	19.1	84.1%	0.3%	0.234%
Merck & Co Inc	182,000	16.3	29.6%	0.7%	0.208%
The Coca-Cola Co	190,000	22.3	27.6%	0.7%	0.202%
McDonald's Corp	126,000	23.3	37.6%	0.5%	0.182%
PepsiCo Inc	158,000	20.7	25.9%	0.6%	0.159%

What do we conclude?

1. Over the long run a good Value strategy beats the S&P 500.
2. The main way it does this is by avoiding boom and bust cycles like the tech bubble of the late 1990's. A Value strategy is less likely than the S&P 500 to experience a severe downturn. This is a big advantage to the investor because it reduces the chance of being forced out of the market during a downturn.
3. The S&P 500 Index is generally regarded as a broad market index, but it can be dominated by a small number of large cap stocks.
4. There can be long stretches of time when the S&P 500 and Value stocks diverge.
5. The reason stocks with relatively high P/Es can prevail for a period of time is because people are free to overpay as much as they like. However, if earnings sufficient to justify the high price of a company are not realized, the price will eventually go down.
6. During the financial disaster of 2007-2009, the S&P 500 declined by 52.7% from its high point to its low point. GETGX declined by 46.3%, LAVLX by 57.8%, and SGENX by 34.5%. Thus, Value strategies were not nearly as effective in reducing risk in this environment as in the tech bubble. This is because this decline was not due to over-valuation of certain stocks but to over-valuation of loans, in particular mortgages, that banks had made. Liquidity disappeared, affecting the price of all kinds of financial instruments regardless of their value. People who needed to raise cash were unable to borrow. Instead, they had to sell something—stocks, for example. The stocks that would have been easiest to sell would have been stocks in solid companies, including Value stocks.
7. We believe the current situation is somewhat similar to the tech bubble, but milder. Interest rates have been very low. In discounting to present value, low rates make future earnings worth more, relative to current earnings, than in a high rate environment. Also, some investors who might prefer bonds in a higher rate environment might switch to stocks, and they might choose large cap stocks for relative safety. Therefore, large cap stocks with relatively high P/Es have been looking better than usual. We expect this to change.