Lampert knows value premium when he sees it — you should too

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Edward Lampert, the chairman and controlling shareholder of Sears Holdings Corp., a value investor touted to be the next Warren Buffett, was recently thwarted in his attempts to take over Sears Canada Inc., a welcome relief to many of the subsidiary's shareholders who thought the offer was too low.

After all, the mantra of value investors is "buy something that is worth $1 for 50 cents." Are Sears Canada minority shareholders justifiably afraid?

One way to look at how successful value investors — like Mr. Lampert — have been is to look at the performance of stocks with low price-earnings multiples against those with high P/Es. It may not be a perfect metric but it gives a good idea of relative performance.

A low P/E is not the only thing value investors look for, however; this is just the first step in their analysis. Screening for low P/E stocks only reduces the universe of possibly undervalued stocks.

The next step is to carry out an in-depth valuation analysis of the low P/E stocks and among them choose the ones that trade well below their intrinsic value.

As academics, we do not generally know which stocks value investors finally select for investment, so we tend to look at the whole group of low P/E stocks (normally those with a P/E ratio of less than nine or 10, depending on the time period) that we refer to as value stocks. But, we do know that value investors will end up choosing stocks from this low P/E group.

In contrast, high P/E stocks (normally those with a P/E ratio of more than 20 or 22, depending on the time period) are known as growth stocks. If value stocks selected in this rough way end up beating stocks with high P/E ratios, this gives a very conservative picture of how value investors will perform. In fact, value investors actually must end up doing much better.

My research, using Canadian data from 1985 to 2002, shows that a value premium exists (namely, that value stocks beat growth stocks) and that this premium is quite impressive in size and consistency.

Out of the 18 years in the sample period, only in four years (1989, 1993, 1994 and 1995) did growth stocks convincingly beat value stocks. For 1985 to 2002, the mean annual value premium (value stock returns minus growth stock returns) is 12.40 per cent, while the median is 9.00 per cent.

Could risk differences be the reason for the discrepancy in returns between the value and growth stocks? I tested this by looking at what happens during recessions and bear markets. If it is risk that drives the difference in returns between value and growth strategies, then value stocks must perform poorly in tough economic and market conditions, namely recessions and bear markets.

My research shows that no matter what the state of the world is, the value strategy beats the growth strategy.

Over all, the mean annual value premium in bear markets is 18.86 per cent, while in bull markets it is 10.36 per cent. The median values are slightly lower at 6.05 per cent and 9.87 per cent.

In recessions, the mean annual value premium is 28.50 per cent and in recoveries it is 9.89 per cent. The corresponding medians are 4.19 per cent and 9.98 per cent.

The value premium is always positive, irrespective of the state of the world. In general, value premiums in recessions and bear markets are higher than value premiums in recoveries and bull markets. My research finds no evidence in Canada that value stocks are more severely affected (and hence "riskier") than growth stocks, given the adverse states of the world.

Moreover, while value stocks tend to be smaller than growth stocks, value portfolios have lower betas than the growth portfolios. Beta is a measure of risk. Higher returns and lower risk — you can't beat it. Liquidity differences between value and growth stocks can't explain the beta differences, as the data show that liquidity measures for value stocks are not generally lower than growth stocks.

Could it be that the value premium is driven only by a few stocks with a very large positive value for the value premium? My research shows that this is not true. The persistence of the value premium is quite obvious.

For the low P/E stocks, about two-thirds of the stocks have a positive return as opposed to only about half of the high P/E stocks. Consequently, the value premium is pervasive and not the result of a few outliers.

Is the value premium industry specific? I looked at the value premium in 14 industries obtained from the TSX index review. In general, with the exception of only one industry (transportation) which had a convincingly negative value premium, the remaining 13 industries had positive value premiums. Hence, once more, the value premium seems to be pervasive and not concentrated only in a few sectors of the economy.

The numbers are comparable in the United States. In fact, they are even stronger.

Where does this leave the minority shareholders of Sears Canada? Maybe they are on to something.