

# The Odd Couple: Recessions and Value

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**David Hintz, CFA**

Portfolio Manager, U.S. Large Cap

**Ethan Kiliany**

Research Analyst, U.S. Equities

## Snapshot

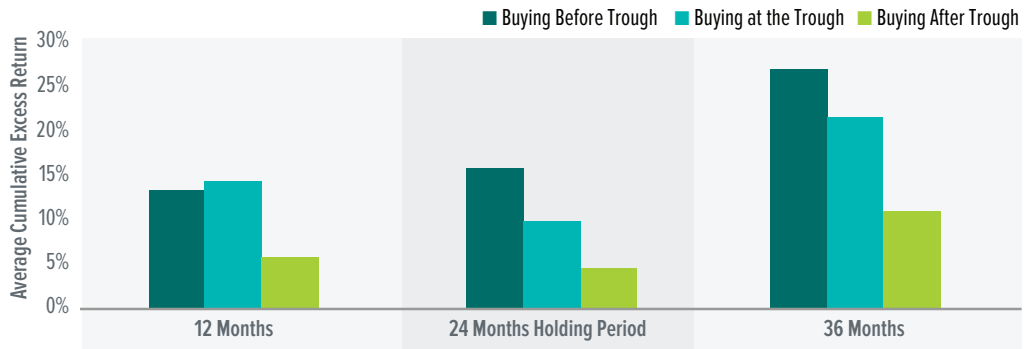
- Value stocks frequently exhibit significant outperformance following recessionary troughs.
- The historic results for value have actually been better if the investment was made prior to a recessionary trough rather than at the time of or after the trough.
- Given the difficulties of market timing and our belief that value is a source of long-term excess performance, it is reasonable to maintain a strategic position in value in the midst of the COVID-19 recession.

As an investor in SEI's portfolios you're well aware that we believe value is an alpha source. Simply put we seek to buy companies that have attractive valuations because we believe there is significant long-term potential that they will outperform a broad market benchmark such as the S&P 500 Index. In practice, this means our portfolios will have a strategic (long-term) bias toward value (and other alpha sources like momentum and stability) when compared to the portfolio's benchmark.

You're probably also aware that a value bias has been quite painful over the past decade. It's easy to find articles written by the financial press that declare value investing is dead. This isn't the first time, nor will it be the last, that someone makes such a declaration—despite abundant academic research and historical data showing value investing has generated excess returns. Of course investors continually ask, "When will value outperform again? What will be the catalyst for this?" While, we certainly wouldn't call a recessionary environment a perfect catalyst for value—and we believe trying to identify catalysts can be a counter-productive exercise anyway—our research does indicate that recessions have historically resulted in favourable environments for value investing.

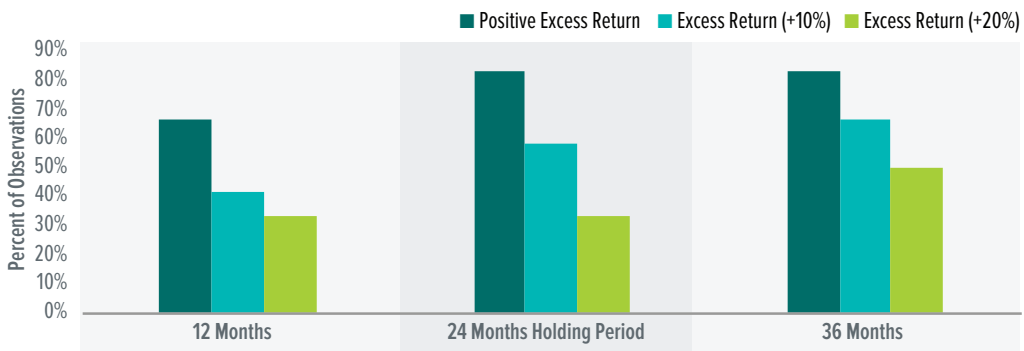
Just like trying to predict catalysts, attempting to time market events is a generally fruitless exercise. In Exhibit 1, we compare the average historical outcomes of hypothetical value investments made at the time of a recessionary trough as well as three months before and after the trough. Our research, based on data from noted academic and author Ken French, indicates that no matter the timing of a value investment, it has typically generated significant outperformance (Exhibit 1) following a recessionary trough. As illustrated in Exhibit 2 for hypothetical value investments made three months before a trough, the results have been fairly persistent. One could argue that the optimal timing for a value investment would actually precedes the recessionary trough. Therefore, we contend that a strategic allocation to value—which, by its very nature precedes a recessionary trough—is an appropriate way to position in this type of environment. Equity markets are widely considered leading indicators and generally begin to recover before the economy improves, meaning investing early may be beneficial.

### Exhibit 1: There has been Value in Investing Before, During and After a Trough



Source: SEI, Ken French. 1/1/1926–31/3/2020. Cumulative excess return of Ken French value factor (cheapest 30% of stocks by price-to-book value) versus S&P 500 Index (prior to 1/5/57 returns of the S&P 90 Index were used). Purchases are hypothetical and do not include any expenses or fees. Buying before or after trough determined as three months before or after the trough.

### Exhibit 2: High Batting Average for Value Buying Three Months Before the Trough



Source: SEI, Ken French. 1/1/1926 – 31/3/2020. Cumulative excess return of Ken French value factor (cheapest 30% of stocks by price-to-book value) versus S&P 500 Index (prior to 1/5/57 returns of the S&P 90 Index were used).

We don't know when the COVID-19 economic recession will bottom out. Annualised U.S. gross domestic product (GDP) for the first quarter of 2020 declined 4.8% according to an advance estimate from the U.S. Bureau of Economic Analysis. We expect second-quarter GDP reports to be significantly worse. This sets up the possibility that the latest recessionary trough has yet to come, perhaps arriving in the second quarter or later this year; of course we won't actually know until after the fact. What we do know is that the data show that value has historically performed quite well at the beginning of an economic recovery, and has continued to outperform while the economy comes out of a recession into an expansion.

## Index Definitions

**S&P 500 Index:** The S&P 500 Index is an unmanaged, market-weighted index that consists of 500 of the largest publicly-traded U.S. companies and is considered representative of the broad U.S. stock market.

**S&P 90 Index:** The S&P 90 Index was a precursor to the S&P 500 Index. It was comprised of 50 industrial stocks, 20 railroad stocks and 20 utility stocks.

## Glossary of Terms

**Alpha source:** Our strategies are designed to capitalise on long-term drivers of market performance through exposure to persistent sources of returns such as mean reversion, trend-following and stability.

**Batting Average:** Batting average is a statistical measure that illustrates how often in percentage terms an investment outperformed a specified benchmark.

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