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Westwood and the **Modern Era of Value Investing**

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The allure of value investing has attracted many disciples over the years utilizing the foundation established by the "Father of Value Investing," Benjamin Graham, and David Dodd in their 1934 seminal book, Security Analysis.[1]

The core principles of value investing have been foundational for institutional investors and asset allocators for decades, and why not? Historically, there have only been eight 10-year periods over the last 90 years (total of 90, 10-year periods) when value stocks underperformed growth stocks. Two of them occurred during the Great Depression, one during the Tech Bubble in the 1990s, and the other five have been more recent over the last five years. In fact, the recent outperformance of growth relative to value year-to-date in 2020 would rank as the largest annual dispersion of all time. The second largest was in 1999 and kicked off a run for value that resulted in over 6% annual outperformance over the next decade. Also worth noting in support of active management in the value space, as of the third quarter of 2020, the median Large Cap Value manager is outperforming the Russell 1000 Value across multiple standard performance time periods including 3-, 5- and 10-years trailing.[2]

Definitions of Value

Deep Value	Classic Value	Relative Value
Investing in companies thought to be trading at significant levels of "statistical" cheapness; can be highly cyclical companies or companies potentially in financial distress possessing extreme risk or uncertainty.	Investing in statistically cheap companies or companies trading less than their intrinsic value; focused on historical profitability and/or traditional value metrics (i.e., P/B, P/E Ratio) returning to or mean-reverting back to prior levels.	Investing in companies that appear to be trading at a discount relative to another metric, including quality or growth metrics. Valuation is not the sole statistical comparison versus peers in absolute terms.

The Allocator's Dilemma: Is Value Investing "Dead"?

The call for the demise of value over the last few years has grown deafening given the underperformance. What if the "classic" definition of value investing being employed by investors, metrics like price-to-book and price-to-earnings, wasn't really that classic after all? The origins of value investing are in identifying and investing in securities where the market price was below the intrinsic value established by fundamental analysis. It wasn't until the seminal work by Kenneth French and Eugene Fama in the early 1990s that the value effect was established using book-to-market (simply the inverse to price-to-book).[3] The next 30 years would see this definition of value, statistically cheap companies, become the measuring stick for evaluating "value" and become the basis for many managers who identify as deep or classic value. For disciples of those strategies, their premise is that companies with below-average valuations will mean-revert to average market multiples. While this occurred for several decades, the shifting economy may be a permanent impediment to this philosophy going forward.

Active management is far from dead and allocators are going to have to rethink the way a value allocation fits within their broader equity portfolio. A portfolio of the cheapest securities may bring an overexposure to unwanted characteristics like higher beta and more cyclical businesses with a lack of diversification. Adding in quality elements — free cash flow generation, strong returns on capital and conservative balance sheets — can offset those exposures while capturing the essence of value investing. Westwood believes our focus on investing at the intersection of quality and value creates more consistent and repeatable alpha generation across the value investing continuum.

Modern Value Investing: Westwood's View

Defining value is tricky business as noted above; take the famous quote from the "Father of Value Investing" Benjamin Graham: "Price is what you pay; value is what you get." Price is readily observable in the market, but what you get may not be immediately evident. Westwood believes value investing is buying companies where price, or what you pay, is below intrinsic value, or what you get. **Intrinsic value is determined by fundamental analysis, using a multi-faceted approach to valuation focused on current and future cash generation in order to correct for and dig deeper than surface-level metrics like book value.** In conjunction with evaluating quality metrics, such as profitability and leverage, we believe there is a return premium at the intersection that can be captured by **both the investment strategy and asset allocation level.** We believe it is important and foundational to invest at the intersection of quality and value in the "modern era" of value investing, and by doing so, it creates a pathway forward for superior risk-adjusted returns with better consistency across the economic cycle and outperformance during down market periods.

Why the Intersection of Quality and Value?

We believe that investing in undervalued, high-quality businesses can generate a return premium resulting in lower absolute downside risk and superior risk-adjusted returns. From a fundamental perspective, superior business models have sustainable competitive advantages that can consistently generate returns on capital in excess of the cost of capital. High-quality businesses also usually have better opportunities to reinvest their cash flows into the pursuit of M&A, value-add assets including both physical and intangible, or returning excess capital to create long-term value for shareholders. We believe that owning portfolios of undervalued quality businesses versus simply statistically cheap companies perform better during periods of volatility resulting in lower downside risk. To realize the return premium, we focus on identifying companies that are at the intersection of quality and value. We believe this requires a fundamental active, multifaceted approach analyzing valuation, profitability and financial strength specific across industries.

Quality Defined

Quality businesses typically possess a similar and desirable set of qualitative and quantitative characteristics. Quality is a distinctive investment attribute that is different than others such as "value" or "growth." The quantitative focus of our fundamental analysis revolves around understanding and identifying companies with strong levels of cash generation, solid returns on capital and conservative balance sheets. Paired with softer and more qualitative elements, such as strong management teams, durable competitive advantages and reasonable growth prospects, these firms are well-positioned to perform through a full market cycle as they weather the bad times and thrive during the good. **This is an important distinction in differentiating "high-quality" from "classic" value investing — which can be linked to heavily indebted, highly cyclical and unprofitable companies.**

The following three characteristics are common with high-quality stocks that demonstrate greater consistency and lower downside risk over multiple market cycles:

Profitability

In the new economy, analyzing return on invested capital (ROIC) and cash flow generation can be a better way to value a company's intellectual capital and ability to generate profits from assets. Consequently, GAAP earnings can distort the "true economic" profitability of a company making traditional valuation methods such as Price to Book (P/B) misleading.

Financial Strength

Strong balance sheets, including the appropriate leverage ratios and ability to service debt throughout the investment cycle and cyclicality of cash flows.

Understanding how management is allocating capital to expand its business, including the ir ability to use equity and debt, is essential.

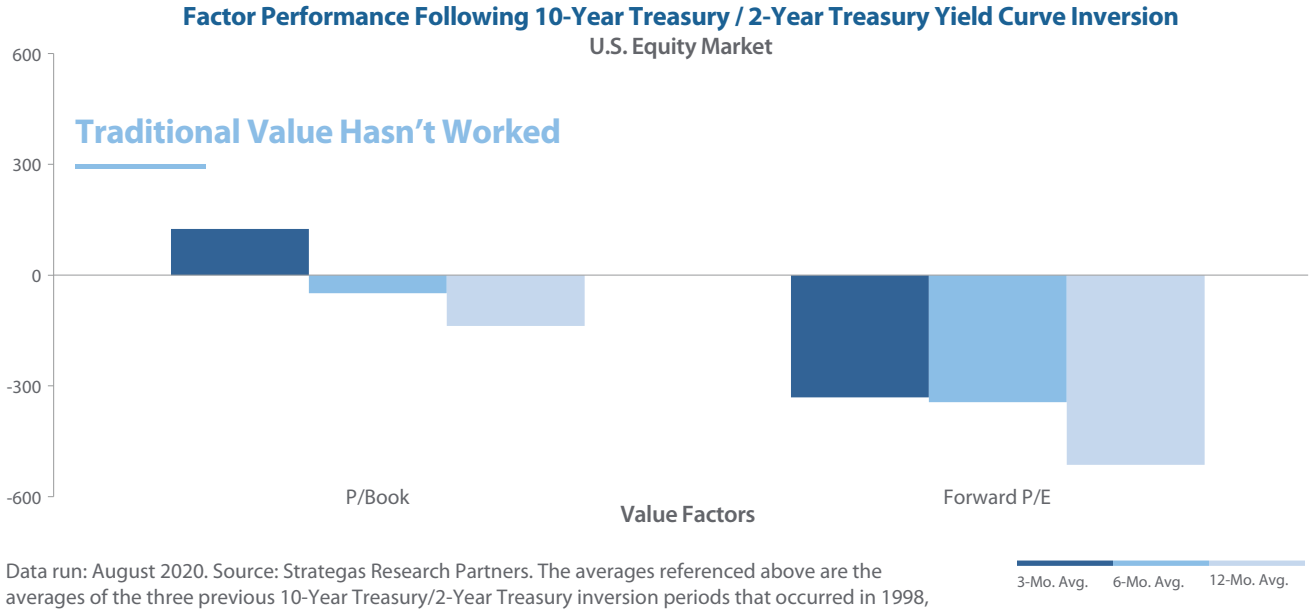
Competitive "Moat"

A company's ability to maintain its advantage in order to protect longterm profits and market share from competing firms is critical. This is most important for maintaining strong fundamentals related to sustainable and predictable growth, stability of cash flows, earnings and capital expenditures.

Quantifying Why Shifting to Quality Is the Path Forward for Value Investors

High-quality companies have historically delivered more stable financial results, leading to outperformance during periods of distress and volatility. This premium awarded is notable, with Figure 1 illustrating the performance of quality and value factors following the last three inversions of the yield curve across various periods. Disappointing many "classic" value investors are the poor outcomes from Price-to-Book and Price-to-Earnings. The recent inversion in 2019 and subsequent onset of the global COVID-19 pandemic have continued this pattern, with consistent performance versus historical observations.

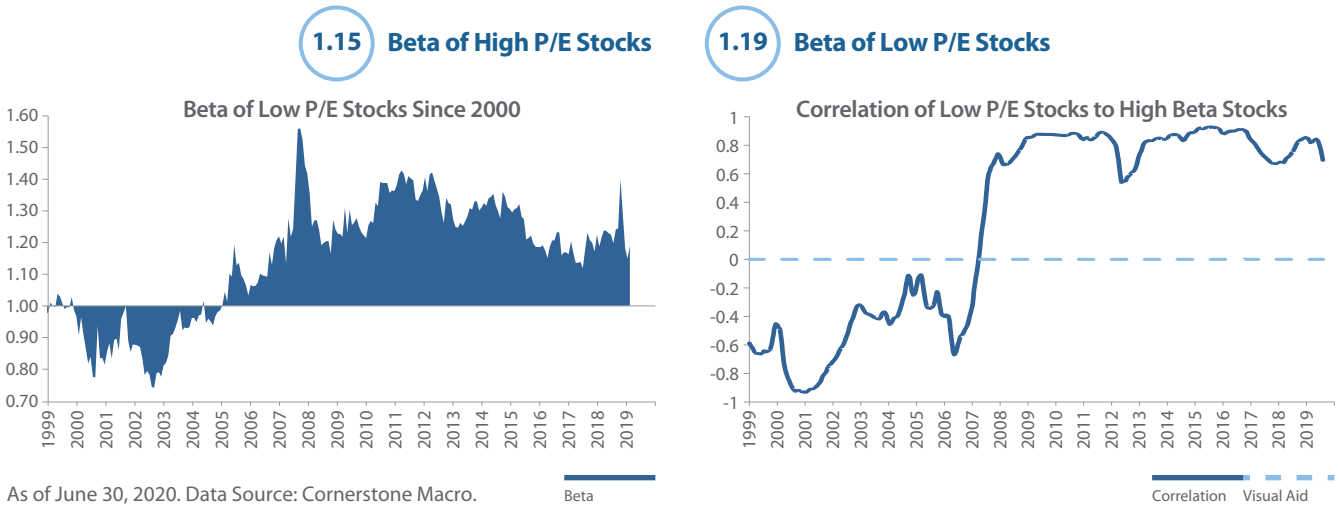
Figure 1: The big miss: Classic value factors haven't worked well during downturns



Data run: August 2020. Source: Strategas Research Partners. The averages referenced above are the averages of the three previous 10-Year Treasury/2-Year Treasury inversion periods that occurred in 1998, 2000, 2005 and 2019. U.S. Equity Market is represented above by the Russell 3000. High debt refers to the highest leverage quintile.

Unfortunately, as mentioned previously, today's accounting rules fail to capture the current reality and lead to Price-to-Book and Price-to-Earnings being flawed metrics and causing underperformance. **This becomes more pronounced during down market periods as "classic" value stocks have become much riskier than investors realize. Over the last 20 years, "classic" value — statistically cheap stocks — have become far more akin to high beta stocks explaining the disappointment investors have experienced (see Figure 2).**

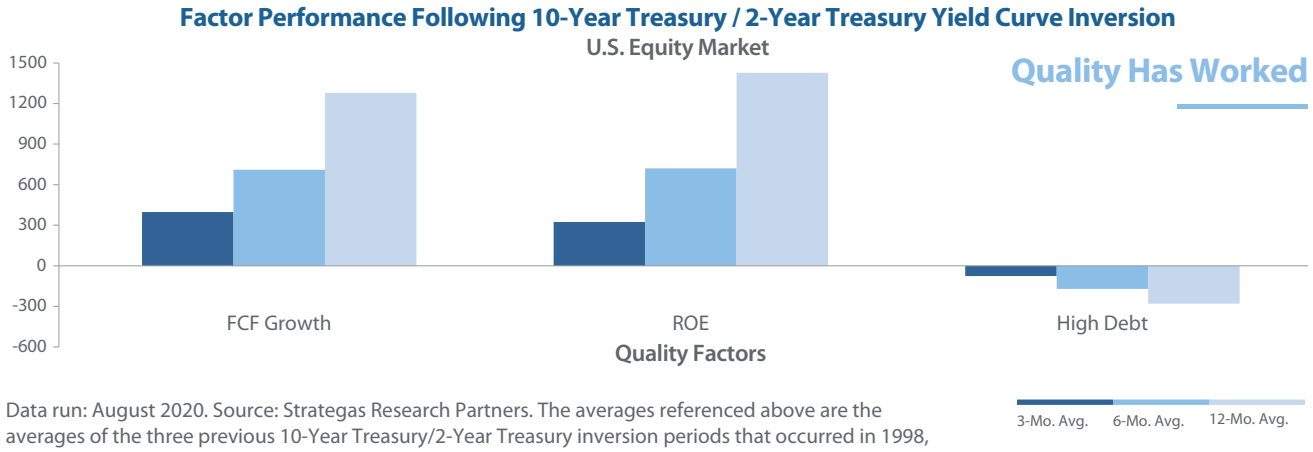
Figure 2: Cheap "value" stocks have become riskier for investors



As of June 30, 2020. Data Source: Cornerstone Macro.

Quality, in contrast, has historically seen consistent performance through a full market cycle as periods of underperformance are more than offset by periods of strong returns (see Figure 3). Quality factors such as free cash flow growth (FCF), return on equity (ROE) and net debt/EBITDA (leverage) have outperformed significantly. These factors were highly prized given the stability they provided in servicing debt and weathering temporary disruptions to their business, contributing to both overall return and better downside performance. As well, these factors capture real value creation beyond just accounting increases while controlling for the use of leverage. The most recent 2019 inversion again saw similar performance from quality factors as with prior observations.

Figure 3: During periods of distress, quality factors, on the other hand, worked



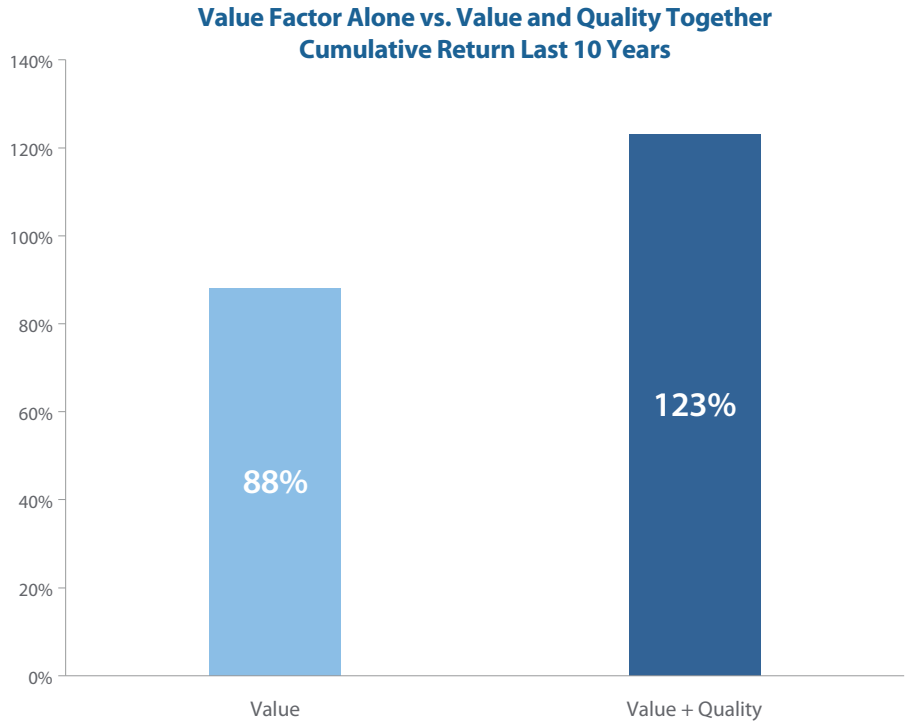
Data run: August 2020. Source: Strategas Research Partners. The averages referenced above are the averages of the three previous 10-Year Treasury/2-Year Treasury inversion periods that occurred in 1998, 2000, 2005 and 2019. U.S. Equity Market is represented above by the Russell 3000. High debt refers to the highest leverage quintile.

Conversely, the most challenging times for quality can be during the early part of an economic expansion as companies that may have escaped financial distress or are more heavily levered to cyclical forces generally see strong but unsustainable rallies in their share price. Quality businesses, having held up better prior, follow them higher but at a lesser pace. These periods tend to be fleeting, as the economic cycle normalizes in the middle and latter parts. This allows their quality attributes — cash generation, balance sheet deployment and strong returns — to separate a high-quality company's performance from their peers. Avoiding traditional value traps and poor fundamental performance by firms during this period is critical for investors in protecting their returns.

Figure 4: Quality — the key to mitigating downside risk and creating more consistency long term

Value factors alone generated **88%** cumulative return over the last 10 years

Value + Quality factors added additional 35% for a total of **123%** cumulative return



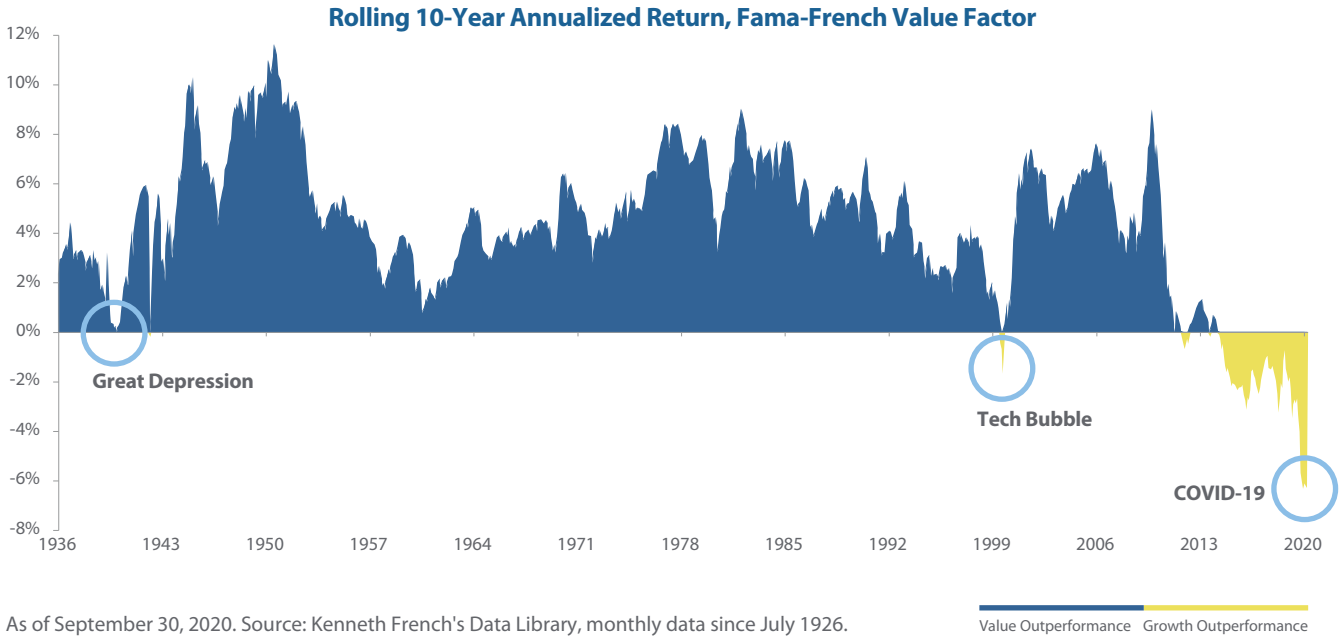
As of March 31, 2020. Data Source: Jefferies, using the Russell 1000 Index.

Our findings infer emphasizing quality metrics in tandem with valuation metrics can provide the risk management and return experience required for institutional investors to shift assets from "classic" value strategies or invest new assets within the value style. Emphasizing quality metrics like free cash flow generation, rather than an over-reliance on price-to-book measures, helps to ensure physical and intangible assets generating real economic profits are captured in the security selection process. In fact, data has shown since 2010, in Figure 4 for example, when you combine 50% value and 50% quality over the last 10 years, cumulative returns improve from 88% for Value to 123% for Value and Quality which would have closed the return gap to growth significantly.

What Went Wrong? Challenges Today With Classic or Deep Value

Since the days of Graham and Fama-French, various economic backdrops have been more or less favorable for the investment in a value style of investing, amid the broader positive trend overall. Through that period, securities that appeared statistically cheap often coincided with being mispriced or undervalued given many of the companies that found themselves with low multiples were experiencing cycle headwinds or a transitory disruption to their growth trajectory.

Figure 5: The worst ever returns for value stocks



As of September 30, 2020. Source: Kenneth French's Data Library, monthly data since July 1926.

Most recently, however, the trifecta of low interest rates, low inflation and low GDP growth has been a significant headwind for many cheap businesses that are overly exposed to cyclical factors and may struggle with profitability and high leverage. The continued shift in the economy from an industrial orientation toward a consumer-driven one could have lasting impacts on value investing, particularly for classic value investors. The current outlook is for this shift to become permanent, given the structural nature, and many cheap businesses may never recover to their former glory. The rise of the consumer's influence in a digital commerce and the growth in intangible assets cannot be overstated in their importance.

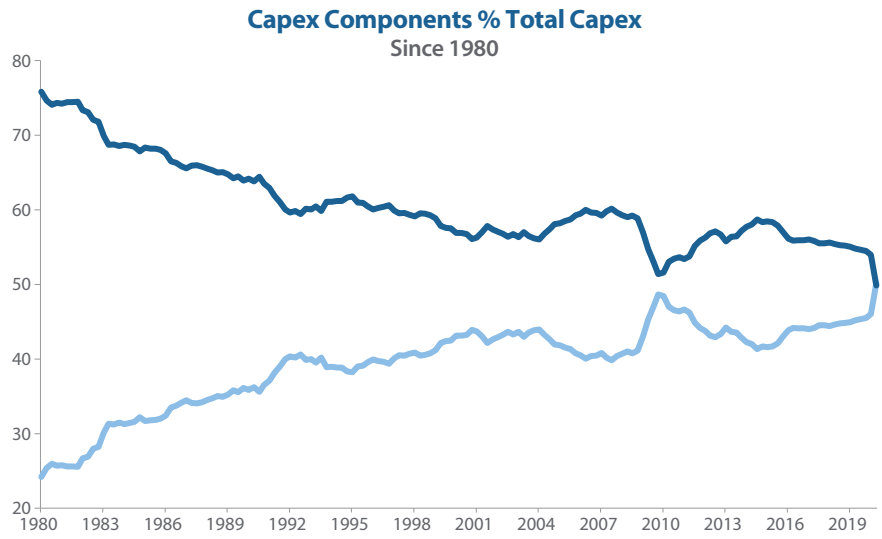
Concurrently, the last 40 years have seen a dramatic reduction in the cost of capital, as inflationary pressures waned, reducing the competitive benefit and long-term value creation through accumulation of large-scale physical assets. As leading companies have shifted their investments away from old-world factories and plants, so too have markets. The representation of cyclicals in broad market indices, including sectors such as Energy, Materials, Industrials and Financials, are at their lowest point in history. In contrast to a core index, those sector weights are more than five times larger within the value indices. Index creators are beginning to explore changes to mitigate some of these less-desirable exposures, however, unless the methodology is dramatically overhauled, the impact will likely be muted overall. This over-concentration to both highly cyclical sectors and underlying statistically cheap companies creates a challenging environment for investment performance for managers in the value space, particularly deep and classic value firms.

Instead of simply facing normal cycle pressures, many of these cheap firms now face existential threats from new entrants and technology-enabled competitors. Fundamental analysis can identify the "winners" from those industries, generally higher-quality companies, as companies today are investing more in intangible assets (see Figure 6), including brands, R&D, patents, algorithms, licensing agreement or intellectual property, than ever before and these are not being accounted for and valued in the same way that tangible, physical assets are.

In 1975, intangible assets represented over $100B of the market, today they represent over $20T (see Figure 7). This creates a prominent and inherent flaw in book value and earnings challenging traditional and deep value investing strategies and investment processes alike.

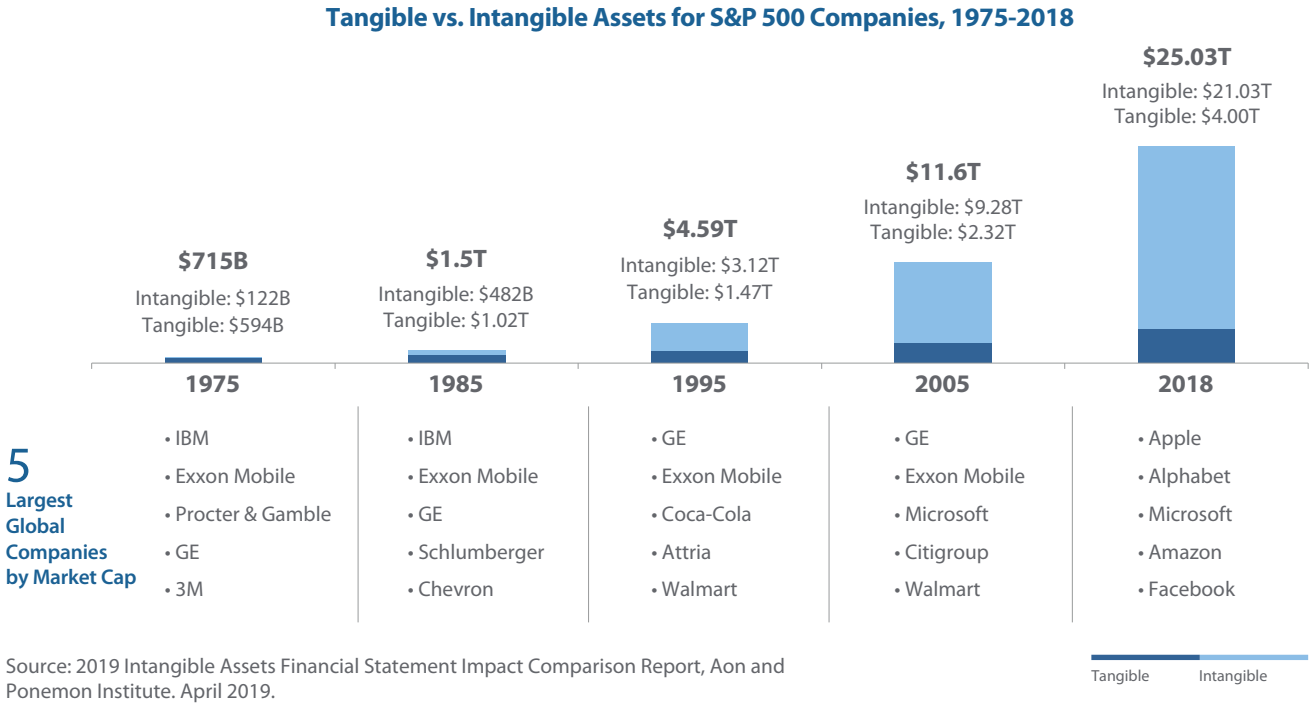
Figure 6: Accounting practices have failed to keep up with how companies invest and grow

As companies have shifted their investments away from old-world factories and plants, so too have markets, as those sectors most exposed to cyclical industries have decreased in weight over the last two decades



As of June 30, 2020. Data Source: Cornerstone Macro.

Figure 7: Price-to-book is no longer a predictive metric and has become distorted



Source: 2019 Intangible Assets Financial Statement Impact Comparison Report, Aon and Ponemon Institute. April 2019.

The increasing importance of intangible assets is one of several structural challenges facing value investors, with another being the rising prevalence of corporate buybacks that also distort book values and earnings and their usefulness in assessing value. **For the period 2009 to 2018, 465 companies in the S&P 500 spent $4.3 trillion on**

buybacks, or more than 40% of the total market capitalization in 2009.[4] This reduces book value and increasingly makes price-to-book far less relevant for assessing the value of a stock. Further, the use of debt financing to fund buybacks, rather than cash generation, can optically improve earnings, but debt requires servicing and ultimately repayment. Recent academic work has highlighted the issues arising from the current accounting standards by (study) New York University business school professor Baruch Lev and the University of Calgary's Anup Srivastava.[5] Together, they found that a simple value strategy relying on the price-to-book ratio had underperformed not just for the past dozen years, but also for the better part of the past three decades. The "madness of accounting," they say, has dragged down the performance of value investing ever since. Focusing purely on accounting-driven cheapness, through book value or net income, may ignore many of the highly cash generative businesses, who are screened out before ever being considered by legacy value investing processes.

The Path Forward: The Westwood Way

In summary, classic value managers who have used "traditional" valuation metrics, such as price-to-book or price-to-earnings, to identify statistically cheap companies as a way of outperforming have proven detrimental to performance and failed many investors. In contrast, by utilizing the original definition of value — paying below intrinsic value for businesses — together with emphasizing quality can offer a compelling risk-adjusted return profile within the value investing landscape. **We believe realizing the return premium for value investors going forward will require actively managed and more concentrated portfolios of stocks that maintain both attractive valuations relative to intrinsic value and the above-mentioned quality characteristics.** Valuation is critical to unlocking the return premium. Quality businesses are not necessarily mispriced and not sufficient alone to generate the return premium. Westwood defines this opportunity set as the "Intersection of Quality and Value."

Long Live *Quality* Value: Solving the Allocator's Dilemma

"Nothing lasts forever" is a bedrock principle most long-term investors have come to understand, particularly those invested in value disciplines. Value investing using a deep or classic value orientation has failed to live up to expectations, getting it backwards by capturing more downside and less upside. Active management has a path forward — through intellectual flexibility, adding quality to the process and taking a modern approach toward value investing. A quality value approach provides a complementary set of exposures to broader economic trends relative to beta-like core allocations and technology-heavy growth styles. Incorporating quality within value discipline helps avoid classic value traps by limiting positions with deteriorating profitability and over-extended balance sheets. Collectively, this inclusion of quality helps to also limit the magnitude of cyclical risk in a portfolio relative to other value investing styles, avoiding those statistically cheap "for a reason" businesses, and captures the increasingly important contribution to intrinsic value from investments in intangibles. By providing strong returns during the good times and resilient performance during periods of volatility, quality value is a better solution for an all-weather exposure to value return drivers.

Perhaps the most dangerous words in investing are "this time is different." The identification of and best method of implementation of Benjamin Graham's pursuit of buying securities below their real value may change, it may evolve, but such is the nature of investing. The ability to truthfully pursue investing with intellectual flexibility is not easy, requiring actively managed portfolios to deliver into the alpha potential. This is a challenge to replicate through either passive vehicles or purely quantitative approaches given the issues laid out above with the current accounting standards, as well as requiring a belief that the past will repeat in the future. Allocators are faced with challenging times, in adapting their view of value or relative value as we defined it, with our belief firmly centered in the benefits of investing at the intersection of quality and value as the solution for today's current issues.

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References

[1] Graham, Benjamin and Dodd, David, Security Analysis, The Classic 1934 Edition (1934).

[2] As of Sept. 30, 2020. Data Source: eVestment. Returns referenced are gross of fees.

[3] Fama, Eugene and French, Kenneth, The Cross-Section of Expected Stock Returns, (1992). Journal of Financial Economics.

[4] As of June 30, 2020. Data Source: Strategas, Compustat and FactSet.

[5] Lev, Baruch Itamar and Srivastava, Anup, Explaining the Recent Failure of Value Investing (Oct. 25, 2019). NYU Stern School of Business.