The Case for Value

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In brief

- Value investing is the art of buying stocks which trade at a significant discount to their intrinsic value.
- Different sub-styles of Value investing exist such as traditional, defensive, and relative value in addition to fundamental active, quantitative, and passive approaches. Some of the most common characteristics of value stocks include high dividend yields and low price to book and price to earnings ratios.
- While value investing has had a difficult decade in the 2010s, it has been an effective strategy over the long-term.
- More recently the style is experiencing a performance revival. Macroeconomic conditions, with rising interest rates and inflation, are constructive for industries and companies which traditionally display value characteristics.
- Value is a style worth considering on diversification grounds as it is a means of improving the balance of equity portfolios and potentially enjoying a smoother ride in terms of absolute and relative returns.
- London CIV takes the view that investors should keep Value on their radar from a longer-term strategic viewpoint. A well-constructed LCIV Value fund can offer Client Funds a useful portfolio building block, helping them implement asset allocation decisions efficiently and cost effectively.
- For an investment manager to be selected to run one of our funds we apply a stringent assessment framework and want to see a firm commitment to best practice in responsible investment and engagement.
- London CIV is experienced in running manager research exercises tailored to Client Fund needs. A recent soft market test has given us good insight into the universe of Value strategies, helped us identify interesting candidates and highlighted the diversification benefits these strategies can bring when combined with growth strategies.
- We are already monitoring several Value managers that exhibit the characteristics we like, and we encourage Client Funds that have identified the need for a global equities Value strategy in their asset mix to get in touch via their London CIV Client Relationship Manager for a discussion on available options.
- We will only build a fund if we have sufficient demand from Client Funds.

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What is Value Equity Investing?

"Price is what you pay; value is what you get" – Benjamin Graham

Origins

Value investing, the art of buying something which trades below its intrinsic value, is among the oldest styles of equity investing. Benjamin Graham and David Dodd provided the theoretical framework used by value investors in modern equity markets. In their book '*Security Analysis*', published in 1934 shortly after the Great Crash, and in Graham's seminal work the *'The Intelligent Investor'*, published in 1949 they laid the intellectual foundations of what would later be called value investing. Through this work they drew a clear distinction between speculation and investing, and critically, encouraged investors to gauge the value of the operating business behind the security. Over the course of his academic and professional career Graham has built a strong following including several prominent investors of our days such as Irving Kahn, Sir John Templeton, and Warren Buffett, arguably the most prominent of students of Graham's at Columbia University.

Benjamin Graham, Warren Buffett and Charlie Munger. Graham is the third from left[1].

Buffett is the best-known value investor and is widely recognised as a role model for many professional and retail investors. Starting his career in 1954, he applied the principles of value investing and accumulated a fortune of billions of US dollars initially through Buffet Partnership Ltd and then through a multinational conglomerate holding company, Berkshire Hathaway Inc. Through his celebrated '*Berkshire Hathaway Letters to Shareholders'*, Buffett has popularised the concepts of 'Margin of Safety' and 'Moat' to characterise attributes of strong businesses, such as robust earnings and solid long-term growth potential. Buffett also emphasized the merits of companies that distribute earnings to shareholders in the form of dividend payments.

While Graham's work has been very influential for fundamental investors, it is the work of two academics, Eugene Fama and Kenneth French (Fama and French), that inspired many value investors who invest using a quantitative approach. In a series of empirical studies[2], they popularised the use

[1] Source: https://www.quora.com/Is-Security-Analysis-by-Benjamin-Graham-still-relevant

[2] Fama, E. F.; French, K. R. (1992). "The Cross-Section of Expected Stock Returns". The Journal of Finance and Fama, E. F.; French, K. R. (1993). "Common risk factors in the returns on stocks and bonds". Journal of Financial Economics.

of Price to Book ('P/B') as valuation metric (more on this below) and demonstrated the historical existence of a 'value premium'[3]. This persisted over long periods of time, averaging 5.5% per annum between 1927 and 2008[4], but has declined since then. According to Fama and French value stocks outperform because they retain higher risk, and this risk is unrelated to the market beta. Therefore 'value', along with other factors such as 'size', is often being refer to as a factor that earns an excess return over the long term.

A Broad Church

Value investing is a relatively simple concept: you buy something which you believe is worth intrinsically more than its market price; you wait until other market participants recognise that value and start buying that asset, thus increasing its price to the level you have assessed as fair; at that point you sell and recycle your capital to invest in a new opportunity. Notwithstanding the simplicity of the concept, the key challenge in delivering this strategy successfully lies in determining the intrinsic value of the stock in question.

Since the days of Graham and Dodd's seminal work, many branches of value investing have emerged. While each branch (i.e., sub-style in manager research parlance) follows the same basic principles, they define intrinsic value differently, they prioritise different elements in their analysis and often have different time horizons and sell discipline.

Valuation metrics sit at the core of value strategies, so it is worth spending some time here to look at P/B and Price to Earnings ('P/E') which are the two most often used. P/B, or the P/B ratio, compares the stock price of a company to its book value per share. Book value per share is the company's net worth (assets minus liabilities) divided by the number of outstanding shares. In some cases, investors will exclude certain intangible assets (e.g., goodwill, brand recognition) from the calculation of the P/B ratio.

P/E, or the P/E ratio, compares a company's stock price to its annual earnings. A P/E ratio of 15, for example, indicates that investors are prepared to pay the equivalent of 15 years of current earnings to buy a company's shares. The lower the P/B or P/E ratio, the more likely the company is considered a value stock.

Beyond the P/B and P/E ratios investors will also look at valuation metrics that use cashflows and enterprise value. A popular cashflow metric is 'FCF' which stands for Free Cash Flow. This is a measure of how much cash a company generates net of all costs, including interest charges, and the capital investment required to sustain the earnings potential of the business. Enterprise value ('EV') is an alternative metric to equity market capitalisation and is used to assess a company's total value. EV includes in its calculation the market capitalization of a company but also short-term and long-term debt as well as any cash on the company's balance sheet. EV is often compared to the earnings generated by a company before interest, tax and depreciation charges ('EBITDA').

Traditional active value is the sub-style that aims to construct portfolios that, in aggregate, trade at discounts to the market across multiple valuation metrics (e.g., P/E, P/B, EV/FCF, EV/Sales) while usually simultaneously delivering an above-market dividend yield. To assess the value of a company and arrive at a target share price investors often use a valuation method known as Discounted Cash Flow ('DCF'). DCF analysis attempts to estimate the value of an investment today by discounting its expected future cash flows. The discount rate used in a DCF analysis is the return the investor seeks to compensate for the risk taken and is usually represented by the risk-free rate plus a risk premium.

[3] The term premium is used to describe the outperformance of value stocks over the wider market.
[4] https://www.mercer.com/our-thinking/wealth/is-there-still-a-case-for-value.html

Traditional value strategies will typically be more overweight the cyclical areas of the market such as Financials, Industrials, Energy, and Materials while being underweight Consumer Staples, Technology, Health Care and, to a lesser degree, Utilities. Exposure to the cyclical areas of the market means that by default this approach tends to experience a greater degree of mean reversion. Traditional value investing is not just about mechanically identifying stocks with low valuation ratios. The real skill lies in the ability of active managers to avoid value traps by identifying undervalued companies that possess strong operating fundamentals, such as higher profit margins, higher returns on equity and assets, attractive growth prospects and solid balance sheets. Ultimately, market recognition of these fundamentals should drive a narrowing of the valuation “gap”, and this will be the primary source of investment returns. Given the usually high exposure to cyclicality of the economy in this strategy, by emphasising strong fundamentals a skilled traditional value manager aims to mitigate the mean reverting tendency of these portfolios and deliver excess returns both in rising and falling markets.

Economic transitions present challenges to all styles of investing. In the past 25 years or so, the traditional value investing approach has been challenged by the increasing importance of **intangible assets**. Intangibles are defined as those assets which are not physical in nature, including a company’s capitalised research and development expenditures (‘R&D’), goodwill and brand recognition. These assets have become more and more important in modern economies, particularly for companies that rely heavily on innovation. Traditional accounting, however, does not reflect the expectation that money spent on R&D, brand development and other non-physical items will yield cash flows over a multi-year horizon which have a material impact on the value of companies. Consequently, many value managers have historically not incorporated intangibles in company valuations.

Given the value placed on intangibles (as a proportion of a company’s value) has increased significantly over the last four decades it has become more important to consider them when valuing companies. For instance, R&D of some of the largest corporations now comprise approximately 11% of the firm’s valuation[5]. With this in mind, many value managers have expanded the traditional approach to include financial data sources that capitalize R&D expense as an asset. Research Affiliates quantitative research concluded that when adding intangibles, the performance of the value factor improved for both growth and value stocks and found that the traditional P/B metric can lead to misclassification of value and growth companies[6]. The findings showed that for growth companies, intangible assets represented two thirds of the company’s value, while for value-oriented companies one third of the value.

Two other popular flavours of value investing are defensive and deep value. **Defensive value** investing focuses on strong, steady companies that produce decent rates of income and capital growth at value for money prices. Dividend yield is often a key characteristic for a defensive value manager, which typically outperforms in down markets, but may be less competitive in up markets. Defensive Value strategies will typically be overweight Consumer Staples, Health Care, and Utilities relative to their value peers while being underweight the more cyclical areas of the market such as Financials, Energy and Materials. Each of these areas will behave differently depending on the prevailing market environment. For example, in periods where investors expect strong economic growth, cyclical stocks will perform strongly while defensive stocks will lag. Conversely, when markets are worried about an economic slowdown or recession, defensive value stocks will perform strongly while cyclical value stocks will falter.

[5] Intangibles: The Missing Ingredient in Book Value, Feifei Li, Research Affiliates, LLC (2020).

[6] https://www.hymans.co.uk/media/uploads/Sustained_underperformance_of_value_-_part_2.pdf (2021)

Deep value stocks usually represent the cheapest quintile of stocks on a price-to-book basis or other valuation metric. Deep value strategies stylistically exhibit many of the characteristics we discussed previously but in extremis and due to their nature can be very volatile. A deep value manager will typically outperform in strong up markets but may be less competitive in down markets.

Lastly, **Relative value** compares the intrinsic value of companies through a relative approach. As opposed to traditional value, where an investor appraises the value of a business using, in most cases, a Discounted Cash Flows ('DCF') type of analysis, relative value strategies are more flexible using current market-based pricing signals to determine what constitutes value or not. They tend to look at what is cheap relative to a company's own history, its industry peers, or a larger market opportunity. Relative value investors do not dismiss the theoretical value of a DCF approach, but they recognise that DCFs have a lot of subjectivity to them in terms of cash flow and earnings estimates and the selection of appropriate discount rates.

Relative value strategies tend to have larger weights to the Information Technology, Consumer Discretionary, and Communication Services sectors while being underweight Financials, Consumer Staples, Energy, and Utilities. Because of these allocations relative value managers may look more like growth-at-a-reasonable price ('GARP') strategies at certain points in the investment cycle.

It is worth noting that very few value equity products adopt a pure stylistic approach. In practice a mixture between substyles is to be expected often incorporating sustainable or environmental social and governance ('ESG') metrics. Notwithstanding some overlap between styles, categorisation is possible and important to investors or the fund selectors in terms of combining a value strategy with other styles of equity investing such as growth or quality. More on this in the third section of this paper.

Characteristics of three main sub-styles are presented in the tables below. In Figure 1, using analytics from the manager research self-reporting platform eVestment, we present sector allocations against the MSCI Value and MSCI World Indices as of 31 December 2021. Notwithstanding this is a point-in-time snapshot, it illustrates well that sector weights can deviate significantly between substyles.

Figure 1: Indices and Value Strategies Sector Weights

	AVERAGE SECTOR % WEIGHT as of 31 December 2021										
	Comm Services	Cons Disc	Cons Staples	Energy	Financials	Health Care	Industrials	Information Technology	Materials	Utilities	Real Estate
Defensive Value	7.7	8.2	12.8	2.5	16.5	12.7	13.7	16.8	4.5	2.3	2.3
Relative Value	8.9	11.8	6.7	3.3	16.7	14.4	13.2	16.9	5.3	1.6	1.2
Traditional Value	8.2	13.7	6.9	6.4	19.4	10.5	14.6	10.5	6.0	3.0	0.9
MSCI Value	4.2	8.3	9.0	5.7	21.8	14.6	11.4	9.3	5.6	5.3	4.7
MSCI World	8.3	12.3	6.9	3.1	13.2	12.6	10.2	23.7	4.2	2.7	2.8

Source: eVestment, Barrow Hanley Global Investors

In Figure 2, it can be seen that as of December 2021, defensive and relative value strategies maintained higher multiples than their traditional value peers. This may cause them to lag their traditional value peers in a strong value market.

Figure 2: Indices and Value Strategies Valuation Fundamentals

	Average Valuation Fundamentals as of 31 December 2021		
	12 Months Forward P/E	P/B	Dividend Yield
Defensive Value	17.1	3.2	2.4%
Relative Value	16.0	2.8	1.8%
Traditional Value	12.8	1.8	2.3%
MSCI World Value	14.0	2.1	2.6%
MSCI World	19.1	3.3	1.6%

Source: eVestment, Barrow Hanley Global Investors

Beyond active value strategies that have been in existence for decades, in recent years there has been a proliferation of **passive** or semi passive (a.k.a. smart beta) value strategies that aim to replicate an index or follow a systematically defined set of rules. Smart-beta value strategies express views systematically, using a combination of valuation tests supplemented by other measures of corporate performance or market activity. In terms of passive instruments, a large selection of popular ETFs and index funds are based on indices constructed by MSCI, S&P and FTSE/Russell.

The family of MSCI Value indices covers global, emerging, and regional markets equities and spans the capitalisation spectrum. Style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield. While MSCI has seen more success with its global equities index 'MSCI World Value', the S&P and the FTSE/Russell value style indices have been particularly popular in the US market due to the S&P 500 and Russell 1000 brands respectively.

Figure 3: Value Indices and their Definition Variables

VALUE INVESTING AS DEFINED BY MAIN INDEX PROVIDERS		
MSCI	**S&P**	**FTSE/Russell**
-Book Value/Price **-Earnings to Price Fwd 12-month** **-Dividend Yield**	**-Book Value/Price,** **-Earnings to Price** **-Sales to Price**	**-Book-to-Price (B/P)** **-I/B/E/S Forecast Medium-term Growth (2ys)** **-Sales-per-share Historical Growth (5yr)**

Source: MSCI, S&P and FTSE Russell.

The Behavioural Angle

Whatever approach is used to calculate the intrinsic value of companies, value investors tend to share the same philosophical underpinnings and behavioural traits. Successful value investors aim to exploit the irrational behaviour of other market participants and are usually characterised by a contrarian mindset and a patient approach. They also take a long-term view and are prepared to be perceived wrong for a significant period of time.

Among the many proposed explanations of why value investing should be effective, those built around principles of behavioural finance have a certain appeal. At its core, value investing seeks to **exploit the irrational behaviour** of emotional investors. Emotion is a constant feature of investment

markets through time, and whilst the companies available to stock market investors change from decade to decade, the human nature of investors does not[7].

Fear and greed remain key forces in the markets and often lead to poor investment decisions based on perception and emotion rather than reality. During extreme periods of mispricing, bubbles can become spectacular as in the late 1920s and with the technology stocks bubble of the late 1990s. In fact, many market observers would argue that equity markets are currently dangerously inflated while others will maintain this is not the case. Therefore, having a **contrarian mindset** is an essential skill for any value investor.

Value investing is frequently characterised as a 'sleeping giant'. Investors who prefer this approach are willing to wait until the 'giant awakens'. However, at times the wait can be longer than they expect allowing doubt to develop. This poses a great challenge to value investors because as the great economist John Maynard Keynes, a value investor himself puts it, "markets can stay irrational longer than you can stay solvent".

Patient, dispassionate, and long-term investors recognise that most businesses are long term in nature and the real effect of short-term profit disappointments on the long-term value of a business is often smaller than the market thinks. Additionally, they recognise that on average and over the longer term, disastrous profit falls are frequently reversed and conversely, extremely strong profit growth tends to slow down. Therefore, they are prepared to go beyond short-term profit disappointment, which often results in a substantial share price fall. Frequently these disappointments can produce a strong emotional reaction from shareholders which patient and dispassionate investors can exploit.

However, not all under-priced stocks are good value opportunities. Over the years there have been instances where stocks trading at low multiples remained at those low levels or even collapsed to zero. These are often referred to as **value traps**. Characteristic examples include Enron and Lehman Brothers which saw significant profit declines, did not recover, and ultimately went bankrupt. It is the job of a skilful value manager to separate the "wheat from the chaff".

Summary

Value investing is the art of buying stocks which trade at a significant discount to their intrinsic value. While value investing is among the oldest styles of equity investing, it was Benjamin Graham and David Dodd who provided the theoretical framework used by fundamental value investors in modern equity markets. Later in the 1990s the academics Fama and French stylised value into a risk factor and popularised valuation metrics such as P/B.

Different sub-styles of value investing exist such as traditional, defensive, and relative value in addition to fundamental active, quantitative, and passive approaches. Ultimately all value investors are looking for companies trading on cheap valuation metrics, typically low multiples of their profits or assets, for reasons which are not justified over the longer term. Some of the most common characteristics of value stocks include high dividend yields, low P/B and P/E ratios.

Various explanations for the long-term outperformance of value stocks have been put forward over the years. These tend to fall into two camps: risk premia (compensation for higher risk) and behavioural (harvest the shortcomings of irrational investors). A value investing approach requires a contrarian mindset, patience, and a long-term investment horizon. While value investing has had a difficult decade in the 2010s, it has been an effective strategy over the long-term across multiple equity markets[2].

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[7] https://www.schroders.com/en/uk/the-value-perspective/what-is-value-investing1/what-is-value-investing/

Why Value? Why Now?

"Stocks aren't cheap and popular at the same time." – Unknown

Lost decade

A simple Google search may have you believe that the above quote should be attributed to Warren Buffet, the well-known value investor who has become known as "The Oracle of Omaha" for his perceived wisdom. The quote however, with which many seasoned investors will find it hard to argue, has been in circulation amongst stockbrokers for decades and its origins cannot be traced with certainty.

Indeed, Value has been an unloved investment style for a while. Before the recent uptick in performance and for more than a decade Value has been an unpopular style of investing, significantly underperforming more glamourous areas of the market like the high growth technology names colloquially known as FAANGs (Facebook, Amazon, Apple, Netflix, and Google).

During that period, new market 'gurus' have emerged like Catherine Wood who is the founder and CEO of ARK Investment Management and manages a series of high-octane growth funds. These funds have been popular with the 'Reddit crowd', a younger generation of retail investors who haven't really experienced any other market conditions than the relentless ascent of high growth technology names. But is that it? Is Value now dead? Has the Oracle of Omaha been wrong all along?

Source: beststocks.com/berkshire-beats-ark-innovation/

Looking at past performance does not always help but it is worth considering why value investing has failed to outperform for more than a decade, in spite of its longer-term success (see Figure 4 below). Several reasons have been suggested for the prolonged underperformance of Value as an investing style from 2007 to 2020. Despite a recent comeback in performance[8] it is important to understand what led to the underperformance before assessing if the recent recovery is going to be sustainable or yet another false dawn. In this paper we summarise what we believe to be the most plausible explanations, but we are well aware of the inherent limitations in trying to explain rationally the behaviour of often irrational market participants.

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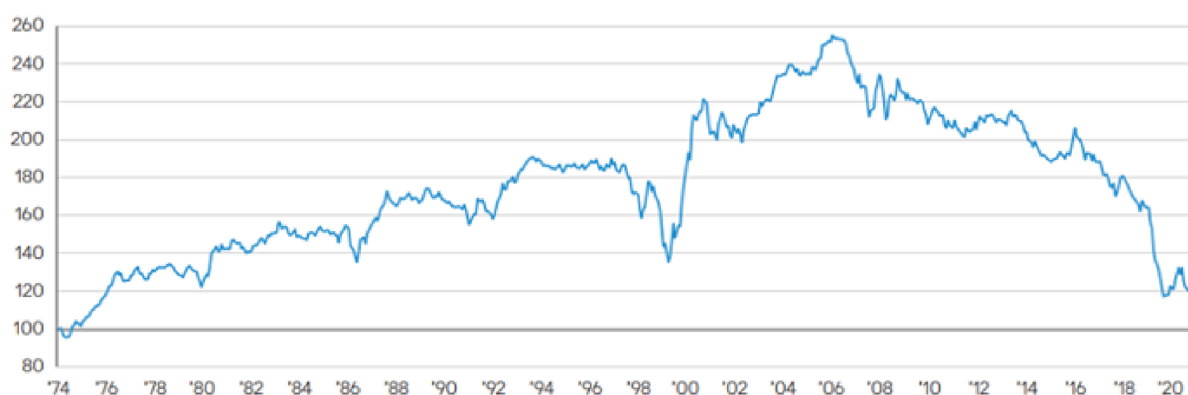
[8] Based on Bloomberg cumulative returns expressed in USD, since November 2020 to the end of May 2022, the MSCI Value Index outperformed the MSCI World and MSCI Growth Indices by 14.5% and 29% respectively.

Figure 4: Cumulative Excess Returns of MSCI World Value vs. MSCI World Growth



Source: JP Morgan Asset Management, MSCI, Bloomberg as of February 2022.

One of the most compelling explanations offered for the underperformance of value stocks is the **low interest rate environment**. Interest rates have been on a downward path since the early 1980s; a trend that accelerated since the Global Financial Crisis ("GFC") and more recently during the pandemic period. As central banks in the West have been fighting with deflation and were trying to avert a global depression, interest rates not only reached multigenerational lows[9] but were expected to remain low for a prolonged period.

This economic backdrop has been supportive for all equity investments, but it favoured most the high growth segments of the market. Interest rates, such as the Federal Funds Rate[10], the UK Base rate, the Euro Short-Term Rate ('€STR') or the 10-year US Treasury yield, are considered representative of the risk-free rate and are a key input in the discount rate used in most DCF valuation models. Low discount rates increase the value of future earnings, which favours 'long duration' investments.

Value equities tend to be short duration investments, with positive earnings growing at a relatively stable rate. By contrast, growth stocks tend to be longer duration investments with cashflows that are much further out in the future. These cash flows are also usually projected to grow at a faster rate than the market, but often with a lower degree of certainty. When the discount rate is low, the value of these long-dated cash flows increases, and as a result, Value stocks tend to underperform growth stocks in falling interest rate environments. By contrast when rates/discount rates rise Value investments tend to outperform the market

Lower interest rates, and a flatter yield curve, can also hurt the profitability of banks (a large allocation in many value indexes, and therefore portfolios). The flatness of yield curves has meant that profit margins from lending (net interest margins) have been very low. On the other hand, it is possible that challenged companies in traditional value industries have benefited from low refinancing rates. Retailers, for example, may have been able to stay afloat longer than they otherwise would. On balance though, persistently low interest rates, have likely helped growth stocks more than value stocks.

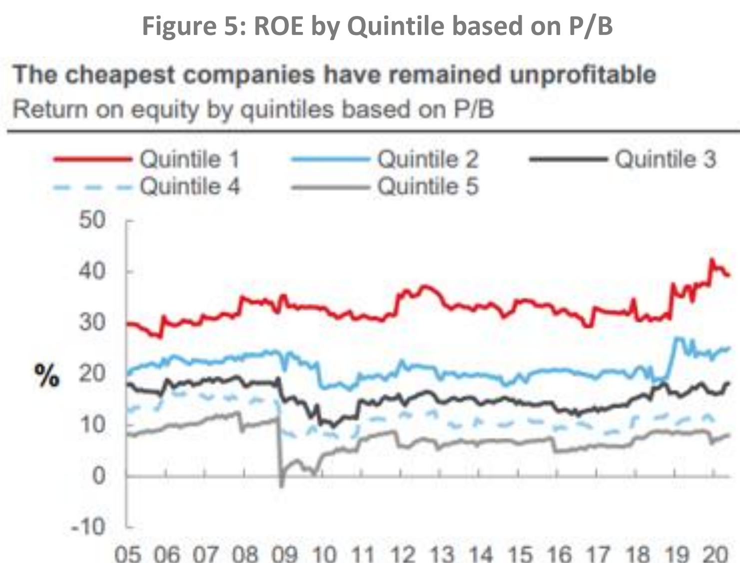
[9] https://advisor.visualcapitalist.com/us-interest-rates/

[10] The Federal Funds Rate refers to the target interest rate set by the Federal Open Market Committee (FOMC) of the Federal Reserve System (Fed) which is the central bank and monetary authority of the United States. This target is the interest rate which the Fed suggests banks charge each other to borrow or lend excess reserves overnight.

Another major reason why the cheapest stocks have stayed cheap is the clear **lack of profits growth**. In a 2020 study, AON's Global Asset Allocation team[11] using 'Return on Equity'[12] ("ROE") as a proxy for profitability has shown that the cheapest stocks, as defined by the lowest P/B, suffered a huge plunge in profits during the GFC and these remained low for all the 2010-2020 decade running at around 8%. For context, the average return on equity of the S&P 500 over the last decade is 14.7%[13]. At the same time, whilst profitability according to this measure has remained largely unchanged in more recent years for the cheapest stocks, the first quintile (red line) has enjoyed a surge in profitability since 2018.

Figure 5 shows the divergence in ROE rates between the cheapest stocks in Quintile 5, which are more representative of "value", and the most expensive in Quintile 1, which might conventionally be called "growth", below is very wide. The cheapest stocks have faced some serious challenges to profitability over the past decade and we can easily see the much higher cyclicality of profit margins for this group (grey line in Figure 5). By contrast, we can see that growth stocks (red line) have been much more resistant to the economic cycle, especially during the GFC downturn of 2008-9. Investors have rewarded this stronger and more resilient profitability, a key explanation for value stocks' underperformance for a prolonged period.

Figure 5: ROE by Quintile based on P/B



Source: AON Global Asset Allocation, FactSet calculations, data as at 12/6/2020

The two dominant sectors within the lowest P/B quintile in the analysis above are Financials and Energy. These sectors are also a large part of the MSCI World Value Index retaining significant average combined weight between 2005 and 2022. The **underperformance of traditional value industries** such as Energy and Financials has played a major role in the 'lost decade' for value. As we mentioned, financial companies and particularly the banks, have struggled for profits due to the prevalent interest rates environment. The generally weak economic activity was also a major headwind for that sector. The anaemic global economy was also detrimental for earnings in the energy sector which additionally suffered from high volatility in energy prices and falling profit margins owing to increased competition and rising substitution from renewable alternatives.

[11] AON Global Asset Allocation, "Will value stocks ever make a comeback?", retrieved March 2022.
[12] Return on Equity, or ROE for short, measures how good the company is in generating returns on the investment it received from its shareholders and is calculated by dividing net income by shareholders' equity.
[13] https://www.businessinsider.com/personal-finance/average-stock-market-return?r=US&IR=T

Conversely, many growth stocks have, for an extended period, repeatedly outperformed expected rates of earnings growth. This growth has often occurred at the expense of traditional value companies' business models. Those are often found in 'disrupted' sectors such as technology and communication services, where investors have been prepared to pay a premium for this growth. Although strong earnings growth cannot continue indefinitely, many leading companies have shown remarkable persistence. The persistence of good news for high-growth stocks has amplified the positive trend in investor sentiment, compounding poor performance for out-of-favour value stocks.

Another reason that has been suggested for the underperformance of value is the changing nature of the economy and the increased importance of **intangible assets**. As we have discussed in the first section of this paper, modern companies need less capital to generate profits and rely more on brand value and investments in R&D. The latter, in particular, represents a growing share of companies' asset base[14]. Concurrently, until the supply chain crisis caused by Covid-19, the global economy was also shifting away from capital-intensive businesses to those that hold less inventory and other physical assets. The future value of investments in intangible assets is not captured by traditional accounting which undermines the use of P/B ratios as a reliable valuation metric.

This has been particularly detrimental for less sophisticated traditional value active strategies or mechanistic quantitative strategies that rely only on P/B as a key valuation input metric. High P/B valuations for technology stocks has led these investors to avoid them which contributed to their negative performance[15]. A 2020 quantitative analysis conducted by Research Affiliates[16] concluded that when adding intangibles, the value factor improved as a result for both growth and value stocks and found that the traditional P/B metric can lead to misclassification of value and growth companies.

ESG factors may also have played a role in underperformance. Value strategies are biased towards carbon-intensive industries such as Energy, Utilities, and Materials. This is evident by the higher carbon footprint of the MSCI Value Index versus MSCI World Index.

Figure 6: MSCI World and MSCI World Value Indices Carbon Footprint

	MSCI World Index	MSCI World Value Index
Climate footprint		
Carbon emissions (t CO2e/$M invested)	72	130
Carbon intensity (t CO2e/$M sales)	169	199
Wtd avg carbon intensity (t CO2e/$M sales)	133	222

Source: MSCI Indices as of June 2021[17]

Until recently, the impact of a tilt to carbon-intensive industries on performance is likely to have been negative, as environmental concerns have risen sharply on many investors' agendas and climate risk has started to get priced into share prices. The rise of ESG considerations by investors has also meant that average portfolio allocations to energy firms have been falling.

To sum up, the low interest rates environment, unsupportive macroeconomic environment for banks, falling oil prices, overall weakness in the profitability for value companies, unrewarded reliance on physical capital and a tailwind for carbon light investments have all played a role in the

[14] Wellington Management, "Redefining 'value' for a modern economy", September 2020.
[15] Hymans Robertson, "The Sustained Underperformance of Value – Part 2", September 2021.
[16] Research Affiliates, "Book Value Is an Incomplete Measure of Firm Size", September 2020.
[17]https://www.msci.com/documents/1296102/18258282/MSCI_Value+ESG+Reduced+Carbon+Target+Select+Indexes.pdf/d42dd2a9-46b4-9398-3df9-d7417b6d4a87

underperformance of Value stocks. In addition, during the Covid-19 crisis, Value did not sufficiently diversify return streams or provide protection in a falling market, characteristics many might have expected.

Tide is turning

Considering the lost decade of Value investing and the disappointing performance during the Covid-19 market scare anyone can be excused for discounting the relevance of value investing altogether. However, there are strong reasons to believe the tide might have turned for Value. In the period from November 2020 to the end of May 2022, the MSCI Value Index outperformed the MSCI World and MSCI Growth Indices by 14.5% and 29% respectively[18]. This coincided with a reversal of many of the trends we have seen over the last 12 years thus bolstering the notion that this time, value stocks may be entering a period of sustained outperformance.

Firstly, the prevailing macroeconomic environment now looks more favourable for value stocks. This is because of two major factors that are interlinked, **rising interest rates** and rising inflation. For the first time in many investors' professional lives, central banks across the globe are increasing interest rates to combat inflation.

As we have seen, low interest rates have helped high growth stocks with cashflows deep into the future to look attractive investments in today's terms due to how the discounted cashflows valuation mechanism works. Reasonably, we can assume that a reversal in this trend will hurt the high growth segments of the market and favour instead short duration investments like value stocks.

Michael Brush, in his stock newsletter 'Brush Up on Stocks'[19] points to research from RBC Capital Markets strategist Lori Calvasina who suggests that when 10-year yields rise as they are now, expensive stocks in areas like technology underperform the cheapest stocks in areas like Cyclicals, Financials and Energy. According to her research this is because there is an inverse relationship between P/E multiples of the most expensive stocks and 10-year yields during Federal Reserve hiking cycles. Calvasina points out that the least expensive stocks have historically outperformed the most expensive stocks when the 10-year yield is rising. This is shown in Figure 7 where the light blue line represents bond yields, and the dark blue line represents cheap stock performance relative to expensive stocks.

Figure 7: Bottom vs Top Quintile Stocks by FY2 P/E Performance vs US 10Yr Yield

Source: RBC US Equity Strategy, S&P Capital IQ/ClariFi, CIQ Estimates, Bloomberg, Large cap universe is the Russell 1000 Index. Quintiles are ranked based on FY2 P/E. Median FY2 P/E is used to represent every quintile. Data as of early Dec 2021.

[18] Source: Bloomberg. Cumulative returns in USD from 2/11/2020 to 30/5/2022.

[19] https://www.marketwatch.com/story/four-reasons-why-value-stocks-are-poised-to-outperform-growth-in-2022-and-14-stocks-to-consider-11641991663 (Jan. 2022).

It is worth noting however, that since 2003 there hasn't been a sustained long period of the 10-year yield increasing. Since 2003, the 10-year yield of US treasuries has gone from c. 4% to 1.4% as of early December 2021[20]. Predicting the direction and level of interest rates is certainly not an easy task and any prognostication has to be taken cautiously. That said, a source which investors lean on for such predictions is Ed Yardeni at Yardeni Research[19]. Yardeni, is projecting that the 10-year yield could rise to 3.0% in Q4 2022[21]. If he is right, that suggests value outperformance will continue.

One reason why interest rates may increase further and remain at elevated levels is **accelerating inflation**. In the first months of 2022 monetary authorities in the US and other key markets have reported that inflation has been accelerating at the fastest pace since the early 1980s. Historically higher inflation has been positive for value strategies. This is because inflation fears push yields upwards feeding into higher discount rates thus producing more modest price targets for previously highly valued growth equities.

In addition, during inflationary times, companies with short duration and relatively predictable earnings may be in a position to boost profit margins by raising prices. This point is captured well in research conducted by John Buckingham who pens "The Prudent Speculator" stock letter. Buckingham notes that as a group, value companies tend to be more mature and have greater capacity to sustain or improve their profit margins. In contrast, growth companies are more sensitive to growth in earnings over long periods, so they benefit less from price hikes, while due to higher inflation they still have to pay their employees more[19]. As illustrated in Figure 8 his analysis shows value equities outperform growth equities on average by 8.3% and by 3.8% over the subsequent 12 months following an inflation spike above and below 6% period respectively[22].

Figure 8: Value and Growth Stocks Returns during Inflationary Periods

Inflation Above 6% (Top) and Below 6% (Bottom) and Subsequent Returns

Period	Value Stocks 3 Months	Growth Stocks 3 Months	Value Stocks 6 Months	Growth Stocks 6 Months	Value Stocks 12 Months	Growth Stocks 12 Months
Arithmetic Avg.	**4.8%**	2.7%	**10.5%**	6.4%	**24.5%**	16.2%
Geometric Avg.	**4.1%**	2.1%	**9.1%**	5.0%	**22.0%**	13.8%
Median	**4.0%**	2.1%	**6.9%**	4.4%	**19.3%**	13.1%
Max	**50.9%**	32.9%	**82.7%**	60.8%	**134.0%**	84.2%
Min	**-19.2%**	-27.6%	**-26.4%**	-35.9%	**-28.0%**	-48.0%
Count	**176**	176	**176**	176	**176**	176
Period	Value Stocks 3 Months	Growth Stocks 3 Months	Value Stocks 6 Months	Growth Stocks 6 Months	Value Stocks 12 Months	Growth Stocks 12 Months
Arithmetic Avg.	**4.1%**	3.1%	**7.8%**	6.0%	**15.4%**	11.6%
Geometric Avg.	**3.0%**	2.4%	**5.8%**	4.7%	**11.2%**	8.7%
Median	**4.0%**	3.6%	**8.0%**	6.5%	**15.4%**	12.6%
Max	**200.5%**	136.1%	**244.7%**	140.3%	**357.8%**	221.9%
Min	**-43.1%**	-40.4%	**-56.1%**	-47.0%	**-71.3%**	-64.8%
Count	**947**	947	**944**	944	**938**	938

Source: Kovitz LLC, The Prudent Speculator, "Inflation and Rising Rates"

The current macroeconomic environment is also supportive of the **traditional value sectors of Financials and Energy**. After a decade of falling interest rates that were a headwind for Financials,

[20] https://www.yardeni.com/pub/glir.pdf
[21] https://www.yardeni.com/pub/yrieconomicforecast.pdf
[22] John Buckingham, The Prudent Speculator, "Inflation and Rising Rates", Dec 2021; arithmetic averages used; examined 176 periods of inflation >6% and 938 periods of inflation <6% from 31.12.1927 to 31.03.2021.

the banking industry can now lean on rising rates and a steepening yield curve to improve profit margins. Additionally, the Energy sector has had stellar performance of late thanks to rising oil and gas prices posting a gain of 56% against the market on a year-to-date basis[23]. Due to the events unfolding in Ukraine and the sanctions imposed to Putin's Russia, a major oil & gas exporter, **energy prices** which have already been on an upward trajectory have seen a rapid acceleration that boosted earnings and margins in the sector.

The Energy sector has historically been a large component of value strategies but as at the end of April accounted for only 7.7% of the MSCI World Value Index. As countries in the West are adapting to the supply shock caused by the sanctions imposed to Russia, energy prices may remain elevated for a significant period. Ultimately though they will normalise so the effect while significant now should not be overstated. Possibly more important over the longer term are the concerns that the war in Ukraine has heightened worries about energy security and the role traditional energy sources such as gas and nuclear will play over the medium term. A more constructive tone from the investment community on those sectors can be supportive for Value and maintain the good momentum in the sector.

Perhaps one of the strongest indications that value was reaching an inflection point was the extreme widening of **valuation spreads** between growth and value. The gap was wide at the end of 2019 and became more pronounced following the Covid-19 crisis, reaching historically high levels in 2020 and again in 2021 as investors continued to pay a premium for growth stocks like the FAANGs that benefited from restrictions in mobility and the 'stay-at-home' government guidance. As the global investment consultants Mercer point out, historically extreme valuation spreads have preceded periods of strong performance for the value factor[24]. A similar conclusion was reached by AON's Asset Allocation research unit11 above who argued that such wide valuation gaps do not last into the long-term and that there is a close link between valuations and long-term returns[11]. Indeed, these views proved prescient.

Despite the recent outperformance, Value's potential for future returns remains promising. As shown by J.P. Morgan Asset Management[25] valuation spreads between Value and Growth are still extreme, and higher than those at the peak of the technology, media and telecom ('TMT') bubble of late 1990s. This is quite remarkable when considering that Value has outperformed Growth by more than 20% since the Pfizer vaccine announcement on 9 November 2020[25].

Figure 9: Relative Valuation of MSCI World Value vs MSCI World Growth

Source: JPMAM based on data from MSCI between 31/12/1974 and 28/02/2022. The relative valuation is based on the P/B, P/E and the dividend yield of the Value relative to the Growth index normalized for comparison.

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[23] Source: Bloomberg. Reference indices: MSCI World Energy Sector Index against the MSCI World Index. Returns in USD from 1/3/2022 to 30/5/2022.
[24] Mercer, "Is there still a case for value?", June 2020.
[25] J.P. Morgan Asset Management, "Value vs. Growth investing: Value returns with a vengeance", March 2022.

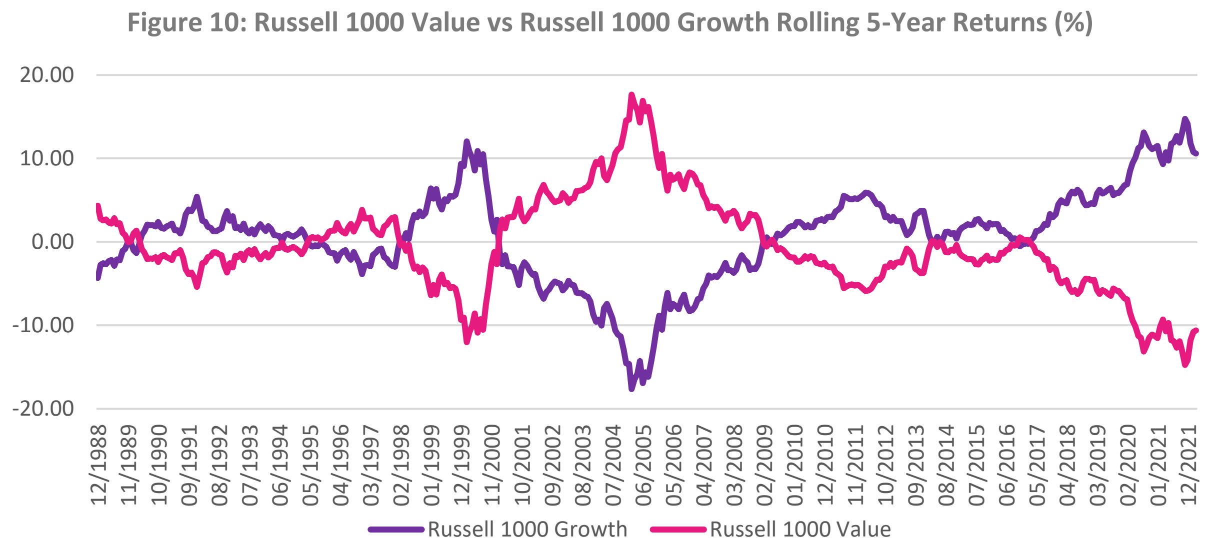
In the **behavioural angle** section of the first part of this paper, we described value investing as an endeavour of rational, patient, contrarian investors to exploit the irrational behaviour of other market participants. If history teaches us anything, it is that periodically some stocks and sectors become investor darlings, whilst others remain out of the limelight for years. This means that investor favourites tend to be more vulnerable to negative surprises. On the contrary, neglected value stocks could benefit from even small positive surprises. This is because investors tend to hold onto "winners" longer than they should and to sell "losers" quickly as they are averse to losses of any kind[11]. As we have seen recently, at some point, these trends reverse, sometimes spectacularly.

Timing the performance of Value, or indeed any other market factor, is difficult; however, the dispersion of valuation spreads, the prevalent macroeconomic environment with higher inflation, higher interest rates and higher energy prices as well as behavioural arguments are all supportive of a sustained comeback for value strategies.

Baskets and Eggs

Beyond a reasonable belief that the tide might have turned for value investing there are structural reasons to maintain a long-term strategic exposure to value. **Diversification** has been described as the only free lunch in portfolio construction. A well-diversified equity portfolio should include exposure to value strategies in order to diversify sources of return and smoothen volatility. Exposure to either growth alone or to value alone cannot achieve this over longer-term investment horizons as they exhibit different return patterns.

Figure 10: Russell 1000 Value vs Russell 1000 Growth Rolling 5-Year Returns (%)



Source: eVestment, rolling 5-year excess returns of R1000 Growth - R1000 Value and vice versa from 1/1/1983 to 3/2022.

As we have seen in the previous section market **leadership rotates** and tactically timing that rotation with accuracy is not always possible. Therefore, maintaining a certain degree of overall style neutrality throughout the cycle is a prudent approach. That was not easy to adhere to in an era when growth so dominantly held the market leadership. Naturally, it may have been tempting to follow the trend and abandon more diversified mixes and the discipline of rebalancing back to predesigned factor weightings

The GFC, the pandemic and the energy crisis caused by the Ukrainian war are all good examples of the many unknowns that can impact markets and alter our best guess at what is to come. Investors with a long-term horizon should be prepared, be well diversified, for any outcome. So as the old saying goes don't put all your eggs in one basket.

Summary

Despite its strong long-term record, value investing has been unpopular for a considerable time. This is hardly surprising as it's a way of investing that spends its time being unpopular until the payoff comes. The reasons for the underperformance over the past 15 years can be traced back to the low interest rates environment, the overall weakness in the profitability for value companies, the unrewarded reliance on physical capital as opposed to intangibles and to an ESG headwind. After a few false dawns, more recently the style is experiencing a performance revival.

We laid out the reasons why we believe the tide has turned for Value and why these strategies may continue to produce good results. Macroeconomic conditions, with rising interest rates and inflation, are constructive for traditional value industries, and relatively mature companies may be better positioned to withstand the effects of cost pressures on their profit margins. Beyond the recent performance uptick, Value is a style worth considering on diversification grounds too.

Diversification analysis suggests that exposure to value helps investors balance their total portfolio returns and potentially enjoy a smoother ride. Changes in market leadership are hard if not impossible to predict hence maintaining a structural rather than tactical exposure to value seems prudent. Therefore, we take the view that for investors it makes sense to keep Value in their radar from a longer-term strategic viewpoint.

A Value Fund for London CIV

"Be stubborn on vision and flexible on details" – Jeff Bezos

The LCIV Platform

As laid out in our 5-year product roadmap presented at the investor conference in September 2021, **London CIV's vision** is to build on the existing foundations and move forward to the next stage of our development by expanding and enhancing our product offering. We are progressively thinking of London CIV as the investment platform that will provide Client Funds with the necessary **building blocks** to implement their asset allocation decisions.

Starting from a base of tried and tested global equity strategies that were migrated to London CIV and through additions driven by specific client demand over the previous six years we have developed in incremental steps a reasonably wide product offering. Figure 11 summarises the characteristics of the LCIV global equity funds using P/E and P/B metrics.

Figure 11: London CIV Global Equity Strategies

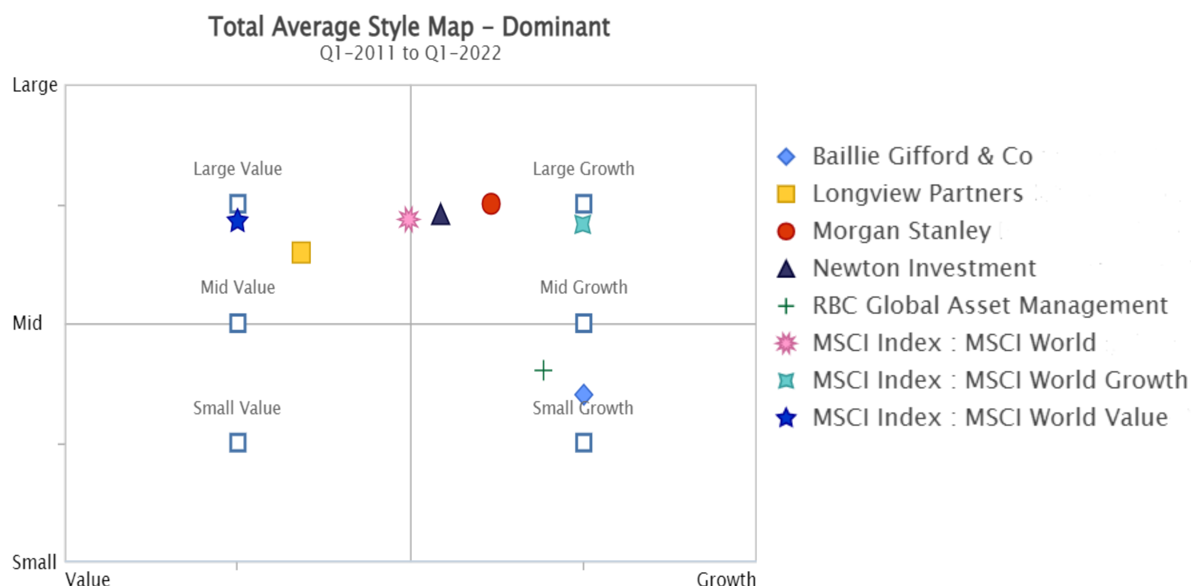
	Global Equities							
Fund	LCIV Global Alpha Growth Paris Aligned Fund	LCIV Global Alpha Growth Fund	LCIV Sustainable Equity Exclusion Fund	LCIV Sustainable Equity Fund	LCIV Global Equity Core Fund	LCIV Progressive Equity Passive Paris Aligned Fund "PEPPA"	LCIV Global Equity Fund	LCIV Global Equity Focus Fund
AUM	**£1,060m**	**£1,965m**	**£411m**	**£1,263m**	**£546m**	**£526m**	**£712m**	**£881m**
Style Characteristics	Growth	Growth	Growth	Growth	Quality	Core / Growth Tilt	Core	Quality/ Value
P/B	4.1	3.7	4.8	4.5	5.3	3.2	3.1	3.8
P/E	31.0	29.9	23.8	22.9	29.6	20.9	19.5	22.3
Launch Date	13/04/21	11/04/16	11/03/20	18/04/18	21/08/20	01/12/21	22/05/17	17/07/17
Manager	Bailie Gifford	Bailie Gifford	RBC	RBC	MSIM	S&P/ State Street	Newton	Longview
No. of Investors	6	9	3	8	2	2	3	5

Source: London CIV, as of 31 May 2022.

As we alluded to, those metrics only provide an indication of what is value or growth but nonetheless are useful in mapping out our products. Other dimensions of style such as quality, defensiveness, and momentum are not directly captured in this static snapshot, and we also need to consider that a number of strategies may rotate over time.

Another way to lay out the current product offering is using the eVestments style analytics which expands the view from just a snapshot to a lengthier period. This analysis also incorporates an additional dimension of style which is the small/large capitalisation exposure. Figure 12 illustrates that our product offering is currently tilted towards growth funds with a significant gap in the value space.

Figure 12: Style Map for London CIV Global Equity Strategies and MSCI Indices



Source: eVestments; manager strategies used in line with those in the LCIV funds[26].

We conclude that the 'growth' shelf of our product offering is well stocked while the value shelf is less well provisioned, leaving room for a "LCIV Value fund provided there is client demand[27].

Characteristics Sought

Rigid as we are in our vision to offer to our Client Funds a complete suite of products that includes a value strategy, we remain flexible on the exact shape that an LCIV Value fund can take. As with similar exercises we have run previously, this will be the product of close collaboration and engagement with investors interested in such a fund. Below we are describing some core characteristics we seek, starting from the generic principles we apply to all of our manager research exercises and drilling down to specific attributes we expect a suitable value strategy to exhibit.

In line with our six **investment beliefs**[28] we seek strategies that are aligned to how we view investing:

- We take a long-term perspective as we believe this helps us to capitalize on market inefficiencies and mitigate the impact of volatility.
- We value risk management as integral to all stages of the investment lifecycle and we design funds to help Client Funds capture opportunities in a risk-controlled way.
- Responsible investment, in our view improves outcomes, mitigates risks and creates opportunities and we integrate responsible investment into every stage of the investment process.

[26] The LCIV Global Alpha Growth Fund and the LCIV Global Alpha Paris Aligned Fund derive from the Baillie Gifford Global Alpha strategy, the LCIV Sustainable Equity Fund derives from the RBC Global Focus strategy, the LCIV Sustainable Equity Exclusion Fund utilises the RBC Global Vision strategy (results not included as they overlap with the RBC Global Vision strategy), the LCIV Global Equity Core Fund derives from the Morgan Stanley Global Franchise strategy, the LCIV Global Equity Fund utilises the Newton Global Equity strategy, the LCIV Global Equity Focus Fund utilises the Longview Partners Equity strategy.
[27] We estimate that Client Funds have invested approximately £650m in active value strategies as of 3/2022.
[28] https://londonciv.org.uk/our-investment-beliefs

- Fees and costs are important and should be managed; remuneration should be aligned with the long-term interests of our Clients Funds. We are prepared to pay for active management only when we believe that the costs incurred are likely to be justified by the benefits.
- In our view, collaboration, clear objectives, robust research and evidence-based decision-making adds value. We work in partnership with Client Funds and external managers to create solutions and we make decisions based on rigorous analysis conducted using a research-based approach to investment.
- We need to be open-minded, proactive and innovative in the pursuit of opportunities which will help Client Funds achieve their objectives. We aim to identify risk premia across the capital markets and strive to respond quickly when opportunities arise.

Grounded on our investment beliefs is our **assessment framework** for candidate strategies. This is based on eight criteria and is the same framework that is used for the on-going monitoring of our funds and investment managers. The eight criteria are:

- Performance;
- Resourcing;
- Process/Strategy;
- Responsible Investment (RI) and Engagement;
- Business Risk;
- Risk Management and Compliance;
- Cost Transparency and Value for Money; and
- Best Execution/Liquidity.

In terms of **performance**, we expect the candidate strategy to have recorded a level of outperformance over medium and longer-term horizons. Any candidate strategies will be assessed against both style (e.g., MSCI Value) and core (e.g., MSCI World, MSCI AWCI) indices. Performance assessment is not just about excess returns but also about how the performance was generated and whether it is repeatable. We also want to see if the manager has kept pace with peers.

A key aspect of performance assessment will be to ensure that the pattern of returns is aligned to a value style of investing and that the strategy has not drifted towards growth during the difficult years for value. Equally important will be to make sure that the manager has avoided value traps because these can have an asymmetric effect on performance. Past performance is not always a good indicator of future performance, especially in an environment that was structurally challenging for value strategies, therefore we use multiple lenses in our assessment.

From a **resourcing** perspective we are screening strategies against expectations for a level of resource that is adequate, and a skillset that is aligned to requirements. Quantitative strategies, for instance, require analysts who are well-trained in mathematical models but can also make the necessary links to real world investments. On the other hand, fundamental strategies with a large number of positions require a deep and well-resourced research platform of financial analysts that can ensure adequate coverage. In more concentrated portfolios we expect to see a smaller but more experienced team of research analysts who can build the strong conviction required to support relatively large positions.

Across strategies we focus our research effort on the key decision makers, the support (i.e., tools and systems) they receive and the stability of the team. We expect key decision makers in value strategies to exhibit a contrarian mindset and a degree of healthy scepticism. While we are

prepared to accept a level of 'key person risk', we remain alert to the risks of 'star fund manager'[29] culture and overconcentration of responsibilities within teams. Where a team-oriented approach is adopted, it is important to establish exactly who does what, who is the main driver of the process and who is ultimately responsible for the portfolio.

Top in our research agenda and evaluation is the assessment of a managers' **investment process**. We make sure that the process is fit for purpose and is applied consistently including any style bias. We expect managers to have an established framework of beliefs, and these should lead to the creation of opportunities to add alpha. We also want to ensure that the manager regularly reappraises their approach to identify areas of improvement. Managers' adaptability to structural changes faced by today's value investor is key, as we have discussed in the case of intangible assets.

It is important that the investment strategy is well-executed, and the overall process is transparent and efficient. In terms of portfolio construction, we prefer strategies which exhibit value characteristics in a relatively pure manner (e.g., traditional, defensive, contrarian and opportunistic value strategies) without mixing value with other stylistic elements. This should be evidenced by markedly and consistently low valuation metrics (P/B, P/E, EV/EBITDA) and higher dividend yield. We like managers that use multiple valuation metrics including those based on cash flows and do not rely just in P/B as over time this can have shortcomings. We maintain a preference for strategies that exhibit high active share[30] and these can be in either the fundamental or the quantitative space. We would not consider strategies with very high risk taking compared to peers and those that do not integrate ESG factors.

Regarding **responsible investment and engagement**, we need to see a strong commitment to best practice evidenced in the decision-making processes, remuneration and a firm commitment to continuous improvement. We expect fund strategies to have strong ESG credentials and adhere to the UK Stewardship code. We also expect managers to exhibit a positive or stable trend in key TCFD metrics (Carbon footprint, Fossil fuel exposure, SBTI alignment) and demonstrate commitment to diversity, inclusion, and equity in the workforce.

A significant part of the universe of value managers at present either ignores or at best applies questionable ESG practices. This highlights misperceptions about potential conflict between performance and ESG. High levels of ESG integration during all stages of the investment process are desirable; however, we will apply a degree of pragmatism in our assessment given the significant weight the utilities and energy sectors tend to have in value strategies. This can occasionally result in larger allocations to carbon intensive industries than in our growth strategies. All strategies will be assessed on the basis of their direction of travel and ability to became Paris Aligned at a future stage without fundamentally altering their investment process and portfolio characteristics.

In terms of **business risk**, we value ownership stability and an organisational environment where key decision-makers are well supported, and incentives are aligned to client objectives. Solid underlying businesses can withstand continued outflows during periods of underperformance, can invest in ESG and can retain their focus on investment returns over asset gathering during periods of outperformance. For smaller investment organisations with a sole focus in value investing strategies the prolonged underperformance may have weakened the business and their ability to attract and retain talent; this will be a key consideration.

[29] https://www.cityam.com/timeline-where-things-went-wrong-for-neil-woodford/

[30] Active Share measures the fraction of a fund's portfolio that differs from the benchmark index. Strategies with an Active Share above 70% are considered highly active.

Regarding investment **risk management and compliance**, we want to see that a comprehensive risk management process is in place, and it is overseen by an independent team. Ideally, risk management should be embedded throughout the investment process and any unrewarded risks should be demonstrably managed. We expect sources of risk to be aligned to expectations and key-decision makers to demonstrate strong awareness of risks, informed by a suitable risk monitoring system. Given the nature of value strategies risks can be asymmetric therefore we like managers that exhibit a strong risk culture that goes beyond simple box ticking.

From a **cost transparency and value for money** perspective we screen managers against a high bar of full transparency and adherence to CTI standard templates. In terms of fees and other costs we expect those to be in line with or lower than median for comparable strategies and expect a strategy to deliver value net of costs.

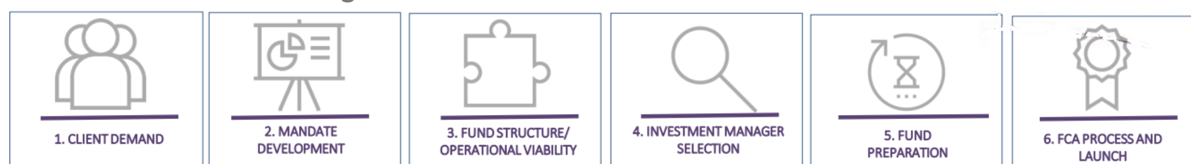
Lastly, we consider **best execution and liquidity management**. Managers with a strong execution function, all relevant trading/sourcing channels covered and no evidence of slippage in implementation of buy and sell ideas score highly. The liquidity profile of the strategy needs to be aligned to expectations and capacity must be managed carefully. The turnover should be in line with expectations. We generally maintain a preference for low turnover strategies; however, we will consider moderately higher turnover when the nature of the strategy justifies it such as in quantitative, opportunistic and contrarian strategies.

Beyond successfully meeting these criteria any selected strategy will need to be **complementary** to the growth strategies on the LCIV platform (LCIV Global Alpha Growth and LCIV Sustainable Equity funds). Any selected strategy should be able to work both as a standalone allocation but crucially as a combination with our other Funds. Ultimately, we are aiming for a Fund strategy that can work for the widest group of eligible clients.

Selection Process

Formal selection and appointment exercises are governed by the London CIV 'Investment Governance Document' and the London CIV 'Selection and Appointment of Investment Managers' policy. The schematic below describes our Fund Launch Framework ('FLF') which is a six-phase process determining how London CIV launches new funds[31].

Figure 13: London CIV Fund Launch Framework



The **LCIV Investment Team leads in Phases 2 and 4** and assists with the other stages:

- Phase 1: Assess client demand for the Fund and set up a Seed Investment Group ('SIG') of those Client Funds that are most interested in pursuing this asset class and strategy and keen to "seed" investments.
- Phase 2: Develop the mandate details with Client Funds and present the investment case to the LCIV Executive Committee ('ExCo') and the Investment Oversight Committee ('IOC').
- Phase 3: Assess fund structure and operational viability. Carried out by the Operations, Finance and Compliance team who present a detailed business case to ExCo for approval.

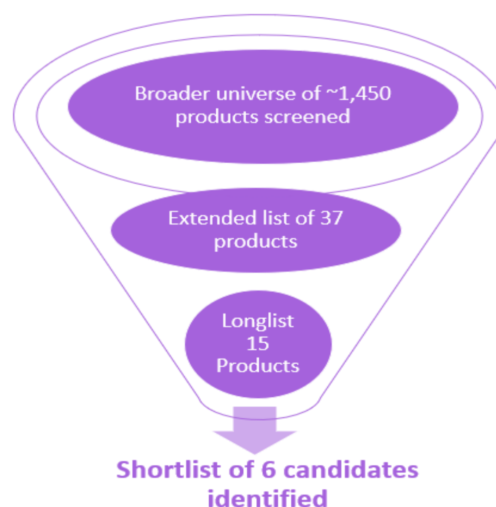
[31] FLF is currently under review and Phases 1 and 2 will likely be consolidated for efficiency.

- Phase 4: Delegated Investment Manager ('IM') selection. The LCIV Investment Team will provide a long list of potential IMs; reduce the list to a short-list through analysis; ask the short-listed managers to fill in a Request for Proposal ('RFP')/ LCIV questionnaire. The short-listed RFPs will be assessed by the Investment Team and the most successful managers will be asked for clarification meetings. At this stage we will also conduct an operational due diligence exercise. To be appointed a manager will need to pass both the investment and operational due diligence assessments.
- Phase 5: Fund Preparation.
- Phase 6: FCA Process and Launch.

A good idea of how phases 2 and 4 can work in practise is given by the example below of a research exercise concerning value strategies. While this was an informal exercise it broadly followed the same research steps as described in the FLF. In autumn 2021, the London CIV Investment Team ran a **'soft market' test** to map the global value managers universe and identify good candidates for inclusion in a value 'prospects list'. The purpose of this informal exercise, carried out upon the request of a group of Client Funds, was to identify value strategies that meet our strict selection framework criteria and can complement well our growth strategies.

For the soft market test:

- Using eVestments we screened a universe of ~1,450 products (530 firms) for the set of desired characteristics (e.g., high active share, ESG, strong valuation focus).
- An extended list of 37 products was identified for further qualitative and quantitative review (team, record, AUM, fundamentals, fit with existing managers).
- Longlist of 15 products was formed and pitchbooks were requested; held exploratory discussions with managers.
- Shortlist of 6 candidates.



The shortlist was then discussed with the group of investors and following that a Request for Information (RFI) was sent to the five managers who invest using a fundamental approach. As per our assessment framework the RFIs covered all aspects of the investment philosophy and investment process of each manager as well as their investment team, the organisation and risk management. Specific emphasis was given to each manager's Responsible Investing policies, ESG integration and value for money proposition.

The assessment of RFIs resulted in the elimination of one manager as it became apparent that ESG is not a strategic priority for the firm and their ESG integration was not at the standard that we expect. This manager does not have a dedicated ESG team, they do not measure the carbon intensity of their portfolios and they have not signed up to the UK Stewardship code.

Introductory meetings with the key decision makers were held with the remaining four managers. Concluding the RFI assessments and after the meetings with the lead portfolio managers we decided to focus the research effort on two managers while also keeping the other two on our 'Value Prospects List'. London CIV continues to monitor these products and will be happy to share more

details on the value strategies we identified via the soft market test and those that we are tracking in our 'Value Prospects List'[32]. For the purposes of this paper, we will anonymise the final two managers in the analytics subsection below. We believe this recently concluded soft market test[33] gives us a head start if we were to initiate a full selection and appointment exercise while concurrently not limiting our ability to incorporate the requirements of 'Seed Investors' at the mandate design stage (Phase2).

Combining Value

In order to assess the complementarity of value strategies to our existing growth managers we looked at a set of analytics including:

1. Performance, risk statistics and fundamentals,
2. Correlations of excess returns,
3. Sector allocations and
4. Style mapping.

For the purposes of this analysis in Figure 14, we used the final two strategies from the soft market test (referred to below as Value Strategy I ('VS I') and Value Strategy II ('VS II')), the Baillie Gifford Global Alpha Fund which is the underlying strategy in our LCIV Global Alpha Growth Fund ('GAG') and the LCIV Global Alpha Growth Paris Aligned Fund ('GAGPA') and the RBC Global Focus Fund which is the underlying strategy for the LCIV Sustainable Equity Fund. To conduct this analysis, we used the manager research platform eVestment.

The key takeaway from our analysis is that the value strategies we looked at (VS I and II) are a strong complement to our LCIV Global Alpha Growth (Baillie Gifford) and LCIV Sustainable Equity (RBC) funds as measured by correlation of excess returns and sectoral allocations. Additionally, the style analysis conducted clearly indicates that Baillie Gifford and RBC maintain a growth bias whereas VS I and VS II have a balancing value bias.

Looking at the **performance and risk statistics** of our growth strategies and the two selected value strategies it can be seen that the two value strategies held up well over the Q1 and 1-year periods whereas Baillie Giffords and to a lesser extent RBC struggled. Over the 1-year period both value strategies proven a good risk mitigator with lower standard deviations than their growth counterparts but over longer durations this balances out.

Figure 14: Performance and Risk Statistics

	Performance YTD	Performance 1 Year	Performance 3 Years	SD 1 Year	SD 3 Year
Baillie Gifford	-12.3%	-6.6%	44.9%	15.97	16.55
RBC	-8.4%	9.9%	54.8%	14.46	14.57
Value Strategy I	2.8%	11.0%	41.0%	8.17	16.84
Value Strategy II	0.1%	10.9%	52.2%	6.55	14.44

Source: eVestments as of 31 March 2022; returns are cumulative over the stated period; SD stands for standard deviation.

The two value strategies complement the two growth strategies well from a **fundamental perspective** as shown in Figure 15. As expected, dividend yield rates are higher for the value

[32] London CIV does not provide manager recommendations via traditional buy lists. The term 'Prospects List' in this paper is used to describe a selection of potentially suitable value managers that London CIV monitors.
[33] Client Funds interested to learn more about the soft market test are encouraged to contact their dedicated Client Relationship Manager.

strategies and P/B and P/E ratios are lower indicating a strong value style bias. To the contrary Baillie Gifford and RBC exhibit higher valuation metrics putting them comfortably in the growth camp. All strategies exhibit high active share, a desirable characteristic as it indicates those funds are not index hugging.

Figure 15: Comparisons on Fundamentals

	Active Share	Dividend Yield	P/E	P/B
Baillie Gifford	84.9%	1.2%	21.3	4.0
RBC	87.1%	1.2%	20.1	4.5
Value Strategy I	93.1%	1.9%	14.8	2.3
Value Strategy II	92.0%	1.9%	13.9	2.2

Source: eVestments as of 31 March 2022; P/E is 12 months forward; Dividend Yield and P/B current as of 31/03/2022.

Looking at 1-year and 3-years **correlations** in Figures 16 and 17, VS I and VS II excess returns over the MSCI World Index have negative correlations to Baillie Gifford and RBC' excess returns, indicating there is a significant diversification opportunity to be gained from investing in either of the two value strategies.

Figure 16: Correlations 1 Year

Correlation Matrix: Excess Returns - 1 Year	Baillie Gifford	RBC	Value Strategy I	Value Strategy II
Baillie Gifford	1.00	0.91	-0.52	-0.66
RBC	0.91	1.00	-0.83	-0.91
Value Strategy I	-0.52	-0.83	1.00	0.97
Value Strategy II	-0.66	-0.91	0.97	1.00

Figure 17: Correlations 3 Years

Correlation Matrix: Excess Returns - 3 Year	Baillie Gifford	RBC	Value Strategy I	Value Strategy II
Baillie Gifford	1.00	0.59	-0.20	-0.15
RBC	0.59	1.00	-0.28	-0.19
Value Strategy I	-0.20	-0.28	1.00	0.76
Value Strategy II	-0.15	-0.19	0.76	1.00

Source Fig 16 and 17: eVestments as of 31 March 2022; excess returns against MSCI World.

The two approaches also show greater distinction in their **sector allocations**, shown in Figure 18. For instance, Baillie Gifford is more concentrated in Technology and Consumer Discretionary areas where VS I maintain a low weight. Conversely, both value strategies retain a larger weight in Utilities and Energy than their growth counterparts.

Figure 18: Sector Allocations

Absolute Sector Weights (%)	Baillie Gifford	RBC	Value Strategy I	Value Strategy II
Technology	16.50	14.55	5.37	18.06
Health Care	13.83	9.68	8.32	10.74
Consumer Discretionary	17.09	13.87	11.48	13.60

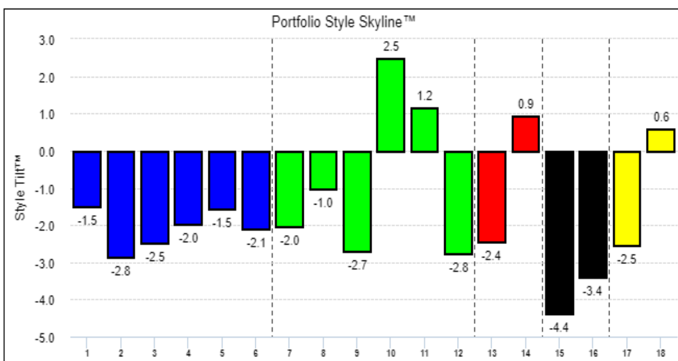
Absolute Sector Weights (%)	Baillie Gifford	RBC	Value Strategy I	Value Strategy II
Consumer Staples	2.84	6.70	8.64	4.84
Energy	0.45	2.48	**4.34**	**3.39**
Materials	7.05	5.84	6.20	5.19
Industrials	**8.95**	14.17	17.34	8.44
Financial Services	15.55	19.82	**18.21**	14.99
Real Estate	1.81	-	2.54	**6.82**
Communication Services	**15.05**	8.96	6.77	7.64
Utilities	-	2.97	**7.63**	**5.64**

Source: eVestments, average weights over calendar year 2021.

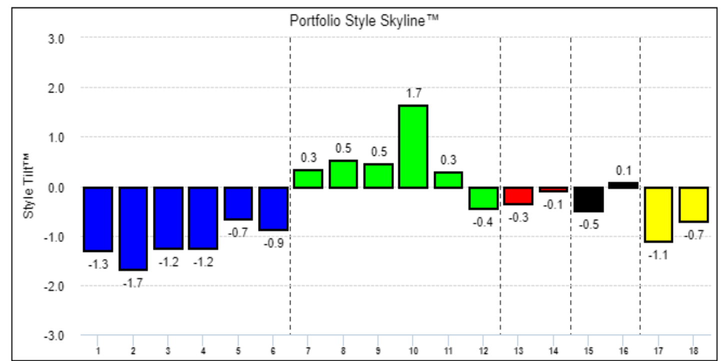
Turning to style analysis, shown in Figure 19, we are using **style skylines** from eVestments to illustrate how the two approaches mirror each other stylistically. This is evident when looking at the blue bars which capture each strategy's exposure to value factors and at the green bars which capture exposure to growth factors. It is also worth noting that both value strategies maintain a large tilt towards smaller and medium capitalisation holdings which also complements well our growth managers.

Figure 19: Style Skyline for Baillie Gifford, RBC, VS I and VS II

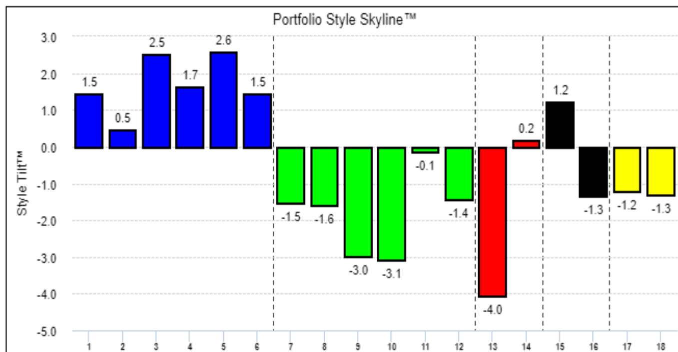
Baillie Gifford



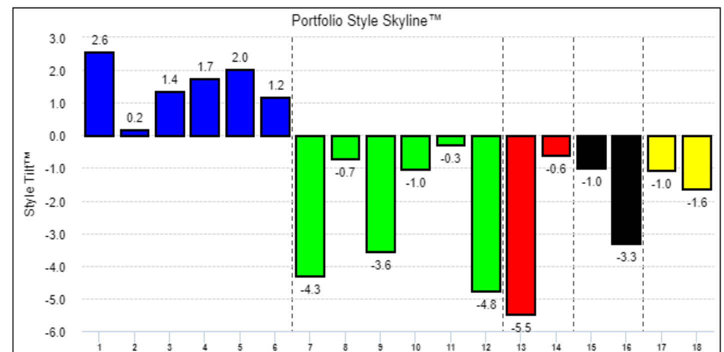
RBC



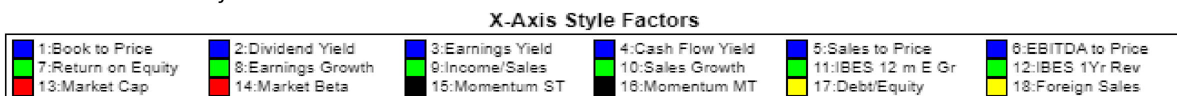
Value Strategy I



Value Strategy II

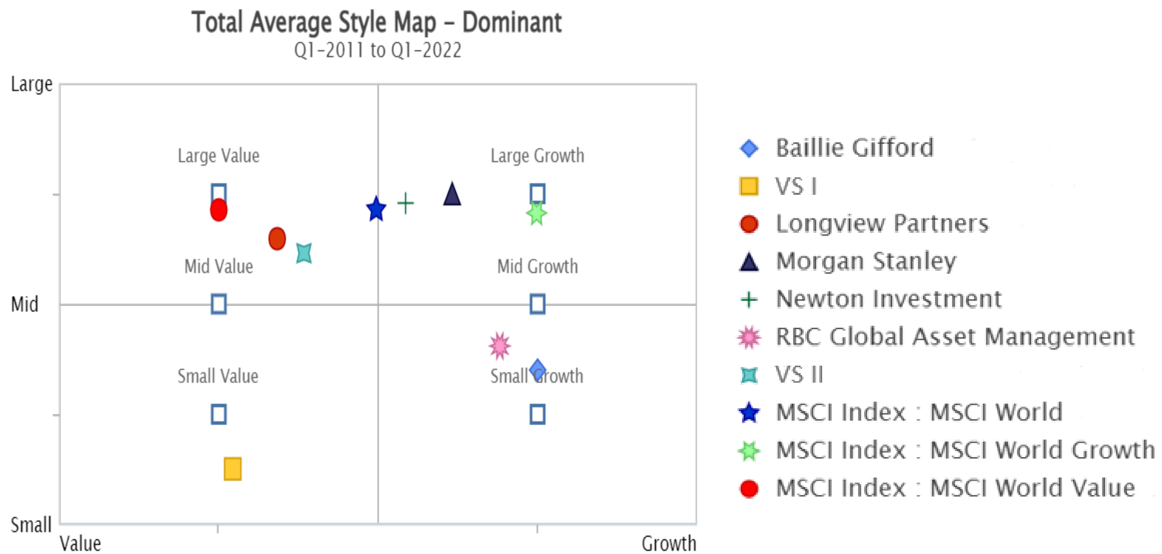


Source: eVestment as of 31 March 2022



In the beginning of this section, we mapped the London CIV strategies according to their dominant stylistic exposures since 2011. Using the same **style map** and adding the two value strategies we can now see a more balanced picture from both a stylistic and a market capitalisation perspective.

Figure 20: Style Map for London CIV Global Equity Strategies, VS I, VS II and MSCI Indices



Source: eVestments; manager strategies used in line with those in the LCIV funds[26].

Summary

A well-constructed LCIV Value fund can offer to Client Funds a valuable building block, helping them implement asset allocation decisions efficiently and cost effectively. For an investment manager to be selected to run one of our funds we apply a stringent assessment framework. This is to ensure performance and risk are in line with expectations, the resourcing level is adequate, and the execution of investment, implementation or risk management processes is strong. As regards to responsible investment and engagement, we want to see a firm commitment to best ESG practice. We require any selected strategy to be cost transparent and add value net of costs.

London CIV has lengthy experience in running manager research exercises tailored to Client Fund needs via Seed Investor Groups. Any such exercise will be governed by our tried and tested fund launch framework. A recent soft market test has given us a good idea of the value strategies universe, helped us identify interesting candidates and highlighted the diversification benefits these strategies can bring when combined with growth strategies.

London CIV is already monitoring several value managers that exhibit the characteristics we like. We encourage Client Funds that have identified the need for a global equities value strategy in their asset mix to get in touch for a discussion on available options.

GLOSSARY of TERMS

Name	Abbreviation	Definition
Active Share		Active Share measures the fraction of a fund's portfolio that differs from the benchmark index. Strategies with an Active Share above 70% are considered highly Active.
Alpha	(α)	Alpha is a term used in investing as a measure of performance and to describe an investment strategy's ability to beat the market over some period. It is thus also often referred to as “excess return”.
Beta	(β)	Beta is the sensitivity of the investment portfolio to the stated benchmark and is a measure of the systematic risk of a security or a portfolio compared to the market as a whole.
Cost Transparency Initiative	CTI	The CTI framework was developed by the PLSA and is a suite of tools and open-access templates which provide a standardised way for asset managers to report costs and charges to investors.
Discounted Cash Flows	DCF	Discounted cash flow (DCF) is a valuation method used to estimate the value of an investment based on its expected future cash flows.
Duration		Duration is a measure of an investment’s sensitivity to interest rate changes.
Earnings before interest, tax and depreciation charges	EBITDA	EBITDA is a business analysis metric measuring the company's overall financial performance. It is often used as an alternative to other metrics, such as earnings, revenue or net income.
Enterprise Value	EV	An alternative metric to equity market capitalisation used to assess a company’s total value. EV includes in its calculation the market capitalization of a company but also short-term and long-term debt as well as any cash on the company's balance sheet.
Exchange Traded Fund	ETF	A basket of securities that tracks an underlying index and can be purchased or sold on a stock exchange the same way that a regular stock can.
FAANG		FAANG is an acronym that refers to the stocks of five large capitalisation US technology companies. These are: Meta (FB) (nee Facebook), Amazon (AMZN), Apple (AAPL),

Name	Abbreviation	Definition
		Netflix (NFLX) and Alphabet (GOOG) (formerly known as Google).
Fama-French Model	FFM	The Fama and French Three-Factor Model is an asset pricing model that expands on the capital asset pricing model (CAPM) by adding size risk and value risk factors to the market risk factor in CAPM. This model considers the fact that value and small-cap stocks outperform markets on a regular basis.
Free Cash Flow	FCF	A measure of how much cash a company generates net of all costs, including interest charges, and the capital investment required to sustain the earnings potential of the business.
Key Person Risk		Key person risk is the risk to an investment management organisation or strategy that one critical employee (usually the lead portfolio manager) permanently departs or is out for an extended period.
Institutional Brokers' Estimate System	IBES or I/B/E/S	I/B/E/S is a database collecting earnings estimates for U.S. companies since 1976. It is used by brokers and active investors to access the estimates made by stock analysts regarding the future earnings of publicly traded US companies.
Margin of Safety		Margin of safety is a principle of investing in which an investor only purchases securities when their market price is significantly below their estimated intrinsic value. Buying securities under this principle is considered offering downside protection.
Mean Reversion		Also known as reversion to the mean, is a theory used in economics that suggests that asset price volatility and historical returns eventually will revert to their long-run mean.
Moat		The term moat refers to a set of business competitive advantages that allow a company to earn outsized profits. It was popularised by the seasoned value investor Warren Buffet who refers to it to a defensive barrier preventing a company's profits from being eroded by competitors.
Price-to-Book	P/B	Price to Book, or the P/B ratio, compares the stock price of a company to its book value per share. Book value per share is the company’s net worth (assets minus liabilities) divided by the number of outstanding shares. In some

Name	Abbreviation	Definition
		cases, investors will exclude certain intangible assets (e.g., goodwill) from the calculation of the P/B ratio. The lower the P/B ratio, the more likely the company is considered a value stock.
Price-to-Earnings	P/E	Price to earnings, or the P/E ratio, compares a company's stock price to its annual earnings. A P/E ratio of 15, for example, indicates that investors are prepared to pay the equivalent of 15 years of current earnings to buy a company's shares. The lower the P/E ratio, the more likely the company is considered a value stock.
Return on Equity	ROE	Measures how good the company is in generating returns on the investment it received from its shareholders and is calculated by dividing net income by shareholders' equity.
Sell Discipline		Investment managers are often reluctant to sell losing stocks leading to potentially even greater losses and are eager to hold winning stocks for longer than they should leading to a style drift. Therefore, the ability of an investment manager to maintain a good sell discipline is a key assessment point for fund and manager selectors.
Standard Deviation	SD	A common risk metric. It measures the average deviations of a return series from its mean. A high standard deviation implies that the data is highly dispersed and there have been large swings or volatility in the manager's return series. A low standard deviation tells us the fund return stream is stable and less volatile
Task Force on Climate-related Financial Disclosures	TCFD	A task force created by the Financial Stability Board to develop recommendations on the types of information that companies should disclose to support investors in appropriately assessing and pricing a specific set of risks related to climate change.
UK Stewardship Code		A code which aims to enhance the quality of engagement between investors and companies to help improve long-term risk-adjusted returns to shareholders. Asset managers who sign up are given a tier rating of one or two. Details of all signatories, with links to the statements on their websites are available on the Financial Reporting Council website

Name	Abbreviation	Definition
		https://www.frc.org.uk/investors/uk-stewardship-code
Value Premium		Value premium refers to the greater risk-adjusted return of value over growth stocks and the wider market.
Value Trap		A value trap is a stock or other investment that appears to be cheap because of attractively low valuation metrics but the stock continues to languish or drop further after an investor buys into the company due to financial instability or weak growth potential.

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