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It's now a year since the bottom of the bear market associated with the global financial crisis. The lead-up to 9 March 2009 saw many investors questioning the merits of the value investment style, particularly the 'deep value' style which comprises the cheapest stocks in the market as defined by various valuation measures such as lower price/book ratios, lower price/earnings ratios, and/or higher dividend yields. Perhaps the most notorious deep value stocks of the global financial crisis were the homebuilders, motor car manufacturers, and the banks. In this period, value stocks were underperforming the already terrible market returns, while large-cap companies, consumer staples, and healthcare stocks were the best performers.

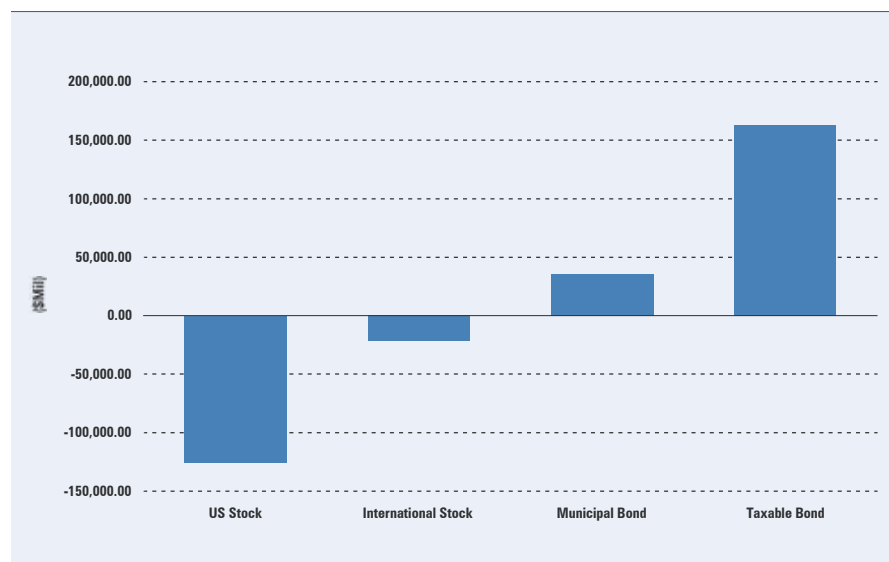
Ibbotson Associates employs several deep value fund managers in our Australian and international share funds. Given the environment we've outlined above, it's worth examining the appropriateness of deep value managers operating in a multi-manager portfolio, as many deep value stocks had either gone to the wall or remained on the brink of bankruptcy as a result of the global financial crisis.

Investor Behaviour in the Global Financial Crisis

Figures 1 and 2 show flows to US mutual funds during the global financial crisis which illustrate typical investor behaviour patterns. Figure 1 shows that investors sold down equities in favour of bonds. This redemption activity placed pressure on share prices.

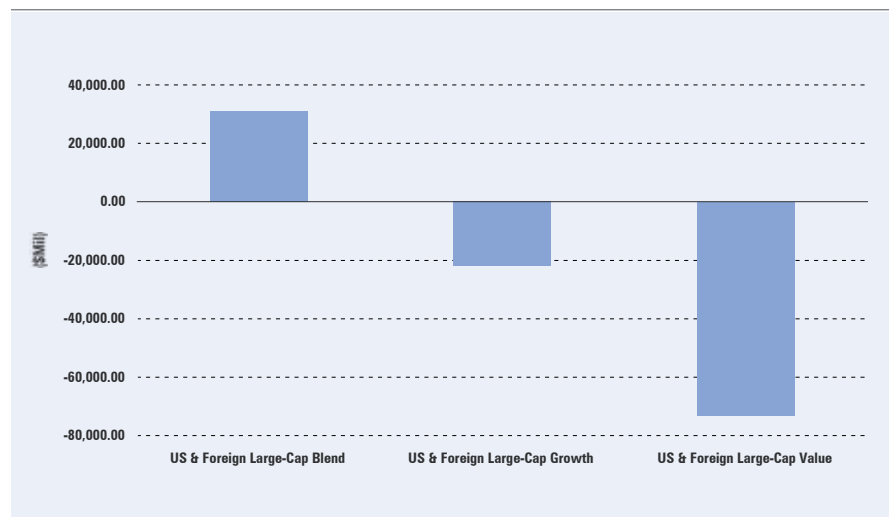
The Lessons of Deep Value Investing

Figure 1. US Mutual Fund Flows By Asset Class Over Two Years to 30 June 2009.



Source: Morningstar Direct.

Figure 2. US Mutual Fund Flows to Large-Cap Equities Categories Over Two Years to 30 June 2009



Source: Morningstar Direct.

Figure 3. Price/Book Spread Ratio Between First and Fifth Price/Book Spread Quintile, 1964–2008.



Source: AllianceBernstein.

Figure 2 shows flows to US and non-US large-cap equities strategies across the blend, growth, and value style categories over the two years to 30 June 2009. The graph shows that more US mutual fund investors redeemed their money from value-style funds than from the other two styles during this period. These redemptions led to greater technical selling pressures on value stocks, as value-style fund managers were forced to sell more portfolio holdings to satisfy these redemptions.

These graphs show US mutual fund data, but it's reasonable to assume that the pattern is similar for retail investors in other countries and globally in the institutional market. Like other fund managers, we at Ibbotson reconsidered the merits of maintaining our deep value exposures. We opted to do so, and did not make the change that many others made. The most common shift was to terminate deep value exposure in favour of a higher-quality portfolio, effectively switching to a portfolio which had stocks with a high probability of surviving the downturn. In effect, it was like buying an insurance policy.

While this may sound like a prudent strategy, it was in fact flawed, because it ignored an essential element of sharemarket behaviour.

Sharemarkets price in expectations, and it was very clear that deep value stocks with associated concerns about debt funding, capital levels, or possible insolvency were being priced accordingly. In fact, as history has shown us, these deep value stocks were priced too pessimistically. This pessimism is one of the key reasons that value investing has a positive long-term return relative to the market.

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The Value Opportunity in Early 2009

There are multiple ways to measure the value opportunity that existed in early 2009. Irrespective of the choice of measure, the consistent finding was that stocks were cheaper

than normal, and that value stocks represented an even greater buying opportunity. This value opportunity is illustrated by the data in Figure 3, provided by one of our global value investment managers, AllianceBernstein. Figure 3 shows the ratio between the most expensive and the cheapest quintiles (as measured by the price/book metric) of stocks in the large-cap developed world equities universe over time. The graph shows that with the exception of the 1999/2000 technology boom period, this ratio was higher in 2007/08 than all previous time periods since 1965. In brief, fear and pessimism in the market had created a significant value opportunity.

The Long-Term Value Premium

At Ibbotson, we believe that there is a long-term value premium of around one percent per annum with a tracking error of around five percent per annum (implying the long-term value premium to have an information ratio of about 0.2). There is countless research on the value premium, led largely by academics from the University of Chicago. Most of this research suggests that we at Ibbotson are conservative in our assessment of the level of this value premium. (There is also very little research to refute the existence of this value premium, and it seems to exist across the globe.)

Figure 4. Rolling 10-Year Excess Performance of Value Style Versus Broader Market, 1974–2010



Source: Morningstar Desktop Consultant.

Figure 4 shows the rolling 10-year excess return of the MSCI World ex-Australia Value Index relative to the broader MSCI World ex-Australia Index. The graph shows that only at the peak of the technology boom in 1999/2000 was the existence of the value premium being questioned. This school of thought proved to be short-lived once this bubble burst.

Ibbotson's Management of Deep Value in 2008, 2009, and into 2010

We have value exposures in our funds through our investments with BlackRock Scientific, Dimensional, and Orbis in Australian shares, and with AllianceBernstein and Dimensional in global shares. We continued to maintain our allocations to these managers throughout 2009 and into 2010. They all performed poorly leading up to March 2009, and have all performed well since that time. On the basis of this experience, it's clear that removal of deep value exposures in late 2008 or early 2009 would have been locking in losses and missing the upside that followed. Pleasingly, we did not experience that outcome.

In terms of navigating 2008 and 2009 with our deep value allocations, we were largely comfortable with maintaining these exposures in our Australian share funds, as the Australian experience was less tumultuous than elsewhere

in the world. It was a different story in our global share portfolios. Financial services companies (particularly in the US) began to show serious distress in July 2008. AllianceBernstein and Dimensional both had their largest sector weightings in financials, which meant that our multi-manager portfolios had considerable exposure to this problem area.

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While we did not know what was ahead, daily returns were illustrating a key point – that these deep value portfolios had higher risk than previously, and that this risk was also higher than was implicit in our multi-manager weighting process. Because of this, we steadily

reduced our deep value allocations over the following months, so that our multi-manager portfolios were not being dominated by these deep value exposures. We trimmed our exposures to these fund managers to a level where their risk contribution was balanced with the other managers. This is typical of the way we manage our multi-manager portfolios.

Many other fund managers started culling their deep value exposures in early 2009. Deep value was apparently 'dead', just as it supposedly had been in the late 1990s during the technology boom. We can see from Figure 4 that the value investment style came roaring back in the early 2000s. Removing the deep value exposure in early 2009 was justified by some investors as being prudent. However, this was acting in contradiction to the years of literature that have shown the value premium to be arguably the most statistically significant risk premium that exists. Any such decision was also in contradiction to data suggesting that the value opportunity was at a cyclically high level. We felt that these supposedly prudent actions were actually very risky ones, given the traditional pattern of the value premium (that the highest returns usually follow the periods of greatest pessimism).

Hindsight will tell us that it was a mistake to cut deep value exposures altogether in favour of 'quality'. It could even be argued that investors should have been increasing exposures to deep value in early 2009. We believe, however, that there are sufficient reasons to justify our actions on this front, as the aforementioned argument assumes that timing the value style is easy (which it is not), and it also dismisses the risk argument, as up-weighting value exposures would have seen a disproportionate amount of portfolio risk in the deep value strategies.

Outlook for Deep Value

The performance of the deep value investment style has returned to favour since March 2009. We do not know the short- to medium-term outlook for the style from here. What we do know is that deep value is an investment style with a long-term history of outperformance and tax-effectiveness, which we will continue to maintain in our portfolios. While our weighting may vary over time on the basis of appropriate risk management, we will not be calling the 'death of deep value' when the next crisis arrives. ■■

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