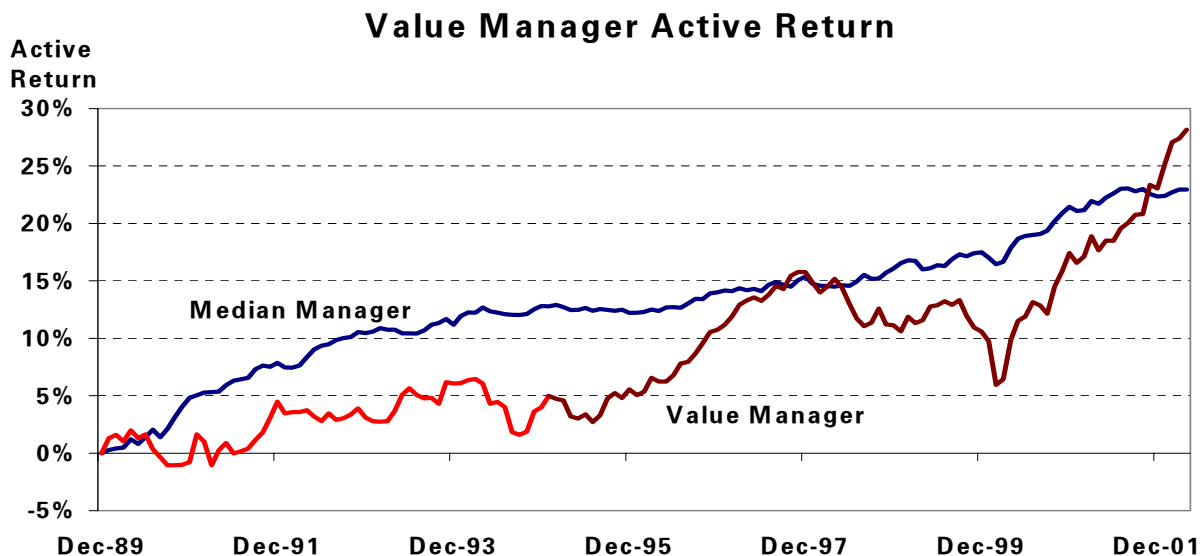


Has the Value Train Already Left the Station?

Value investing bases stock selection on low prices relative to income and assets. Value managers currently crowd the top quartile of equity manager performance surveys, having achieved significant outperformance over recent years. Is value investing an intrinsically superior style or are we just passing through the up phase of the value cycle?

To answer this question we examined the performance of value managers over the last decade and also analysed shifts in the way stocks have been priced in the Australian share market. To examine the performance of value investing we pooled two information sources. Broker Salomon Smith Barney (SSB) maintains a suite of indices for value and growth investing around the globe, starting in 1989. These are a valuable reference for earlier periods when manager performance surveys had limited coverage. From 1995, the specialist sector survey of asset consultant, William M Mercer achieves reasonable coverage of a number of value managers and the median performance of that group can be spliced with the early years of the SSB style index. This composite measure of the excess return due to value investing is compared below to the cumulative active performance of the median manager derived from the median monthly returns of the Mercer database.



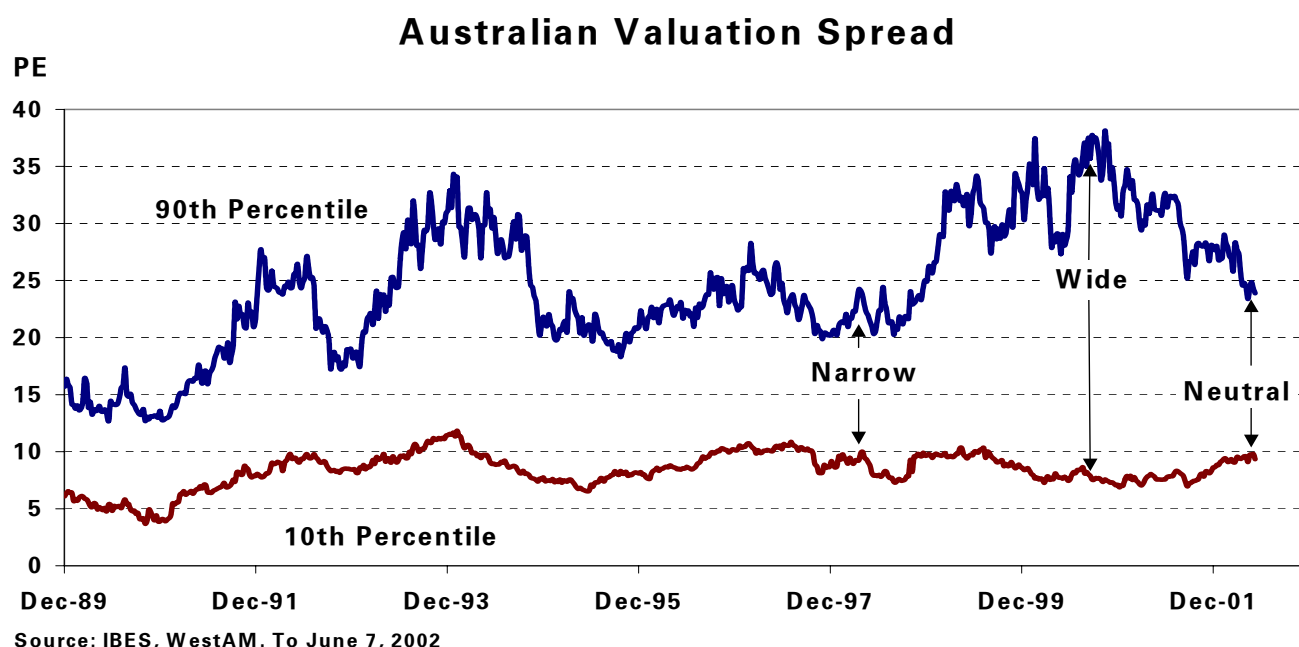
Source: William M Mercer, Salomon Smith Barney, WestAM. To April 2002
 Value managers, based on van Eyk classifications where available, include CitiGroup, Constellation, Dimensional, GMO, Hopkins, Integrated Equity, Lazard, Maple-Brown Abbott, Perennial, Tyndall

As can be seen, the cumulative return of the median manager has tended to lie above that of the value manager, except for the most recent period. The median manager has performed exceptionally well in Australia, adding an average of close to 2%pa in active return over the last twelve years. Value investing has actually added a little more over the entire period although the road has been rocky and subject to large swings.

In the early 1990's, the economic recession brought financial distress to a number of apparently cheap stocks. Merrill Lynch quantitative strategist Richard Bernstein in his book, 'Style Investing', argues that value investing works best when growth is abundant, but struggles when earnings growth is scarce. In the latter environment investors are willing to reward companies with secure growth, and are less discriminating about the cost of that growth security. In environments where earnings growth is hard to come by, the financial and operating leverage of some value stocks can also be heavily penalized.

Interestingly, with the recent appreciation of the Australian dollar against the US dollar, earnings growth is under a new threat as exporters are less competitive in overseas markets, and import competing industries face fresh challenges. At the same time monetary policy has started to tighten.

As well as the environment for earnings growth, another guide to the future success of value investing is the valuation spread across the equity market. The chart below shows the trajectory of the 90th and 10th percentile price earnings ratios in the Australian market over the past decade.



At the end of 1997 a cheap stock traded on a forward PE of around 10 and an expensive stock traded on a PE of around 20, a spread of 10 PE points. By early 2000 this spread had widened to around 30 PE points with cheap stocks trading on PE's of below 10, and expensive stocks trading at PE's close to 40, and above. This phenomenal widening of the valuation spread was very destructive to value investing and in fact some value managers caught in that storm are no longer around today. The sun broke through the clouds with the burst of the technology bubble in March 2000. The PE spread has since contracted back towards a more normal level of around 15 PE points, and on the way buoyed the performance of value managers. The PE contraction since 2000 corresponds with the recent outperformance of value shown in the first chart.

It is likely that the return of the valuation spread to more normal levels has removed much of the opportunity for value managers to earn super-normal returns. The contraction in the valuation spread could overshoot but developing threats to earnings growth makes this less likely. WestAM finds value works best in combination with other factors which moderate episodic swings. When exploited in this way, we expect value to continue to support outperformance in the future.