M.M.WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY

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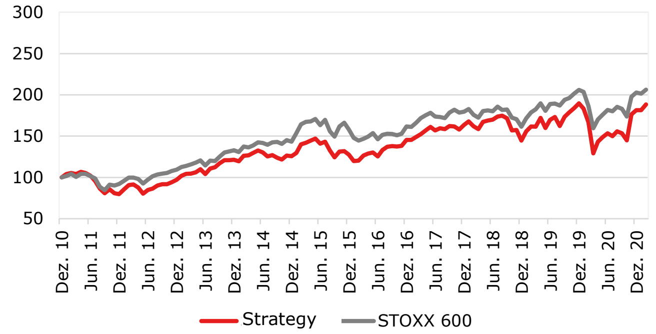
As in real life: Why there is little point in extreme bargain hunting

The propensity to hunt for bargains appears to be a general human phenomenon. However, painful experience shows that bargains do not always deliver what they promise. Too often, supposedly good buys turn out to be the result of bad decisions because not only the price, but also the quality was low. So, from a long-term perspective, cheap purchases may then often become quite expensive. But does this experience also apply to the stock market? Well, the stock market is full of bargain hunters looking for low-priced entry opportunities. Even today, for example, all followers of the value investment style are ultimately – to quote the father of value investing, Benjamin Graham – always looking for companies that are worth a dollar but only cost 50 cents.

However, while this approach had quite some appeal in a period of still inefficient markets (the quote is from the 1930s), the question must be allowed whether this working hypothesis is still justified today. A first look at the performance of value indexes suggests that it no longer has been in the last ten years. There is no clear evidence of a tendency towards systematic outperformance. Instead, the opposite seems to be the case. But to be fair, we have to point out that simple value indexes like those used to manage value ETFs, for example, are not necessarily based on the value investment style of a Benjamin Graham or are incompatible with it. For, Graham never proposed simply buying stocks without reflection that are the cheapest in an investment universe (as measured by a metric like the price-earnings ratio). Instead, he was always about first considering what a fair valuation ratio might be in order then to buy a stock at a sufficient remove from that, which would serve as a safety margin. Now, it is in the nature of things that no one in the world definitively knows where the fair value for a stock's price-earnings ratio lies. If it were possible to deduce that objectively, markets would no longer play a role and would simply be unnecessary. But since that is not the case, a method has become established in practice by which one could infer an approximately fair valuation ratio indicatively. One calculates the historical average of valuation ratios (price-earnings, dividend yield, price-book value ratio, etc.) and compares that with the current values. The resulting difference is put into the ratio of all other resulting differences for all the stocks in an investment universe. If a stock then deviates much more from its historical valuation ratios than other stocks, we can interpret that as a sign of a misvaluation.

A bargain hunter on the stock market might thus have found a method with which only 50 cents would have to be paid for a company that seems worth a dollar. But would this method have also worked in recent years? We have answered this question by calculating for all stocks of the STOXX 600 in its respective historical composition, based on several valuation ratios, how strongly the stocks deviate from their own historical data (measured in terms of standard deviations). We have only used analysts' estimates that were also historically available in exactly such a way as to be perfectly replicated in a real-time application. Then, for at least six months, we always bought the stocks that were quoting significantly below their historical valuation ratios. The result is sobering, as the chart below shows.

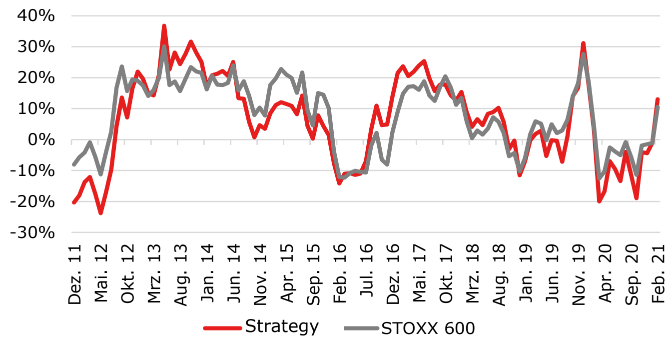
Strategy backtest (purchase of shares with attractive valuation relative to own history) and benchmark



Source: Refinitiv Datastream

The cumulative performance is slightly below the benchmark. In most phases, the strategy's rolling annual rate was near the benchmark's. Simply put, we could have saved ourselves the trouble of looking for bargains.

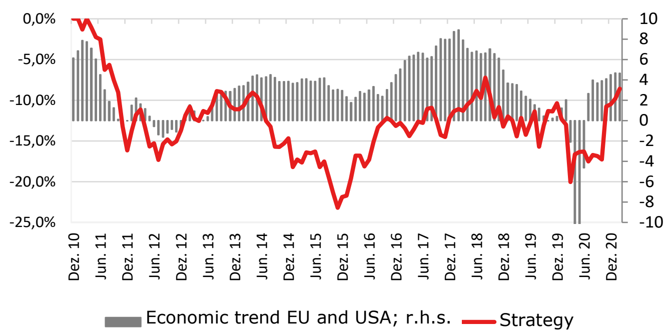
Strategy backtest and benchmark y/y



Source: Refinitiv Datastream

The underwater chart of the active return also indicates that performance relative to the benchmark was somewhat better when economic data were trending positively, while recessionary phases tended to see relatively poorer performance. That is not atypical for the performance behavior of very cheaply valued companies, since the cheap valuation is usually accompanied by low balance sheet quality, which can become a burden for the company in recessionary phases.

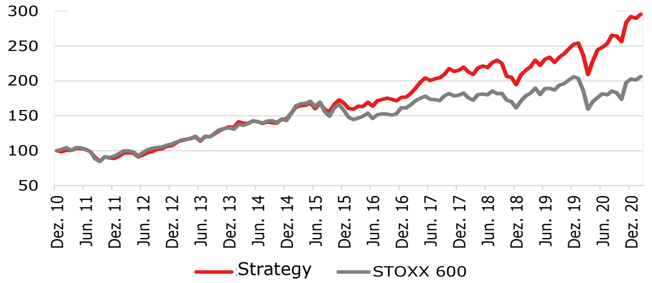
Underwater chart of the active return of the strategy and economic trend



Source: Refinitiv Datastream

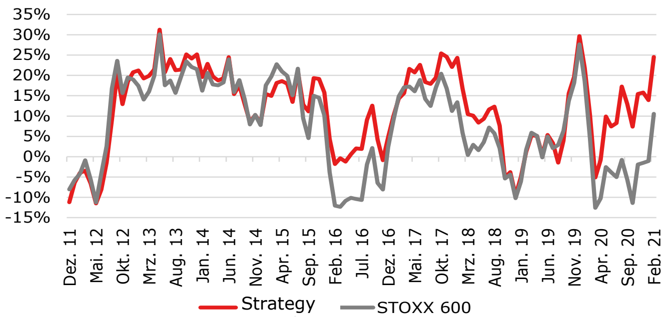
To understand the phenomenon better overall, we have also reversed the strategy. Instead of buying the bargains, we have bet in a second run-through on stocks that seemed especially expensive relative to their own history. We are very surprised by the result. We would have expected performance near the benchmark again. Instead, we see significant outperformance, especially from 2015 onward. Chronologically, the beginning of the outperformance coincides perfectly with the beginning of the European quantitative easing program, a topic we will return to later.

Strategy backtest (purchase of shares with high valuation relative to own history) and benchmark



Source: Refinitiv Datastream

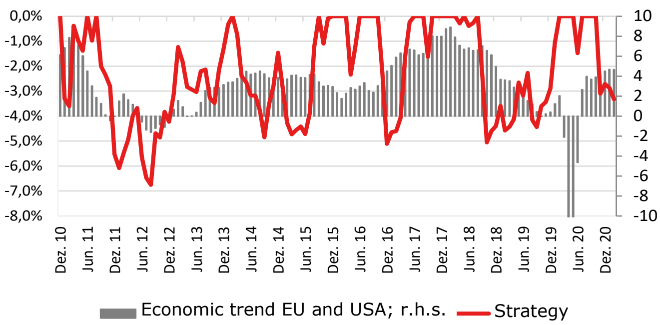
Strategy backtest and benchmark y/y



Source: Refinitiv Datastream

In contrast to the first backtest, the strategy's rolling annual rate here exhibits an almost continuously growing lead over the benchmark from 2015 onward. The correlation of the active return with the economic cycle also appears largely absent, as the chart below shows. In particular, a correlation is hardly discernible from 2015 onward.

Underwater chart of the active return of the strategy and economic trend



Source: Refinitiv Datastream

The results, at least on our interpretation, urge great humility. Clearly, the companies that were valued lower over time deserved it, as they on average have not subsequently made up the undervaluation. And the companies that the market always valued higher over time were likewise not advantaged by a random process. Instead, there were evidently good reasons to value these companies differently over time, since a subsequent mean reversion that one would expect on average has also not occurred. On the contrary, for companies that had been more expensive before, that trend clearly continued on average after being purchased. It seems as if the market has a keen sense for the quality of companies. Decreasing quality is penalized, and increasing quality is rewarded by way of rising valuations. From this perspective, falling valuations of a company are a warning signal, not a bargain indicator. On the other hand, rising valuations tip us off to business opportunities resulting from a company's higher quality and intrinsic value. It is not for nothing that the portfolio with the supposedly overvalued stocks exhibits not only better performance – contrary to what many textbooks would postulate – but also more attractive risk properties. Their volatility and VAR are better than the benchmark's.

The results are so astounding that we must consider the possibility that a misinterpretation may perhaps explain them. An error may have been made by not taking sectoral effects into account. Technology stocks, for example, have undergone a remarkable rally in recent years. But they also exhibit the property of being rather expensive and become even more expensive over time. Now, if the strategy portfolio set up in the backtest had consisted primarily of technology stocks, the conclusion could presumably no longer be generalized, having been driven mainly by effects specific to one sector. But that is not the case. The backtest is set up so that exactly the best 6% of all stocks in a sector (at the already very granular ICB Level 4) are bought at every rebalancing date. That way, the resulting portfolio is highly diversified and comparatively close in sectoral structure to the benchmark. However, since the stocks in the backtest are always weighted equally at the rebalancing date, and not according to market capitalization, the weighting of the technology sectors was actually below the benchmark weight. Consequently, the result cannot be explained by sectoral effects. A better approach to explaining it would presumably refer to the European Central Bank's very accommodative monetary policy, to which bond purchasing programs gave additional impetus as of March 2015. Generally, investors find it difficult to buy stocks with rising valuation ratios. However, the reason for this reluctance disappears with low interest rates, since the net present value of future earnings rises sharply in such an environment and makes higher valuation ratios seem increasingly plausible. That may partly explain why the second strategy we tested began to perform especially well exactly when the ECB began to buy bonds. However, we do not believe there will be a change of course in monetary and fiscal policy in the foreseeable future. As long as interest rates remain near zero, investors will be glad to accept significant valuation premiums on improving prospects of future earnings. Those who sell such companies because of their high valuation will be selling the ones with the best earnings prospects and doing without their future performance. Generally, our calculations have already long shown that it is increasingly pointless for individual investors to try to outsmart the overall market in regard to valuation. There are good reasons to concentrate on topics like balance sheet quality, profitability, earnings growth, the competitive environment, and the quality of management. On the subject of valuation, on the other hand, you will too often get your fingers burned.

Market Data

Stock marktes	As of 30.04.2021 16:14	Change versus 22.04.2021 -1 week	26.03.2021 -1 month	28.01.2021 -3 months	28.04.2020 -1 year	31.12.2020 YTD
Dow Jones	33886	0,2%	2,5%	10,7%	40,6%	10,7%
S&P 500	4196	1,5%	5,6%	10,8%	46,5%	11,7%
Nasdaq	14036	1,6%	6,8%	5,2%	63,1%	8,9%
DAX	15217	-0,7%	3,2%	11,4%	41,0%	10,9%
MDAX	32828	-0,1%	3,9%	4,3%	43,9%	6,6%
TecDAX	3515	-0,5%	4,0%	3,1%	23,1%	9,4%
EuroStoxx 50	4000	-0,4%	3,5%	12,5%	36,4%	12,6%
Stoxx 50	3402	-0,2%	3,2%	8,0%	17,6%	9,5%
SMI (Swiss Market Index)	11096	-1,1%	-0,2%	2,3%	12,2%	3,7%
Nikkei 225	28813	-1,3%	-1,2%	2,2%	45,7%	5,0%
Brasilien BOVESPA	119996	0,5%	4,5%	0,9%	47,6%	0,8%
Russland RTS	1490	-0,8%	2,8%	7,6%	34,3%	7,4%
Indien BSE 30	48782	1,5%	-0,5%	4,1%	51,9%	2,2%
China Shanghai Composite	3447	-0,5%	0,8%	-1,7%	22,7%	-0,8%
MSCI Welt (in €)	2963	1,2%	2,8%	9,6%	32,1%	12,1%
MSCI Emerging Markets (in €)	1365	1,6%	1,9%	1,3%	36,3%	7,5%
Bond markets						
Bund-Future	169,88	-106	-224	-789	-287	-776
Bobl-Future	134,77	-14	-62	-64	-50	-41
Schatz-Future	112,09	-1	-6	-27	-7	-19
3 Monats Euribor	-0,54	3	3	3	-30	5
3M Euribor Future, Dec 2017	-0,53	1	3	5	-11	0
3 Monats $ Libor	0,19	1	-1	-2	-57	-5
Fed Funds Future, Dec 2017	0,09	0	2	2	0	0
10 year US Treasuries	1,64	9	-2	59	103	73
10 year Bunds	-0,21	9	18	37	26	37
10 year JGB	0,10	4	2	7	15	8
10 year Swiss Government	-0,22	4	10	25	23	28
US Treas 10Y Performance	679,60	-0,6%	0,9%	-3,9%	-7,0%	-5,1%
Bund 10Y Performance	664,50	-0,2%	-1,1%	-2,9%	-1,9%	-2,9%
REX Performance Index	492,21	-0,2%	-0,7%	-1,5%	-0,7%	-1,4%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,24	2	6	18	-36	22
IBOXX BBB, €	0,67	2	0	11	-111	12
ML US High Yield	4,73	-3	-16	-14	-384	-25
Convertible Bonds, Exane 25	8337	-0,4%	2,2%	0,6%	14,3%	0,1%
Commodities						
MG Base Metal Index	426,40	3,5%	9,7%	19,7%	68,9%	20,2%
Crude oil Brent	67,26	2,7%	4,1%	21,0%	227,3%	29,6%
Gold	1767,30	-1,0%	2,0%	-4,8%	3,8%	-6,9%
Silver	26,06	-0,6%	3,9%	-0,6%	73,0%	-1,2%
Aluminium	2394,60	1,3%	5,2%	20,7%	63,4%	21,3%
Copper	9880,25	4,9%	10,2%	25,4%	90,2%	27,5%
Iron ore	179,31	1,7%	7,4%	6,3%	113,8%	15,1%
Freight rates Baltic Dry Index	3007	9,3%	38,1%	104,6%	359,1%	120,1%
Currencies						
EUR/ USD	1,2063	0,1%	2,4%	-0,2%	10,9%	-1,7%
EUR/ GBP	0,8709	0,3%	1,8%	-1,4%	0,0%	-2,7%
EUR/ JPY	131,58	1,0%	1,7%	4,3%	13,4%	4,0%
EUR/ CHF	1,0989	-0,4%	-0,9%	1,9%	3,8%	1,7%
USD/ CNY	6,4675	-0,4%	-1,1%	0,3%	-8,7%	-0,9%
USD/ JPY	108,61	0,6%	-1,0%	4,2%	1,6%	5,2%
USD/ GBP	0,72	0,0%	-0,4%	-0,9%	-10,2%	-1,3%

Source: Refinitiv Datastream

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