SEI New ways. New answers.®

The Odd Couple: Recessions and Value

JUNE 2020

David Hintz, CFA
Portfolio Manager, U.S. Large Cap

Ethan Kiliany
Research Analyst, U.S. Equities

Snapshot

- Value stocks frequently exhibit significant outperformance following recessionary troughs.
- The historic results for value have actually been better if the investment was made prior to a recessionary trough rather than at the time of or after the trough.
- Given the difficulties of market timing and our belief that value is a source of long-term excess performance, it is reasonable to maintain a strategic position in value in the midst of the COVID-19 recession.

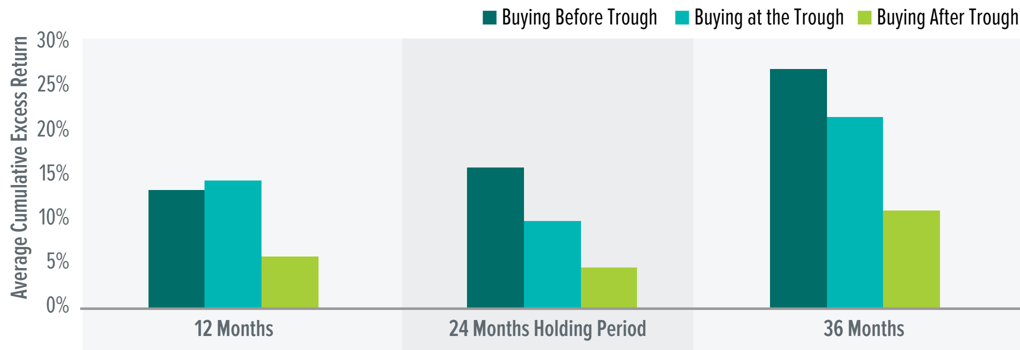
As an investor in SEI's portfolios you're well aware that we believe value is an alpha source. Simply put we seek to buy companies that have attractive valuations because we believe there is significant long-term potential that they will outperform a broad market benchmark such as the S&P 500 Index. In practice, this means our portfolios will have a strategic (long-term) bias toward value (and other alpha sources like momentum and stability) when compared to the portfolio's benchmark.

You're probably also aware that a value bias has been quite painful over the past decade. It's easy to find articles written by the financial press that declare value investing is dead. This isn't the first time, nor will it be the last, that someone makes such a declaration—despite abundant academic research and historical data showing value investing has generated excess returns. Of course investors continually ask, "When will value outperform again? What will be the catalyst for this?" While, we certainly wouldn't call a recessionary environment a perfect catalyst for value—and we believe trying to identify catalysts can be a counter-productive exercise anyway—our research does indicate that recessions have historically resulted in favorable environments for value investing.

Just like trying to predict catalysts, attempting to time market events is a generally fruitless exercise. In Exhibit 1, we compare the average historical outcomes of hypothetical value investments made at the time of a recessionary trough as well as three months before and after the trough. Our research, based on data from noted academic and author Ken French, indicates that no matter the timing of a value investment, it has typically generated significant outperformance (Exhibit 1) following a recessionary trough. As illustrated in Exhibit 2 for hypothetical value investments made three months before a trough, the results have been fairly persistent. One could argue that the optimal timing for a value investment would actually precedes the recessionary trough. Therefore, we contend that a strategic allocation to value—which, by its very nature precedes a recessionary trough—is an appropriate way to position in this type of environment. Equity markets are widely considered leading indicators and generally begin to recover before the economy improves, meaning investing early may be beneficial.

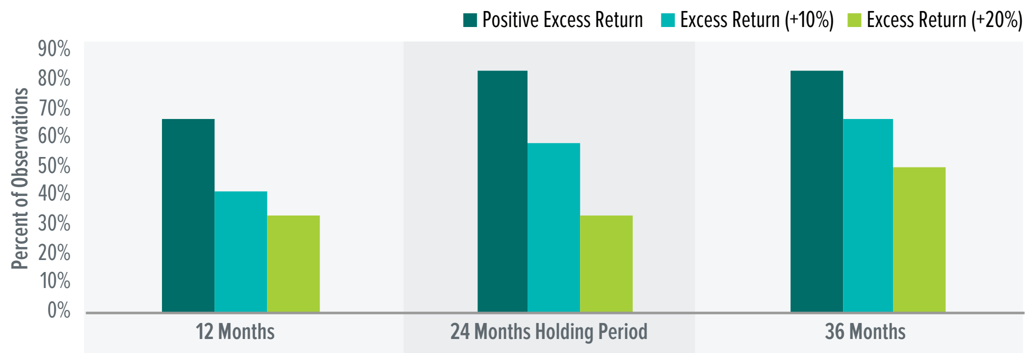
Unless otherwise noted all performance is in USD.

Exhibit 1: There has been Value in Investing Before, During and After a Trough



Source: SEI, Ken French. 1/1/1926 – 3/31/2020. Cumulative excess return of Ken French value factor (cheapest 30% of stocks by price-to-book value) versus S&P 500 Index (prior to 5/1/57 returns of the S&P 90 Index were used). Purchases are hypothetical and do not include any expenses or fees. Buying before or after trough determined as three months before or after the trough.

Exhibit 2: High Batting Average for Value Buying Three Months Before the Trough



Source: SEI, Ken French. 1/1/1926 – 3/31/2020. Cumulative excess return of Ken French value factor (cheapest 30% of stocks by price-to-book value) versus S&P 500 Index (prior to 5/1/57 returns of the S&P 90 Index were used).

We don't know when the COVID-19 economic recession will bottom out. Annualized U.S. gross domestic product (GDP) for the first quarter of 2020 declined 4.8% according to an advance estimate from the U.S. Bureau of Economic Analysis. We expect second-quarter GDP reports to be significantly worse. This sets up the possibility that the latest recessionary trough has yet to come, perhaps arriving in the second quarter or later this year; of course we won't actually know until after the fact. What we do know is that the data show that value has historically performed quite well at the beginning of an economic recovery, and has continued to outperform while the economy comes out of a recession into an expansion.

Index Definitions

S&P 500 Index: The S&P 500 Index is an unmanaged, market-weighted index that consists of 500 of the largest publicly-traded U.S. companies and is considered representative of the broad U.S. stock market.

S&P 90 Index: The S&P 90 Index was a precursor to the S&P 500 Index. It was comprised of 50 industrial stocks, 20 railroad stocks and 20 utility stocks.

Glossary of Terms

Alpha source: Our strategies are designed to capitalize on long-term drivers of market performance through exposure to persistent sources of returns such as mean reversion, trend-following and stability.

Batting Average: Batting average is a statistical measure that illustrates how often in percentage terms an investment outperformed a specified benchmark.

Important Information

SEI Investments Canada Company, a wholly owned subsidiary of SEI Investments Company, is the Manager of the SEI Funds in Canada.

The information contained herein is for general and educational information purposes only and is not intended to constitute legal, tax, accounting, securities, research or investment advice regarding the Funds or any security in particular, nor an opinion regarding the appropriateness of any investment. This information should not be construed as a recommendation to purchase or sell a security, derivative or futures contract. You should not act or rely on the information contained herein without obtaining specific legal, tax, accounting and investment advice from an investment professional. This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. There is no assurance as of the date of this material that the securities mentioned remain in or out of the SEI Funds.

This material may contain "forward-looking information" ("FLI") as such term is defined under applicable Canadian securities laws. FLI is disclosure regarding possible events, conditions or results of operations that is based on assumptions about future economic conditions and courses of action. FLI is subject to a variety of risks, uncertainties and other factors that could cause actual results to differ materially from expectations as expressed or implied in this material. FLI reflects current expectations with respect to current events and is not a guarantee of future performance. Any FLI that may be included or incorporated by reference in this material is presented solely for the purpose of conveying current anticipated expectations and may not be appropriate for any other purposes.

Information contained herein that is based on external sources or other sources is believed to be reliable, but is not guaranteed by SEI Investments Canada Company, and the information may be incomplete or may change without notice.

There are risks involved with investing, including loss of principal. Diversification may not protect against market risk. There may be other holdings which are not discussed that may have additional specific risks. In addition to the normal risks associated with investing, international investments may involve risk of capital loss from unfavourable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Emerging markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size and lesser liquidity. Bonds and bond funds will decrease in value as interest rates rise.

Index returns are for illustrative purposes only, and do not represent actual performance of an SEI Fund. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.

©2020 SEI