Timeless investment strategies

Which investment strategies are likely to generate the best long-term returns on equity markets?

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PRIVATE BANKING

Introduction

While large-cap technology stocks have become a staple of the investment world, we seem to overlook the fact that other investment strategies have proved their worth over the years. These include the principles followed by value investing enthusiasts such as Warren Buffet, Benjamin Graham, and David Dodd.

Tweedy, Browne Company, the American investment advisory and fund management firm, published a white paper over three decades ago outlining soundly validated investment methods, based on over 50 academic studies. Below, we offer a summary of the best-performing investment strategies on the equity markets. As you will see, most of these principles are currently being undermined by the current market configuration. Waiting for a possible comeback?

Buy stocks with the lowest Price to Book value (P/B)

Countless studies have confirmed that, over long periods of time, stocks with a low price to book value (P/B ratio) tend to outperform those with a higher ratio. The underlying rationale is that, over time and barring bankruptcy, the market value of these companies should converge to, if not exceed, their book value. Tweedy, Browne meticulously apply this approach, targeting stocks in the lower 20-30% of their P/B, viewing them as potentially undervalued and therefore attractive investment opportunities. This selection technique was first established by Benjamin Graham, the father of value investing.

Graham's strategy of buying shares at 66% or less of a company's net current assets is based on the belief that these shares are trading below their liquidation value. Net current assets are the value of a company's assets that can be converted into cash or used to repay short-term debts within one year, net of all short-term debts.

For example, if a company has $100 in current assets and $40 in current liabilities, Graham will not pay more than $40 (66% of $60, net current assets) for this stock. Over the 30-year period studied (1920-1956), the average performance of this strategy was around 20% a year. It should be noted, however, that the "66% of net current assets" criterion is not so easily implemented, as the stocks concerned are quite rare on the stock markets.

Over long periods, stocks with low P/B ratios tend to outperform those with high ratios.

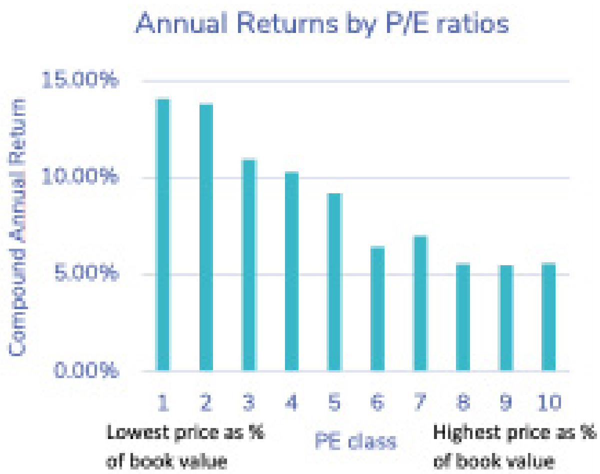
Source data: "Decile Portfolios of the New York Stock Exchange, 1967 - 1984", Yale School of Management, 1986

Buy stocks with the lowest price-to-earnings (P/E) multiples

Tweedy, Browne's investment strategy is to buy stocks with low price-to-earnings multiples. Their research shows that, over the long term, stocks purchased at low multiples tend to outperform those purchased at high multiples. By investing primarily in stocks whose price/earnings ratios are in the lower 20-30% of the market, Tweedy pursues an approach that has proven profitable over time. Graham, for his part, advocated investing in companies whose earnings yield (the inverse of P/E) was equal to 200% of the yield on AAA-rated bonds.

Tweedy refines its investment criteria by focusing on companies that not only trade at discounted prices, but also present favorable earnings growth prospects. As Warren Buffet once said, "Growth and value are joined at the hip". Stocks that combine a low price/earnings ratio with strong earnings growth prospects are particularly attractive, as they are likely to outperform stocks with stagnant or uncertain growth prospects.

Over long periods, stocks with low price/earnings multiples tend to outperform those with higher multiples.



Source data: "Decile Portfolios of the New York Stock Exchange, 1967 -1984", Yale School of Management, 1986

Buy stocks with high dividend yields

Tweedy, Browne's strategy is also to select stocks based on the highest dividend yields, believing this to be a key indicator of a company's value. The dividend yield is the dividend per share over the next 12 months, divided by the current share price. Historically, stocks offering higher dividend yields tend to outperform their lower-yielding counterparts. Research by David Dreman between 1970 and 1996 highlighted that high dividend yield stocks consistently outperformed others based on low price-earnings ratios, low price-to-book-value ratios, and low price-to-cash flow ratios, particularly during market downturns.

Nevertheless, Tweedy refers to a 2006 study by Credit Suisse Quantitative Equity Research, which reveals a direct correlation between low payout ratios and higher future performance. The payout ratio is the dividend per share divided by earnings per share for the same period. The study shows that a strategy of investing in the highest dividend-yielding stocks, combined with low payout ratios, produces the best returns.

Over long periods, stocks with high dividend yields tend to outperform those with low dividend yields, particularly when combined with low payout ratios.

Source : Tweedy, Browne, 1992

A significant pattern of purchases by one or more insiders

Another investment strategy followed by Tweedy, Browne is to match the buying (or selling) of insiders, such as managers and directors. Insiders tend to buy their own company's shares when they believe they are undervalued. This approach is based on the idea that insiders, thanks to their in-depth knowledge and access to essential information about their companies, are best placed to assess the company's true value. However, only relatively large-scale insider operations offer an informative signal. Corporate share buyback programmes indicate that management is convinced that the company's shares are undervalued and are therefore a strong signal of future appreciation.

Studies suggest that investments in companies following public disclosure of insider buying often outperform the market benchmark. In addition, companies that actively buy back their shares outperform the market, particularly when these buybacks are carried out by executives and directors (when the latter are major shareholders).

For example, last week Jeff Bezos sold 12 million Amazon shares worth over $2 billion, for the first time since 2021. Is this a sign that the stock is overvalued?

This operation is actually part of a larger programme to sell around 50 million shares. According to Bloomberg, Bezos is taking advantage of the rising share price to support his philanthropic projects.

Significant buying behavior from one or more insiders suggests that they consider these shares to be undervalued, indicating a potential for future appreciation.

Source: Speed Trader

Buying after a significant decline in share price

One counter-intuitive investment approach is to look for opportunities in stocks that have experienced significant price declines, often triggered by falling earnings or disappointing quarterly results. Tweedy, Browne believes that, over time, a company's performance has a natural tendency to "revert to the mean" of performance. This principle suggests that markets tend to overreact to both good and bad news. As a result, stocks that have been subject to bad announcements, such as a drop in earnings, are likely to be undervalued and, consequently, to appreciate over the long term.

Studies have shown that the worst-performing stocks in the short term outperform the best-performing stocks over the long term. By identifying and investing in these stocks that have suffered temporary setbacks, it is possible to outperform the best-performing stocks of recent times.

Equity performance tends to revert to the mean.

	Average Annual Returns		
	1973 - 1977	1978 - 1982	1983 - 1987
30 Worst performing stocks, 1973-1982	(9.96)%	7.92%	30.84%
30 Best performing stocks, 1973-1982	12.72	15.96	13.32
Market index	5.64	17.40	20.76

Source: The Over-Reaction Effect — Some U.K. Evidence, by D. M. Power and A. A. Lonie T, 1991

A bias towards small-cap stocks

Several studies suggest that, over the long term, small-cap stocks tend to outperform large-caps. Tweedy's analysis includes equally compelling results for international markets such as the UK, France, Germany, and Japan, where small-cap stocks have also generated excess returns.

The appeal of small-cap stocks stems from their growth potential and the frequent underestimation of their value. These companies often operate in niche sectors or have the flexibility to innovate, factors which favour share price appreciation. Decades ago, Nobel laureates Fama and French highlighted the "small-cap effect", the principle whereby small-cap stocks reward their greater volatility and risk exposure.

Small-cap stocks tend to outperform large-cap stocks over long periods.

Parameter	Large cap	Mid Cap	Small Cap
Risk (Probability of negative returns)	Low	High	Very High
Probability of exceptionally high returns	Low	High	High
Liquidity	Very Good	Good	Low
Company Information Availability	Very Good	Good	Poor

Source: MoneyWorks4Me

Conclusion

Tweedy, Browne's paper presents a holistic approach to value investing, combining characteristics such as low valuation multiples, sound financial health, insider confidence and relatively low market capitalisation. These criteria are often interdependent elements which, together, reveal undervalued stocks with growth potential.

As their study points out, there is no single investment formula that consistently produces outstanding performance, over every period of time. However, there are recurrent and frequently interrelated patterns of successful investment over a long period of time.

Yet these principles have failed to generate outperformance in recent years. Low P/E, high dividend yield and small-cap stocks have underperformed strongly lately. Indeed, the "Magnificent 7" have diametrically opposed characteristics: they are the largest market capitalisations, their P/E multiple is very high, and their dividend yield is very low or null.

For several years now, investors have been focusing on large-cap growth stocks and so-called "momentum" strategies, i.e., buying stocks that have performed very well recently. In fact, the outperformance of growth stocks has reached an extreme level. This is an appropriate time, therefore, to recall certain investment principles that proved their worth in the not-too-distant past.

Annual performance of the Russell 1000 Growth vs. Russell 1000 Value index between 1979 and 2023

Russell 1000 Growth vs. Russell 1000 Value (Total Returns, 1979 - 2023)

Year	Growth	Value	G-V	Year	Growth	Value	G-V	Year	Growth	Value	G-V
1979	23.9%	20.5%	3.4%	1994	2.6%	-2.0%	4.6%	2009	37.2%	19.7%	17.5%
1980	39.6%	24.4%	15.2%	1995	37.2%	38.4%	-1.2%	2010	16.7%	15.5%	1.2%
1981	-11.3%	1.3%	-12.6%	1996	23.1%	21.6%	1.5%	2011	2.6%	0.4%	2.3%
1982	20.5%	20.0%	0.4%	1997	30.5%	35.2%	-4.7%	2012	15.3%	17.5%	-2.3%
1983	16.0%	28.3%	-12.3%	1998	38.7%	15.6%	23.1%	2013	33.5%	32.5%	1.0%
1984	-1.0%	10.1%	-11.1%	1999	33.2%	7.3%	25.8%	2014	13.0%	13.5%	-0.4%
1985	32.9%	31.5%	1.3%	2000	-22.4%	7.0%	-29.4%	2015	5.7%	-3.8%	9.5%
1986	15.4%	20.0%	-4.6%	2001	-20.4%	-5.6%	-14.8%	2016	7.1%	17.3%	-10.3%
1987	5.3%	0.5%	4.8%	2002	-27.9%	-15.5%	-12.4%	2017	30.2%	13.7%	16.5%
1988	11.3%	23.2%	-11.9%	2003	29.7%	30.0%	-0.3%	2018	-1.5%	-8.3%	6.8%
1989	35.9%	25.2%	10.7%	2004	6.3%	16.5%	-10.2%	2019	36.4%	26.5%	9.8%
1990	-0.3%	-8.1%	7.8%	2005	5.3%	7.1%	-1.8%	2020	38.5%	2.8%	35.7%
1991	41.3%	24.6%	16.7%	2006	9.1%	22.2%	-13.2%	2021	27.6%	25.2%	2.4%
1992	5.0%	13.6%	-8.6%	2007	11.8%	-0.2%	12.0%	2022	-29.1%	-7.5%	-21.6%
1993	2.9%	18.1%	-15.2%	2008	-38.4%	-36.8%	-1.6%	2023	42.7%	11.5%	31.2%

CREATIVE PLANNING @CharlieBilello As of 12/31/23

Source: Charlie Bilello

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