# Valuation Timing

While value stocks tend to outperform growth stocks over time, the value premium can't be reliably timed. However, by adjusting the tilt toward value based on valuation spreads, investors can potentially capture higher returns when spreads are wider and reduce tracking error when spreads are lower. Take more value exposure when you are paid more for it.

Value stocks have, over time, outperformed growth stocks. They don't do it every year. If they did, there would be no risk and thus no premium. An investor could make a lot of money if they could time this premium effectively. Invest in value when value is going to outperform and invest in growth when value will underperform. Simple

Unfortunately, there is no reliable way to time the value premium. No matter what metric you use to sort on, the value premium is always positive. This makes sense if you believe that both the value premium is a compensation for risk and market prices are fair. Sometimes unexpected bad news occurs or risks materialize and, thereby, value stocks underperform. While at other times unexpected good news comes in. Overall, investors demand a higher return for investing in value stocks and, on average, they outperform.

While the value premium is positive, it is not always positive by the same amount. Therefore, investors can use "valuation spreads" to better understand the magnitude of the expected value premium.

# Valuation Spreads

Value is a relative metric. There will always be some stocks that are more value and others that are more growth. At times, growth stocks are really "growthy," as compared to the value stocks, and at other times the value and growth stocks are not very different. More specifically, the ratio of the average Price to Book of growth stocks to the average Price to Book of Value stocks is called the valuation spread. This spread is not static and changes over time. Let's examine the future value premium when spreads are wide (above the median) and when spreads are tight (below the median).

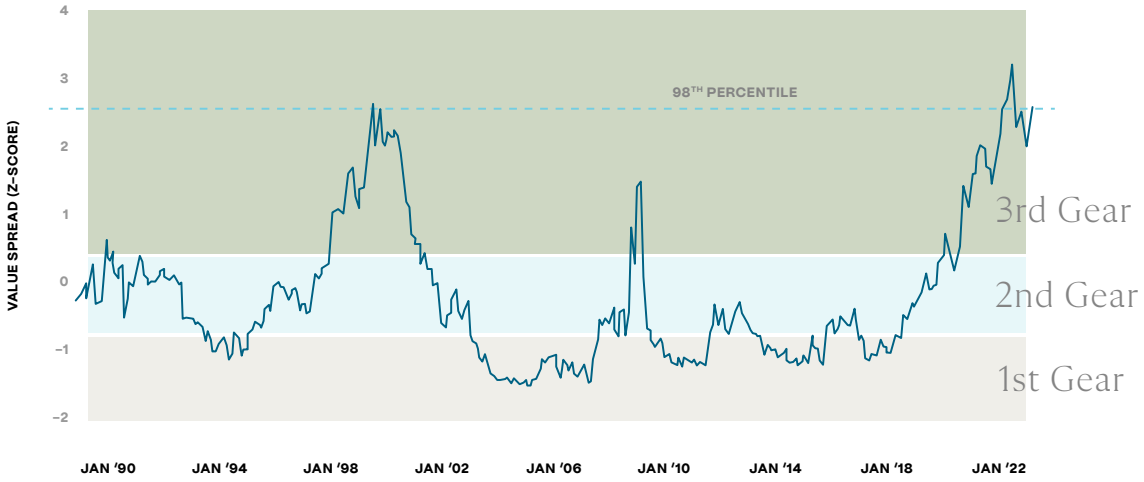
SUBSEQUENT 5-YEAR RETURN DIFFERENCE BETWEEN VALUE AND GROWTH (%)

| MONTHLY VALUATION SPREAD | TOTAL MARKET |
|---|---|
| Below Median | 0.56 |
| Above Median | 3.95 |
| All Periods | 2.21 |

*Data from 12/31/1979 – 12/31/2019. Periods greater than one year have been annualized. Past performance is no guarantee of future results. Returns are represented by Russell size and valuation indices. Source: Avantis Investors, Morningstar, Russell.*

# Sin a Little

As seen in the chart above, the value premium is always positive regardless of the valuation spread. Always. Translation: it never makes sense to tilt to growth. However, the value premium is much bigger when spreads are wider. An investor is paid much more for taking value risk when spreads are wider. Thus, if an investor tilts slightly more to value when valuation spreads are wider, they can capture a higher expected return. In turn, when the expected premium is lower, an investor can tilt less to value (but still maintains a value tilt) and takes less tracking error.




To use a racing analogy, rather than always being stuck in second gear and not reacting to what market prices are telling us, an investor can change gears when it is appropriate to capture the value premium when they are paid more for it and reduce tracking error when the bang for the buck is not as great.

Importantly, this is not an investment strategy that asset managers can pursue when they have a large AUM. Why? It is too expensive and time-consuming to trade in and out of value in a cost-effective way. However, with lower AUM, executing this strategy can be accomplished without trading costs adversely impacting the premium trying to be captured.

This 'passive-aggressive' approach is what sets this approach apart. By adapting to valuation spreads, one doesn't just passively ride the market waves; they strategically position themselves to capture more of the value premium when it's most rewarding. This nuanced strategy attempts to deliver a smarter, more effective form of evidence-based investing that truly maximizes expected long-term returns.