THE BRANDES INSTITUTE

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International Large-Cap Stocks: Is Value in the Early Stages of Recovery?

In his 1949 book The Intelligent Investor, *Benjamin Graham observed that the market tends to overvalue stocks of companies which are "glamorous" for some reason, such as having high growth rates, and undervalue stocks of companies facing temporary challenges. Since then, there have been numerous studies of the performance of value versus glamour stocks, including the seminal 1994 study "Contrarian Investment, Extrapolation and Risk" by Josef Lakonishok, Andrei Shleifer and Robert Vishny (LSV). Given the compelling results of LSV's work, the Brandes Institute has been updating and expanding our analysis for more than a decade.*

Our current research shows that international large-cap value stocks recently have experienced a series of rolling five-year periods in which they have either lagged or performed broadly in line with their glamour counterparts. This is their longest stretch of weak relative performance over the 34 years for which we have studied returns. In this article, we explore the track record of value versus glamour in the international large-cap space, the reasons behind value's near-term underperformance, and evidence that a recovery in value already may have begun.

Executive Summary

- Over the long term, large-cap value stocks in non-U.S. markets have outperformed large-cap glamour stocks.
- However, over recent rolling five-year periods, international large-cap value stocks have stumbled versus their glamour peers, driven by the weak performance of European financials.
- There are signs that value's slump may be waning, and that non-U.S. large-cap value stocks may be entering a period of relative strength.

Long-Term Outperformance

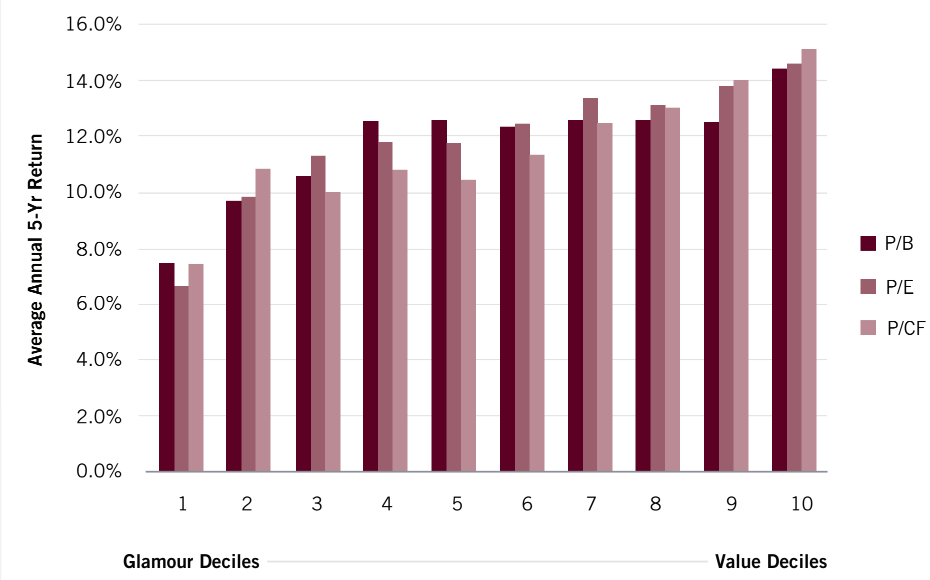
Over the past 34 years, international large-cap value stocks[1] have generated higher returns than international large-cap glamour stocks across different valuation metrics.

In the "Value vs. Glamour: A Long-Term Worldwide Perspective" study, the Brandes Institute measured the performance of value and glamour stocks across regions, market capitalizations and valuation metrics. Our most recent study covered the period from June 1980 through June 2014.

Exhibit 1 shows that, over this entire period, large-cap value stocks in 22 developed countries outside the United States outperformed large-cap glamour stocks. Value's outperformance, or the value premium, was evident regardless of the valuation metric used to classify securities—whether price-to-book (P/B), price-to-earnings (P/E) or price-to-cash flow (P/CF) ratios.

[1] For our study of international large-cap stocks, we pulled all stocks from the Worldscope database (via FactSet) in 22 developed countries outside the United States. For a complete list of these countries, see Appendix A in "Value vs. Glamour: A Long-Term Worldwide Perspective." After this initial screen, we excluded the smallest 50% of companies in terms of market capitalization to create what we believed to be a more investable universe. This left us with 3,081 companies as of June 30, 2009 (the construction date of our most recent groups of deciles). Then, we grouped the largest 30% of the remaining companies in a large-cap segment and assigned the smallest 70% to a small-cap segment. This segmentation left 925 international large-cap stocks for study.

Exhibit 1: Value Outperformed Glamour Regardless of Valuation Metrics
Rolling 5-Year Annualized Returns of Valuation Deciles, International Large-Cap Sample, 1980-2014



Source: Worldscope via FactSet, Brandes Institute, as of 6/30/2014. Past performance is not a guarantee of future results. Stocks were divided into deciles based on their fundamentals (e.g., P/B, P/E and P/CF).

Short-Term Underperformance

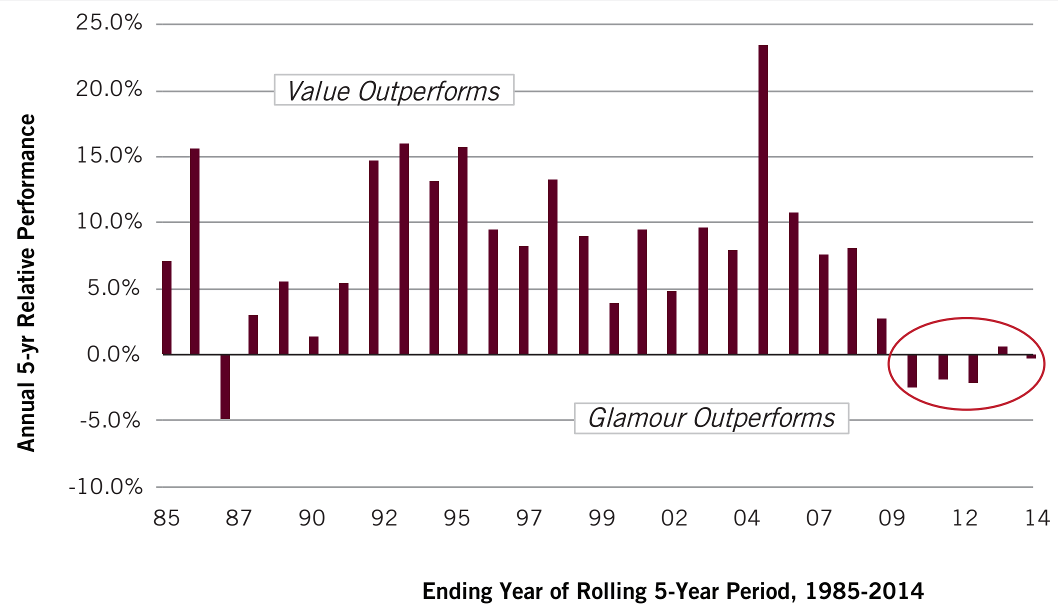
While outperforming over the long term, international large-cap value stocks either trailed international large-cap glamour stocks or produced similar returns over recent rolling five-year periods.

In Exhibit 2, we subtracted the five-year returns of decile 1—the extreme glamour decile—from the returns of decile 10, the extreme value decile. Value dominated in all but one five-year period from 1985 through 2009 but then lagged glamour by approximately 2.0% (annualized) in each of the rolling five-year periods ending in June 2010, 2011 and 2012. Value's performance versus glamour was essentially flat in the two subsequent 5-year periods ending in June 2013 and 2014.

Results were similar when looking beyond the extreme glamour and value deciles. In the vast majority of rolling five-year periods from 1985 through 2009, deciles 8-10—the top value deciles—generated higher returns than deciles 1-3, the top glamour deciles. The top glamour deciles then trumped the top value deciles in each of the five-year periods ending in June 2010, 2011 and 2012 by anywhere from 2.0% to 2.7% (annualized). For the 5-year periods ending in June 2013 and 2014, the top three glamour and value deciles performed broadly in line with one another.

Exhibit 2: Value Has Recently Struggled Versus Glamour

Annualized Rolling 5-Year Relative Performance of P/B Deciles, International Large-Cap Sample, 1980-2014



Source: Worldscope via FactSet, Brandes Institute, as of 6/30/2014. Past performance is not a guarantee of future results. Rolling periods represent a series of overlapping, smaller time periods within a single, longer-term time period. For example, over the 34-year period covered by the most recent Brandes Institute "Value vs. Glamour" study, there is one 34-year rolling period, twenty-five 10-year rolling periods, and thirty 5-year rolling periods.

Short-Term, *Concentrated* Underperformance

The underperformance of non-U.S. large-cap value stocks was concentrated in three 12-month periods.

The recent rolling five-year periods in which decile 10 value stocks either lagged or performed in line with decile 1 glamour stocks encompassed the nine 12-month periods shown in Exhibit 3. Significant underperformance in the 12-month periods ending in June 2008, 2011 and 2012 drove value's weak rolling five-year results.

Exhibit 3: In Three, 12-Month Periods, Value Substantially Trailed Glamour
Annual Returns of P/B Deciles, International Large-Cap Sample, 2006-2014

	ONE-YEAR RETURNS		
12 MONTHS ENDING	DECILE 10 VALUE	DECILE 1 GLAMOUR	DIFFERENCE VALUE-GLAMOUR
6-30-2006	30.25	23.26	6.99
6-30-2007	31.32	30.99	0.33
6-30-2008	**-13.12**	**0.36**	**-13.48**
6-30-2009	-32.34	-31.09	-1.25
6-30-2010	12.21	15.52	-3.31
6-30-2011	**22.41**	**32.95**	**-10.54**
6-30-2012	**-28.41**	**-6.10**	**-22.31**
6-30-2013	32.74	21.27	11.47
6-30-2014	35.75	21.37	14.38

Source: Worldscope via FactSet, Brandes Institute. Past performance is not a guarantee of future results.

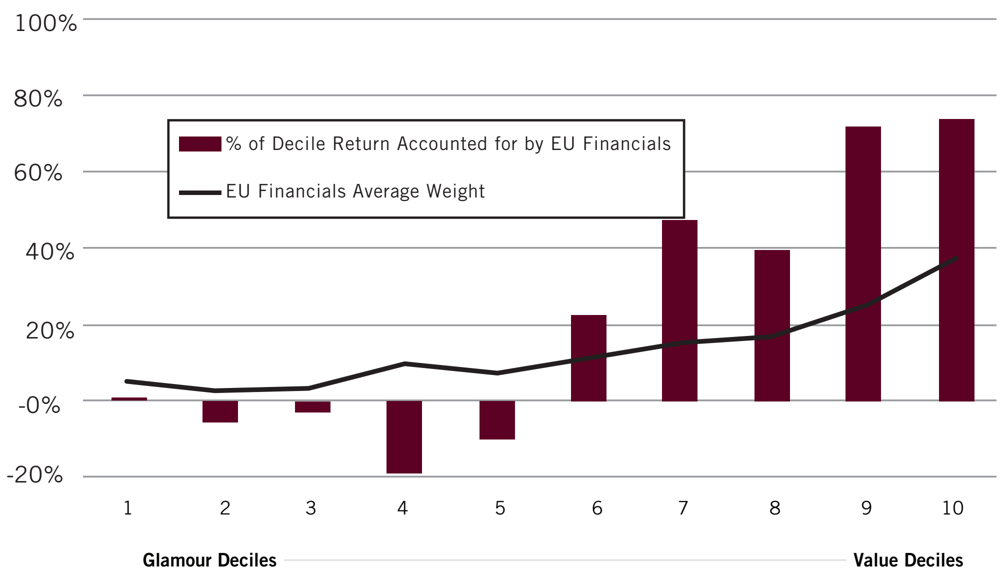
European Financials

European financials, which are heavily represented in the value deciles, played a central role in the underperformance of value versus glamour during these three 12-month periods.

Within the international large-cap segment, the performance of European financial stocks goes a long way in explaining why value trailed glamour in each of the 12-month periods ending in June 2008, 2011 and 2012. As shown in Exhibit 4, European financials represented a substantial percentage of the top value deciles and had an even greater impact on returns than their weight would imply. So as went European financials, so went the value deciles, and European financials—especially banks—performed very poorly on a relative basis; see Exhibit 5.[1]

[1] According to MSCI's Global Industry Classification Standard (GICS®), the financials sector contains companies involved in banking, thrifts & mortgage finance, specialized finance, consumer finance, asset management and custody banks, investment banking and brokerage and insurance. This sector also includes real estate companies and REITs. In contrast, when we reference 'banks,' we are referring only to companies engaged in banking.

Exhibit 4: European Financials Dominated the Value Deciles …
EU Financials' Weight Within P/B Deciles and Percentage of Decile Returns Driven by EU Financials; International Large-Cap Sample; 2008, 2011 and 2012



Source: Worldscope via FactSet, Brandes Institute. Past performance is not a guarantee of future results.

Exhibit 5: … And Relative Returns of European Financials Were Generally Poor
Annual Returns of P/B Deciles; 2008, 2011 and 2012

	ONE-YEAR RETURNS		
12 MONTHS ENDING	INTERNATIONAL LARGE-CAP UNIVERSE	DECILE 10 EUROPEAN FINANCIALS	DECILE 10 EUROPEAN BANKS
6-30-2008	-9.33	-19.91	-29.82
6-30-2011	30.25	23.21	2.44
6-30-2012	-15.01	-42.36	-55.15
6-30-2009	-32.34	-31.09	-1.25

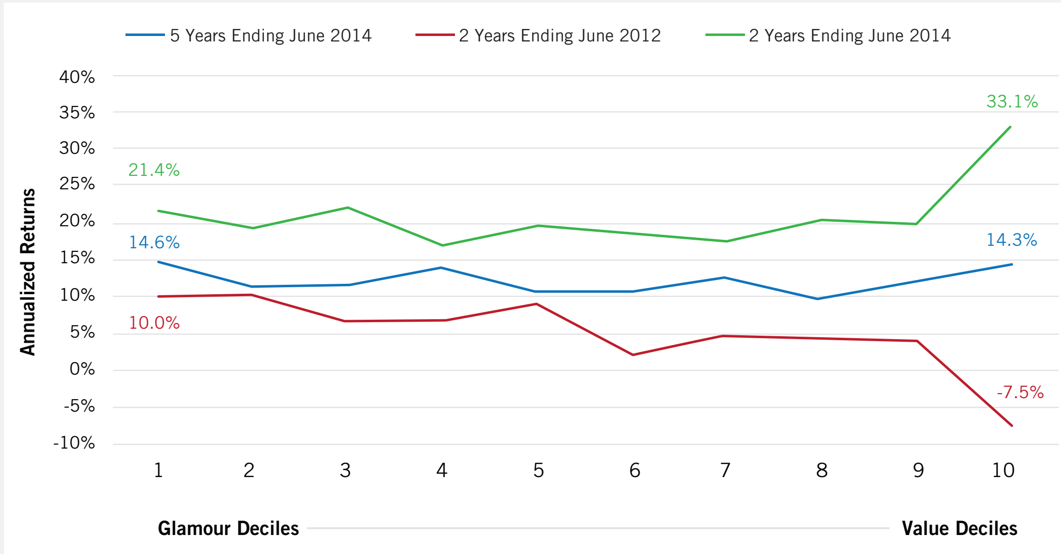
Source: Worldscope via FactSet, Brandes Institute. Past performance is not a guarantee of future results.

The Value "Runway"

A rebound in relative performance, attractive valuations and the possibility of mean reversion suggest that the cycle may be turning in favor of value.

Decile 10 value stocks outpaced their glamour brethren by double digits in each of the 12-month periods ending in June 2013 and 2014, as previously shown in Exhibit 3. Exhibit 6 illustrates that these two years of good relative performance have helped neutralize the two unusually bad years ending in June 2011 and 2012. As a result, decile 10 value underperformed decile 1 glamour by a modest 0.3% during the five years ending in June 2014.

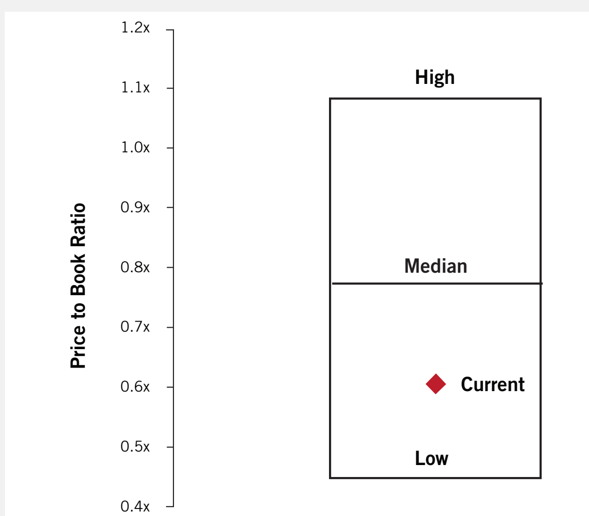
Exhibit 6: Value Has Led Glamour Over the Last Two Years
Annualized Returns of P/B Deciles, International Large-Cap Sample



Source: Worldscope via FactSet, Brandes Institute. Past performance is not a guarantee of future results.

In addition to recent strong relative returns, valuations are another reason for optimism about the near-term prospects for non-U.S. large-cap value stocks, as shown in Exhibit 7. There have been only three prior periods since 1980 when decile 10 international large-cap value stocks were this attractively valued on a P/B basis. In the five years following each of these periods, this group of stocks delivered an impressive 21.0% annualized return.

Exhibit 7: Value Stocks Are Trading Well Below the Historical Median
Price-to-Book Ratio of Decile 10 Value Stocks, International Large-Cap Sample, 1980-2014

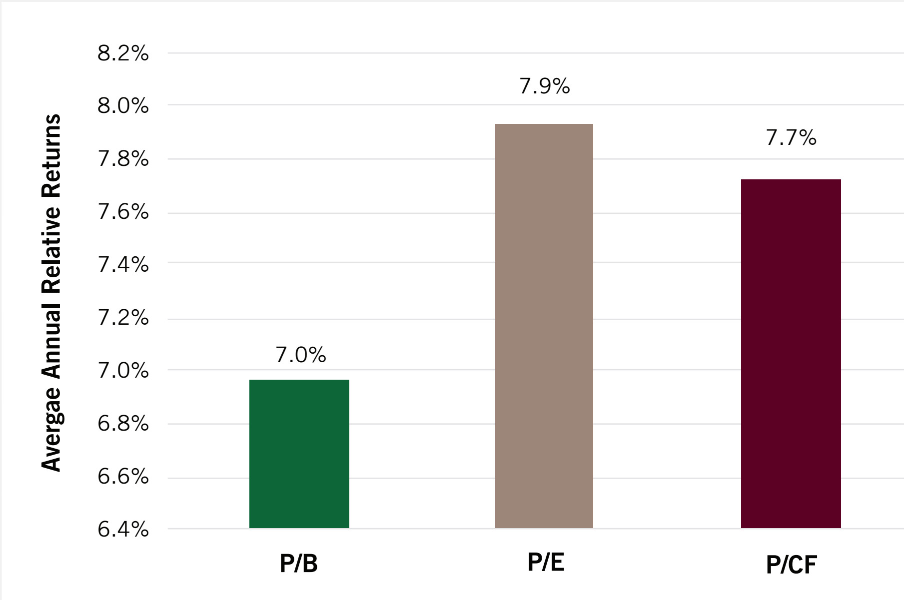


Source: Worldscope via FactSet, Brandes Institute. Current value is as of 6/30/14.

Lastly, following the longest stretch of value underperformance during the 34 years for which we have studied returns, could the style cycle be poised for a reversion to the mean? Of course, it is important to note that the "mean" in this case does not suggest a zero-sum game. In fact, Exhibit 8 shows that, from June 1980 through June 2014, the mean is synonymous with annualized outperformance in the range of 7.0% to 7.9% for decile 10 international large-cap stocks over their decile 1 glamour peers.

Exhibit 8: Reversion to the Mean Includes the Value Premium

Average Annualized Relative Returns—Decile 10 Value Minus Decile 1 Glamour, International Large-Cap Sample, 1980-2014



Source: Worldscope via FactSet, Brandes Institute as of 6/30/2014. Past performance is not a guarantee of future results.

Conclusion

Although we can't predict performance, international large-cap value stocks appear to be in the early stages of recovery, perhaps offering an opportunity for investors to consider establishing an allocation or increasing their existing exposure.

Over recent rolling five-year periods, international large-cap value stocks either trailed international large-cap glamour stocks or produced similar returns. Their performance was adversely affected by the weak relative results of European financials, which tend to be value stocks. However, value appears to be making a comeback versus glamour, having significantly outperformed in the 12-month periods ending in June 2013 and 2014. While past performance is not a guarantee of future results, value could continue to outperform given inexpensive valuations relative to history and the possibility of reversion to the mean—the mean being the premium international large-cap value stocks historically have commanded versus their glamour counterparts.

(You can download Value vs. Glamour: A Long-Term Worldwide Perspective at brandes.com/institute.)

Past performance is not a guarantee of future results.

Price/Book: Price per share divided by book value per share.

Price/Earnings: Price per share divided by earnings per share.

Price/Cash Flow: Price per share divided by cash flow per share.

International and emerging markets investing is subject to certain risks such as currency fluctuation and social and political changes; such risks may result in greater share price volatility.

Unlike Treasury securities, stocks are not backed by the full faith and credit of the United States and will experience market fluctuations.

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