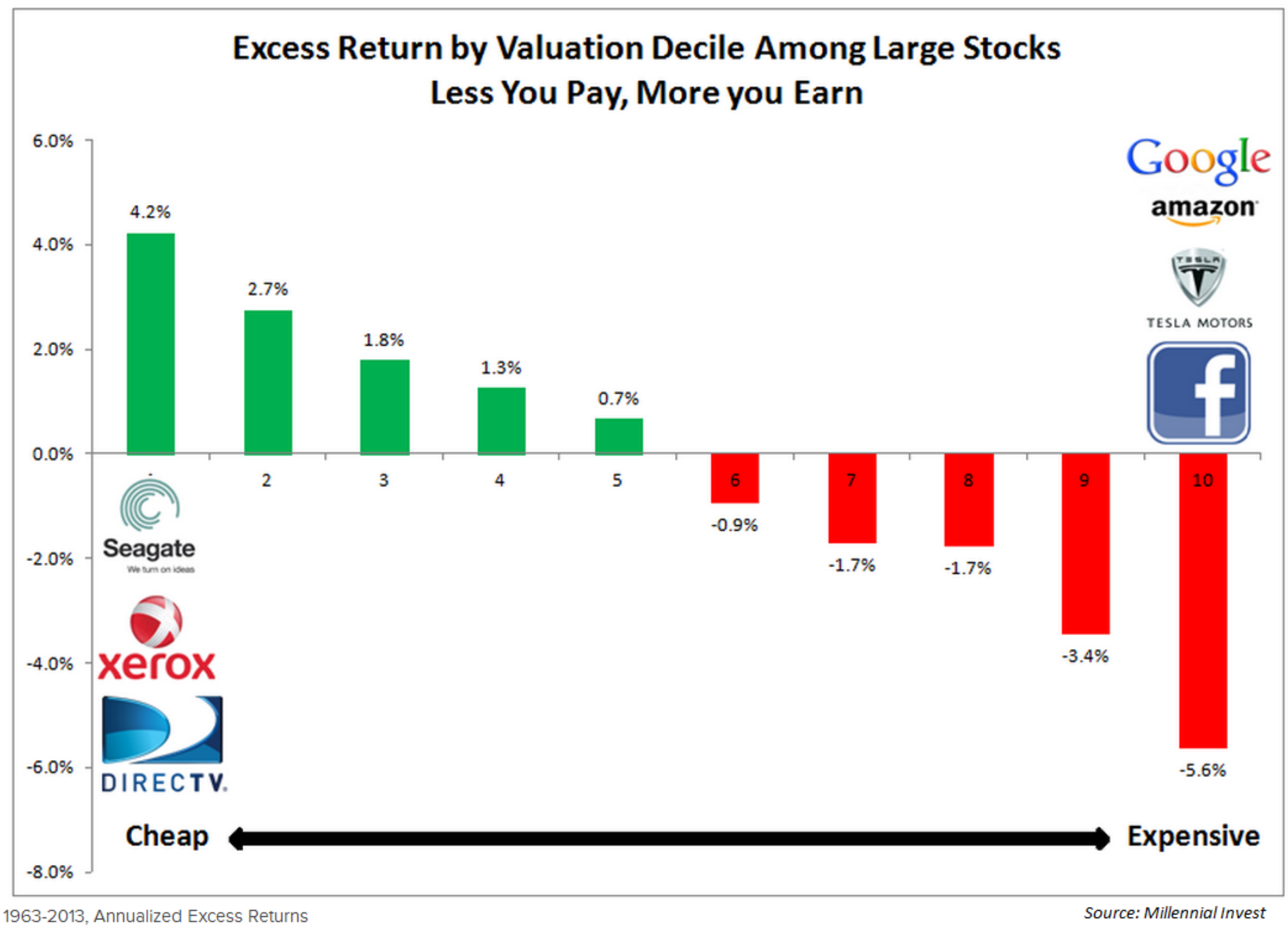
Why Aren't There More Value Funds?

> "Value investors are not concerned with getting rich tomorrow. People who want to get rich quickly, will not get rich at all. There is nothing wrong with getting rich slowly." – Warren Buffett

As we've discussed previously, value investing has been shown to outperform over longer cycles historically. Here's a nice chart from Patrick O'Shaughnessy at Millennial Invest that shows the value premium over time:



So companies with lower valuations have given investors a performance boost over the higher valuation companies. This is a well-known fact to most professional investors.

Oddly enough, this dynamic hasn't translated into the world of mutual funds. I ran the Reuter's mutual fund screener to break out the total number of U.S. value and growth stock funds . Here are the results:

Number of Mutual Funds			
	Value	Growth	Growth Advantage
U.S. Large Cap	484	722	49%
U.S. Mid Cap	220	407	85%
U.S. Small Cap	286	548	92%
Totals	990	1,677	69%

Source: Reuters

Overall there are roughly 70% more growth funds on the market than value funds. So why is this the case if value investing has been shown to be the better performer over time?

Here's Howard Marks on value investing from *The Most Important Thing:*

Value investors buy stocks (even those whose intrinsic value may show little growth in the future) out of conviction that the current value is high relative to the current price.

Growth investors buy stocks (even those whose current value is low relative to their current price) because they believe the value will grow fast enough in the future to produce substantial appreciation.

The choice isn't between value and growth but value today and value tomorrow. Growth investing represents a bet on company performance that may or may not materialize in the future, while value investing is based primarily on analysis of a company's current worth.

Value stocks tend to be boring. Many are stodgy dividend-paying companies while others may have hit a rough patch and sold off. Basically, buying growth is sexier than buying value. Growth investing usually centers on exciting industries, revolutionary products and the potential for a home run.

It's much easier to build a narrative around growth stocks. Since Wall Street runs on earning fees they will generally push products that are easier to sell. Mutual fund consumers can buy into the growth story but value investing is a much harder sell. Most average investors need that story to invest to rationalize their decisions.

And many times growth stocks do perform better than value stocks for long stretches of time.

Famed value investor Joel Greenblatt once said, “If value investing worked every day and every month and every year, of course, it would get arbitraged away, but it doesn't. It works over time, and it's quite irregular.”

The reason value investing works over the *long-term* is because many times it doesn’t work over the intermediate term. In fact, growth has outperformed value by most measures over the past 5 and 10 year periods through the end of March (but the tide is slowly starting to turn in value's favor).

Of course not every single mutual fund invests in the same value investing framework as Marks or Buffett and not all growth funds buy only the most expensive names. These are simply style boxes they have been put into based on their portfolio characteristics. Plus these aren't the only two investing styles that work.

Even though it's been easier to sell growth up to this point, this trend won’t last forever. With the rollout of smart beta funds I expect the gap between growth and value funds to narrow substantially since most smart beta funds are tilted towards value stocks. Smart beta works as a great narrative as well.

If this story follows past cycles, value will become a huge hit with investors right before it goes through an inevitable rough patch. That’s when the patience of the true long-term investors will be tested and the performance chasers will lose yet again.

Sources:
The Most Important Thing
Lao **Tsu Can Make You a Better Investor (Millennial Invest)**

Now onto the best stuff I've been reading this week:

- Understanding the smart beta debate (**Prag Cap**) and how to evaluate your portfolio whether it's smart beta or not (**Millennial Invest**)
- It's no ones fault but your own if you're not saving (**WSJ**)
- How to think about the huge gains in the stock market going forward (**Washington Post**)
- For most average investors cookie cutter portfolios work just fine (**Oblivious Investor**)
- Avoid portfolio managers touting it's a "stock picker's market" at all costs (**Pension Partners**)
- Why do Americans think housing is such a good investment (**Prag Cap**)
- Why you need to get rid of the ad-hoc decisions in your portfolio (**Turnkey Analyst**)
- Try harder or doing something easier? (**Abnormal Returns**)

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