Value Investing + Relative Strength = Higher Returns

One needs to look no farther than Warren Buffett to see that value investing works. Many others have applied these same principles to amass lesser, but still sizable, fortunes. But despite its successes, this strategy is challenging for many investors to follow because it can take a great deal of time for the market to recognize that a particular stock's valuation is too low.

At other times, stocks that appear cheap keep on declining due to fundamentals that continue to deteriorate. As such, fundamental analysts should consider adding a simple technical tool to their stock selection criteria to help them to avoid these common "value traps": relative strength. Read on to find out how to combine this discipline with a value investing strategy for superior results.

Value in the Stock Market

Fundamental analysts use the data available in a company's financial statements to determine a theoretically fair price for a company's stock. When the market price is lower than the fair value, these analysts rate the stock a "buy". Specific criteria they look at includes common items like the price-to-earnings ratio (PE ratio) or dividend yield, as well as more obscure ratios such as the price-to-cash-flow ratio.

Quite a few studies have been done by the academic community to determine whether value investing works. To complete these studies, researchers usually divide the universe of stocks into different groups based solely on different valuation-based ratios. These studies consistently demonstrate that value investing works well and generally outperforms the market averages over the long term.

Among the first studies was a paper published by Eugene Fama and Kenneth French in 1992 called "The Cross-Section of Expected Stock Returns". This study showed that stocks with low price-to-book (PB) ratios have higher average annual returns than growth stocks, which are defined as those with high PE ratios.

To implement a value investing methodology, an investor could buy a group of stocks with the lowest PE ratios from a broad index like the S&P 500. In theory, market-beating results are achievable over longer time horizons because eventually, the market will realize that these stocks are underpriced, and as more investors recognize this fact the stock price will increase.

Our members turned $1k to $10k with Penny Stocks!

The Value Trap

While a stock with low valuation may be an undiscovered gem, it may also be a company racing toward bankruptcy. Famed investor Peter Lynch summarized this situation with a single question, "If it's gone down this much already, how much lower can it go?" The answer, he noted, is that any stock can fall to zero. Determining the future prospects of a company is one of the core challenges confronted by value investors.

This dilemma is the value trap. Value investing requires a long-term time horizon because the investor is betting that the market will eventually recognize the mispricing.

It may take years for the market to find this value and the stock can stay priced at these undervalued levels for extended periods. While dividends provide some measure of comfort to many investors, by tying up their capital in a stock that's going nowhere, even value investors are missing out on better opportunities to profit. (To learn more, read *Value Traps: Bargain Hunters Beware!*)

Timing Value-Based Buys

In "What Works on Wall Street" (1998), James O'Shaughnessy tested more than 60 investment strategies involving various fundamental criteria. His results showed that some fundamental filters beat the stock market as a whole. His test period began with data from 1951 and ran through 1996. For this test, the portfolio consisted of the top 50 stocks determined by the criteria and was revised annually. A summary of these test results is in Figure 1. He found that the price-to-sales ratio (P/S) offered the best results.

Strategy	Average Annualized Return without Relative Strength
Low P/E Ratio	11.18%
Low P/B Ratio	14.38%
Low P/S Ratio	15.42%

--	--
Market Average	14%

Figure 1: These results show that value investing can work, even when applied in its simplest form.

O'Shaughnessy also tested each of these filters with relative strength. The idea behind relative strength is to find the strongest stocks, or the ones that are going up the most in price. For these tests, O'Shaughnessy calculated relative strength by looking at the stocks' returns over the past year. Those with the greatest returns and the lowest fundamental valuations were selected for the portfolio. These results are shown in Figure 2. (For more insight, see *Buy High And Sell Low With Relative Strength*.)

Strategy	**Average Annualized Return without Relative Strength**	**Average Annualized Return with Relative Strength**
Low P/E Ratio	11.18%	16.66%
Low P/B Ratio	14.38%	17.27%
Low P/S Ratio	15.42%	18.14%

Figure 2: These results demonstrate how relative strength can be combined with value investing to improve performance, as all three strategies outperformed the broad market\'s 14.77% annualized return.

The results that O'Shaughnessy obtained demonstrate the importance of testing market wisdom. The P/E ratio is the most widely followed fundamental measure of a stock's value, and is frequently mentioned by commentators when they discuss a stock. Of the three ratios tested, it delivered the worst performance. The returns obtained from using only the P/E ratio to make investment decisions actually trailed the market.

O'Shaughnessy found that using only relative strength to select stocks also beat the market. The 50 stocks with the highest rate of change were held in a portfolio that was reviewed annually. While superior to the market return, Figure 2 shows that combining relative strength with fundamental filters may provide even better results. Buying the strongest stocks with the best valuation ratios clearly beat the market.

Conclusion

Value investing has been shown to work. Adding relative strength to this investing style can improve returns by buying value stocks that are currently moving higher. This timing element improves returns by avoiding the problem of waiting for the market to recognize the undervaluation. Applying this straightforward approach can greatly minimize the risk of value investing.

Try Our Stock Simulator!
Test your trading skills!

by Michael Carr

Mike Carr, CMT, is a member of the Market Technicians Association and editor of the MTA's newsletter, *Technically Speaking*. He is a full-time trader and writer.