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Value Clustering a Bullish Sign for Stock Pickers

Lost in the noise of a strong bull market is the widening gap between low-multiple and high-multiple stocks. During October, Frank Value Fund holdings reported increased earnings, but many of our stock prices trailed the broader indexes. As a result of cheap stocks getting cheaper, our current holdings list is clustering in the bottom decile of stocks based on our valuation and quality metrics, and this phenomenon is often a harbinger of significant outperformance. Normally, as ideas work out and multiples expand, a material portion of the portfolio trades outside of the bottom decile. However, our net selling in Q3, as well as opportunistic purchases of four value stocks in October has contributed to this clustering. Clustering means quality value is not only being ignored but also penalized. With solid earnings and low valuations, our holdings are rare opportunities in an increasingly more expensive stock market. When clustering is present, we believe it is an attractive buying opportunity, especially considering the higher valuations of popular indexes like the S&P 500 and the Russell 2000.

Investors focused on the ridiculous valuations of recent Initial Public Offerings are rightly appalled, but instead of avoiding all stocks, opportunity can be found in less ballyhooed companies. Of the four value stocks we purchased in October, three were great growth companies experiencing temporary problems a few years removed from their IPOs. Once the investment bankers leave the scene, IPOs often decline significantly in price. Price declines sometimes are the result of slowing growth or strategic missteps, but these can be fixable issues, especially if the underlying company retains its competitive advantage. In 2013, possessing a negative YTD return frightens investors enamored with high broader market returns. On top of ugly charts, these “broken” IPOs have short public trading histories, making them unappealing to investment committees with rigid criteria. Competition to purchase these names is low. Fewer natural buyers means the price has come down to attract new capital. Investors who can look past these issues will see solid businesses trading at low valuations with bright futures full of growth opportunities. Compare that to slow or negative earnings growth on many S&P 500 companies or nose-bleed valuations on numerous small and momentum stocks, and you can understand our optimism when it comes to buying and holding specific companies.

Some stocks are cheap but all indexes are not. Investors looking to the equity markets for superior long term returns must pick their spots carefully. Our experience shows that a select few value stocks are attractively priced while considering a reversion to the mean in profit margins and completion of the current business cycle. Data from Kevin Simms of AllianceBernstein also confirms our findings. According to Simms, the gap between the top and bottom quintiles based on P/B ratios is still 45% above typical trough levels. This spread can contract in two ways, value stocks outperform or “glamor” stocks underperform. We believe both could occur simultaneously, bringing pain to indexers and momentum-chasers alike. Opportunities remain for those focused on valuation and fundamentals.

Since October 1st, the Frank Value Fund has purchased new positions in:

SAIC – Science Applications International Corporation
PFMT – Performant Financial Corporation
VRA – Vera Bradley
VSI – Vitamin Shoppe

Source:http://www.institutionalinvestor.com/Article/3271753/The-Value-Returns-to-Value-Investing.html?ArticleId=3271753#.UoFAoBAudNd