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STRATEGIES

The Value-Stock Advantage May Be Just a Mirage

By MARK HULBERT

Many investors think that they know how to tell a value stock from a growth stock. Yet the distinction is actually very difficult to define.

It has not always been that way. Benjamin Graham, the generally recognized father of value investing from the middle of the last century, had a clear definition of a value stock: it trades for less than two-thirds of net current assets a share.

Net current assets are total current assets minus all liabilities. A company that meets the Graham definition thus gives investors the chance to buy a dollar's worth of current assets for less than 67 cents. Not a bad deal, if you can get it.

These days, you rarely can. Many companies in Mr. Graham's day satisfied his definition, but in recent decades it has been unusual for even a handful to do so.

But that does not necessarily mean that value investors have left the market. Instead, many of them have relaxed the Graham standard in recent decades.

Rather than focusing on current assets of a company, they have zoomed in on book value, which is less restrictive because it also includes noncurrent assets. These investors have also become relativists; to them, value stocks are simply those in the bottom half of companies ranked by price-to-book ratios.

As a result, some stocks now qualifying as "value" would be surprises to Mr. Graham. Consider [Veritas Software](#), which is part of the Standard & Poor's 500/Barra Value Index. Despite having a price-to-book ratio of 2.54, a number that would be high by Graham's standards, Veritas nevertheless makes the list because that number still falls in the lower half of the market.

Relaxing the Graham standards would not be a problem if the definitions in use were helpful. But some academics are dubious because, when defined in terms of relative book value, value stocks do not perform significantly differently over the long term than growth stocks do.

This result runs counter to research conducted by Eugene Fama of the University of Chicago and Ken French of Dartmouth, showing that, since 1927, stocks with the very lowest price-to-book ratios have done several percentage points a year better than those with the very highest ratios.

According to Tim Loughran, a finance professor at the University of Notre Dame, the bulk of this difference can be traced to the value stocks' January performance, which he calls a fluke. Professor Loughran says that this strong performance is caused by tiny companies, whose stocks typically trade near their bid prices at year-end, because of tax-loss selling, and nearer to their asked prices in January.

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To get a more accurate picture of value and growth, he suggests eliminating January from the picture. In all other months over the last 75 years, value outperformed growth by an average of just 15 hundredths of a percentage point. Professor Loughran suspects that after taking commissions and bid-asked spreads into account, this advantage is not enough to be meaningful.

If value does not really beat growth over the long run, how do researchers account for the huge difference in their performances over the last two and a half years? Andre Shleifer of Harvard and Nick Barberis of the University of Chicago have an answer: All it takes for the growth and value styles to swing in and out of favor is for investors to think that there is a genuine difference between them. An actual, objective difference is not necessary.

The new research has this implication: If the gyrations of growth and value are not based in reality, they inevitably will correct themselves. Stocks become good candidates for purchase as investors shun them in favor of whatever is in style.

A more basic lesson is this: Don't blindly accept categories created by others. If you can't make sense of them, think twice before basing investment decisions on them.

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