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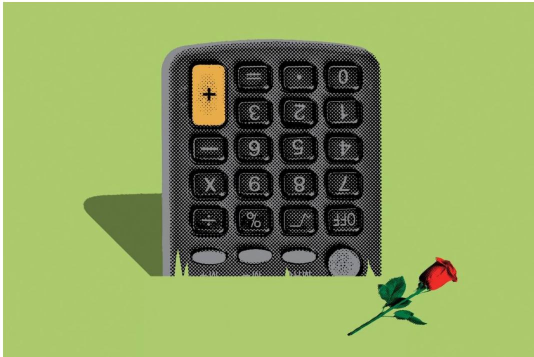
Why the Traditional Way of Measuring 'Value' Stocks May Be History

Some argue that the price-to-book-value ratio has lost its relevance due to the increasing significance of intangible assets



Should the traditional way to measure 'value' stocks be sent to the graveyard? **PHOTO:** OLIVER MUNDAY FOR THE WALL STREET JOURNAL

By Mark Hulbert

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Is "value" dead? Or have we just been measuring it in the wrong way?

It's an urgent question, because value stocks—when defined according to the traditional criterion, low price-to-book-value ratios—have lagged behind growth stocks for at least a decade now. And though value stocks in the past have come roaring back after going through similarly long periods of lagging, some researchers are questioning whether they will do so again.

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That's because a growing percentage of companies' market value now comes from intangible assets—things like patents, trademarks and research-and-development expenditures—that are either ignored in the book-value calculation or reflected inconsistently. Therefore, the researchers say, the price-to-book ratio has lost its relevance.

If they are right, we can't expect stocks with the lowest such ratios to reassert their historical dominance over stocks with the highest ratios. And it may call for using a new measure that more accurately measures value, once again allowing investors to feel comfortable about following a value strategy.

What is clear is that value as a stock-picking style has been a laggard in recent years. Over the past decade, growth stocks (as presented by the 50% of stocks with the highest price-to-book ratios) beat value by 1.9 annualized percentage points, according to data from Dartmouth College Prof. Kenneth French. That's a huge reversal from the previous eight decades, during which value (the 50% of stocks with the lowest price-to-book ratios) beat growth by 4.6 annualized percentage points.

There also can be little doubt that intangibles have grown in importance. According to Ocean Tomo, an intellectual-property consulting firm, 84% of the S&P 500's market capitalization now comes from intangible assets, up from just 17% in 1975.

Losing relevance

Baruch Lev, a professor of accounting and finance at New York University, is one of those arguing most forcefully that the increasing significance of intangible assets is the leading cause of book value's loss of relevance. He says that the accounting treatment of intangible assets—under GAAP, or generally accepted accounting principles—is both outdated and inconsistent: When a company invests in developing patents, its brand or efficient business processes, for example, GAAP requires that the investment be treated as an expense rather than as an asset. But if the company buys an intangible asset instead of generating it internally, then GAAP calls for it to be listed as an asset on its balance sheet.

"Every aspect of the financial report is adversely affected by this dated, industrial-age treatment of intangible capital," Prof. Lev argued in his 2016 book, "The End of Accounting and the Path Forward for Investors and Managers," co-written with Feng Gu, a professor of accounting and law at the University at Buffalo. "And given the likely continued rise in the role of intangibles in corporate value creation, the decline in the usefulness of financial reports is all but certain to persist."

To be sure, not everyone is ready to write the price-to-book ratio's obituary. In an interview, Kent Daniel, a finance professor at Columbia University and a former co-chief investment officer at Goldman Sachs, acknowledges that GAAP's treatment of intangible assets leaves much to be desired. But he says the price-to-book ratio has always been an imperfect and noisy measure of a firm's value. For example, book value has never "captured the value of a firm's growth prospects at all." So its failure to fully and accurately reflect the value of intangible assets doesn't necessarily mean that it isn't able to do a decent job differentiating between underpriced and overpriced stocks.

In fact, Prof. Daniel says some researchers have found that the book-to-value ratio actually does a better job differentiating among companies that have spent the most on R&D than with firms that spend the least. Investment in R&D, of course, is one of the most significant categories of intangible assets.

Another clue that the price-to-book ratio may still be relevant comes when using it to forecast the S&P 500's return over the subsequent 10 years. Its record since 1975 has been better than it was over the prior five decades.

Book value's problems

If the price-to-book ratio is still somewhat effective, then why has value lagged behind growth in recent years?

One answer comes from a study set to appear in the Journal of Financial Economics. Ray Ball, an accounting professor at the University of Chicago and a co-author, says the source of the deterioration is that book value has come to be dominated by one of its two main components.

This offending category is "contributed capital," or the sum of all of a company's past equity issuances, less share repurchases. Though a ratio of price to contributed capital per share has never had much predictive value, this didn't affect the effectiveness of the price-to-book ratio so long as contributed capital represented a small share of book value, Prof. Ball says. But as it has grown to be a larger share, the price-to-book ratio has lost much of its relevance.

The other major component of book value is retained earnings, and Prof. Ball says that a ratio of price to retained earnings per share remains as effective an indicator as ever in predicting stock returns. His recommendation to investors who have been relying on the price-to-book ratio is to focus instead on this modified ratio based on retained earnings.

Prof. Ball's recommendation points to a broader theme shared by many value-oriented advisers: "Value" is better seen as a reflection of many different indicators rather than of just book value alone. In a 2015 study in the Journal of Portfolio Management, Clifford Asness, founding co-principal of AQR Capital Management, along with three colleagues, mentioned the ratios of price to earnings, dividend, cash flow and sales. The study found that a composite

value indicator based on these many different measures produced better risk-adjusted returns than the price-to-book ratio alone.

A long wait

Regardless of how value has been defined, however, the fact remains that value stocks on average have performed dismally over the past decade. But Prof. Daniel reminds us that value in the 1990s went through a similarly long period in which it lagged behind growth, and then—following the bursting of the internet-stock bubble—came roaring back.

“I would guess that something similar will occur in the future, but I’m not sure,” he says, “and I’ve been wrong for a long time now!”

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