Value Stocks Are Hot—But Most Investors Will Burn Out

"Most people aren't cut out for value investing, because human nature shrinks from pain," the money manager Jean-Marie Eveillard told me this past week. His words are a reminder that making money on cheap stocks—the goal of every value investor—is harder than it sounds and can take years to play out.

Lately, value investing has seemed easy. Over the past year, the Russell 1000 Value Index, a yardstick of cheap stocks with sluggish expected earnings, is up 19%, compared with 11% for pricier "growth" stocks and 15% for the full Russell 1000 index of big U.S. stocks. The public has started to notice: Mutual funds specializing in large value stocks took in $2.4 billion in January.


Christophe Vorlet

But as Mr. Eveillard warns, the long-term rewards don't go to people who think value investing is easy. Superior returns can be earned only by those who know that it is hard—and stay put.

Take it from Mr. Eveillard. From 1979 through 2004, he was the lead manager of the SoGen International Fund (now First Eagle Global). Over that period, the fund earned an average of 15.8% annually, versus 11.3% for the MSCI World Index of global stocks—one of the widest and longest margins of outperformance on record.

But in the late 1990s, "new economy" stocks—think Internet startups—were hot. Mr. Eveillard owned the old economy: railway, gold-mining and Japanese insurance companies. His fund trailed the index by 25 percentage points in 1998.

"After one bad year investors were upset," he recalls. "After two they were mad, and after three they were gone." Between 1997 and early 2000, investors yanked out two-thirds of the fund's assets—and then missed out on its later years of superb performance.

The fund industry has long marketed the chimera of "consistency," the idea that a great stock picker can always earn higher returns than the market. Investors who buy into this myth often sell in a panic as soon as the next crash proves that no stock picker can always outperform.

Over the decade ended Dec. 31, value funds specializing in large stocks returned an average of 6.7% annually. But the typical investor in those funds earned just 5.5% annually, according to Russel Kinnel, director of fund research at Morningstar MORN +1.58% .

That is partly because many investors bailed out after these funds lost an average of nearly 37% in 2008; the subsequent rebound was captured only by those who stuck around. "Too many investors tend to think that [value] strategies are flawless or 'bearproof,'" Mr. Kinnel says—and then sell out in shock when they realize the strategies aren't.

Summit Street Capital Management, an investment partnership in New York, recently analyzed a group of value investors with long records of superior returns and found that even the best underperformed one-third to 40% of the time. "It's hard not to get shaken out unless you understand that and have conviction," says Summit Street partner Jennifer Wallace.

You also should understand how the present and future might differ from the past. Since 1926, value stocks have outperformed growth stocks by an average of four percentage points annually, according to the authoritative index compiled by finance professors Eugene Fama of the University of Chicago and Kenneth French of Dartmouth College.

But be warned: Today's typical value fund might not be able to deliver the superior returns generated by bargain stocks in earlier decades.

Nowadays, most value managers search for stocks that are cheap relative to current or expected earnings. The bargain stocks in the best-known Fama-French index were selected on a different measure: book value, a basic yardstick of corporate net worth.

Many stock pickers don't pay much attention to book value anymore. And while small-company returns accounted for much of the historical high returns on the Fama-French index, most managers today favor larger companies.

Value stocks also are less of a bargain than they used to be. Historically, they averaged 54% cheaper than growth stocks, as measured by prices relative to earnings, says Eric Weigel, director of research at the Leuthold Group, an investment firm in Minneapolis. Today, value is 40% cheaper.

So value might fade again before long. To be a value investor, it isn't enough to buy cheap stocks or the funds that own them. You have to stick around until the market recognizes their worth. Mr. Eveillard, now 73 years old and an adviser to his old fund, is still finding bargains in Japan and among gold-mining stocks—but he is prepared to "suffer" until the market proves him right.

—intelligentinvestor@wsj.com; twitter.com/jasonzweigwsj

Write to Jason Zweig at intelligentinvestor@wsj.com

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