Factor/Style Investing

Deep Value

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The authors define deep value as episodes in which the valuation spread between cheap and expensive securities is especially wide relative to its history. Examining global individual equities, equity index futures, currencies, and global bonds, the authors find that deep value is (1) highly compensated; (2) related to worsening fundamentals; (3) associated with higher risk but not fully explained by known risk factors; and (4) characterized by selling pressure related to overextrapolation of past returns and, although arbitrageurs take the other side, they face elevated trading costs and risk. These findings support a theory of return extrapolation driving the value risk premium over other behavioral and rational explanations.

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