Mood Ring

'Growth' And 'Value' Reflect The Market's Fast-Changing Temperament

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Growth and value investment styles have emerged over recent years as distinct asset classes in the investment world, particularly among pension plans and other fiduciary institutional investors. Yet, if you ask five professional investors or analysts for a definition of either growth stocks or value stocks, you likely will get five different answers.

William F. Sharpe once wrote: "Much has been written about both the small-stock and the value/growth phenomena. While the terms 'value' and 'growth' reflect common usage in the investment profession, they serve only as convenient names for stocks that tend to be similar in several respects. As is well-known, across securities there is significant positive correlation among: book/price, earnings/price, low earnings growth, dividend yield and low return on equity. … Those concerned with these distinctions have focused most of their research on long-run average return differences; that is, they have asked whether small stocks or value stocks 'do better than they should' in the long-run. Less attention has been paid to likely sources of short-run variability in returns among such groups. For present purposes it suffices that such variability is substantial."[1]

Interestingly, in the same article, Dr. Sharpe's analysis utilized benchmarks that delineated the two styles using only the relationship of book value (also known as shareholders' equity) and market price. Stocks with "high" P/B ratios were growth, and stocks with "low" P/B were value. As Dr. Sharpe indicated, delineating the two styles by a single factor may begin to define them but does not necessarily go far enough to allow investors to see clearly the volatile short-term impact of style swings. The more reliable the distinction, the more capability we have to choose proper benchmarks and then to allocate investments according to the expectations of those indexes. The net result is that we achieve greater control of the expected performance of that portfolio.

If we must define a style through delineation, we should, when available, use all factors that contribute to that delineation. One way to begin building definitions for the two styles is to ask what things are generally held to be true regarding growth and value. What characteristics of a stock (and the company that issued it) would make it universally perceived among investors as a growth or value security? Growth and value generally can be seen as a security's expected performance under given market conditions based on the influence of the fundamental data of the company that issued it. Expanding on Dr. Sharpe's comments, if Security A has:

- a high historic price to earnings ratio (P/E) and a high expected P/E
- high historic earnings growth and high expected earnings growth
- high price to book ratio (P/B)
- low dividend yield,

it starts looking undeniably like a growth stock from a growth-oriented company. Conversely, if Security B has:

- low P/B ratio
- high dividend yield
- low positive historic P/E and low positive expected P/E
- low positive earnings growth and low but positive expected earnings growth,

it clearly is a value stock.

These fundamentals reflect the assertion of many investors that "earnings drive prices." Given a market in which earnings are rising and/or are expected to rise, it is logical to assume that Security A would be seen as appealing and, in attracting investment capital, would experience price appreciation. Given a market wherein earnings are expected to remain flat or fall, Security B would be seen as attractive in the marketplace, and its price would be expected to go up. Growth and value in this context can be likened to the colors of the market's mood ring.

A Circular Relationship

The key word is "expectation." It is true that a company's profit expectations normally don't fluctuate significantly from month to month. But it is also true that market sentiment imposes its own interpretations of both individual company performance and the collective profit outlook. Moreover, in many ways, the relationship between market mood and corporate earnings is circular. Many corporate capital structures nowadays consist of diversified investments across many industries, or are leveraged based on their stock prices.

A corporate pension plan is a good example. If a defined benefit plan currently has less expected value than is necessary to cover projected pension liabilities, the plan sponsor is required to adjust its income by the amount of the contribution needed to boost the plan's value. If the expected value of the plan's assets exceeds liabilities, the company is required to show the excess value as income. In other words, the plan assets affect the company's bottom line as much as widget sales.

A market downturn reduces the value of equities held by the pension plan and thus negatively impacts earnings. Similarly, a bull market bolsters corporate profits. In a different vein, when interest rates fall significantly, corporations not only borrow more freely for new projects, but they also may refinance existing debt at more attractive rates, which improves their capital models and cash flows.

Thus, just as corporate earnings can drive the market, the market can influence the earnings of companies whose stocks are in it. It is my theory that this interdependence of market temperament and earnings trends can lead to expectation cycles of much shorter duration than is typically supposed.

The Illusion Of Trends

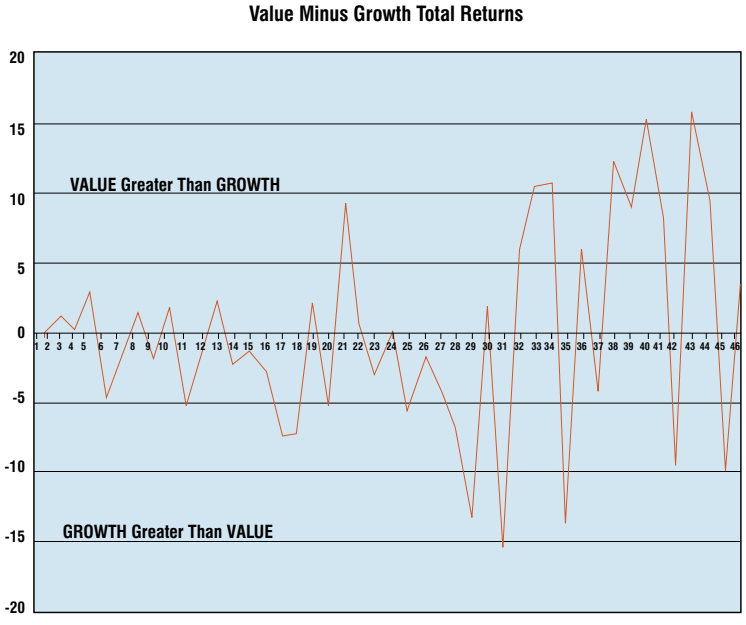
In grouping and measuring growth and value stocks, index purveyors employ a variety of definitions. Yet, one can see that across those varied methodologies, the leadership rotates back and forth between growth and value on a monthly and even daily basis. This condition implies that the long-term growth and value cycles we see discussed regularly in Wall Street research and in the media are really the greater sum of short-term fluctuations of growth-to-value and value-to-growth performance differences over periods of the observers' choosing.

Rather than viewing growth and value as long-term style trends, it may be more helpful to envision the market as a large multifaceted environment—think pinball machine or maze puzzle—in which market sentiment continually bounces around like a steel ball. If half of the room is designated growth and half is designated value, longish-term market trends would then be the side of the room with the most bounces over whatever period.

Figure 1 shows the monthly differential return of a capitalization-weighted combination of the Dow Jones U.S. Growth indexes (large cap, mid cap and small cap) and a cap-weighted combination of Dow Jones U.S. Value indexes for each month from August 1997 through May 2001. A chart plot point above the zero line indicates that value outperformed growth, and the number on the Y axis represents the percentage points of outperformance. Plot points below the zero line indicate growth outperforming value, and again the numbers represent the percentage points.

Much of this 46-month period is widely

Figure 1 **Value Minus Growth Total Returns**



Monthly Total Return Difference August 1997-May 2001

regarded by the investment community to have been a "growth market." Indeed, growth prevailed in two stretches of consecutive months, six from September 1998 through January 1999 and seven from June 1999 through December 1999. However, further analysis reveals that growth's domination was a thin 52% (24 of 46 months) in that period. In fact the arithmetic average difference in monthly returns was only 0.17%, with a standard deviation of the differences being 7.3%. Further, the annualized total return of the Dow Jones Value index (9.14%) was greater than that of growth (6.12%). If one were to have been able to move from growth to value with perfect timing in that period, one would have achieved an annualized return of about 51%, disregarding turnover costs.

For investors who practice tactical asset allocation, this characteristic of short-term leadership fluctuation means low correlation between growth and value (as measured by the indexes), which of course is very desirable because it means greater opportunity to reduce risk and maximize return. If an investor could even marginally predict short-term growth or value leadership and had access to efficient investment vehicles, he/she should be able to enhance portfolio total return.

Strategic Applications

Daydreams aside, let's look at a more conservative asset allocation strategy to approximate what a pension fund might actually be able to do. Using the same 46 months, assume an investment that began with a 60% Dow Jones Total Market Growth index fund allocation and a 40% Dow Jones Total Market Value index fund allocation on Aug. 1, 1997. This allocation would approximate a cap-weighted growth and value portfolio. Assume that a difference of two standard deviations, or approximately 15 percentage points in monthly total return between the two indexes, is a signal to allocate 60% of the portfolio to the index fund with the lower return in the previous month and 40% to the index fund with the higher return. Except for this single condition, no other tactical changes may be made to the allocations.

What happens? Only three times does such a broad return differential (and resulting re-allocation) occur by the end of February 2001. Yet, by the end of May 2001, the result of making these two allocation shifts is more than two percentage points of additional annualized total return to the portfolio, as opposed to doing no tactical allocation.

Looking at a longer time frame, Figure 2 shows the results of designating each month from January 1980 through May 2001 as a growth-dominant month or a value-dominant month. Dominance is determined by whether at least two-thirds of the most readily available growth indexes had higher performance than their respective value counterparts or vice versa. Months in which there wasn't a two-thirds majority are designated "unclear."

Figure 2

	January 1980 through May 2001			
	DOMINANT	**DOW JONES**	**RUSSELL**	**S&P/BARRA**
GROWTH	98	40	30	28
VALUE	115	51	32	32
UNCLEAR	44			
TOTAL MONTHS	257	91 (43%)	62 (29%)	60 (28%)
CLEAR DOMINANCE	83%			

	January 1994 through May 2001			
	DOMINANT	**DOW JONES**	**RUSSELL**	**S&P/BARRA**
GROWTH	39	17	9	13
VALUE	42	26	10	6
UNCLEAR	8			
TOTAL MONTHS	89	43 (53%)	19 (23%)	19 (23%)
CLEAR DOMINANCE	91%			

The indexes are published by Dow Jones, Russell and S&P/Barra.[2]

The number of indexes varied throughout this period. From 1980 to January 1986, for example, there were 10 indexes or five growth/value pairs, requiring three out of five to agree to designate growth or value dominance.

	Total Pairs	Minimum Agreement Required for Dominance
January 1980-December 1985	5	3
January 1985-May 1991	7	5
June 1991-December 1993	8	6
January 1994-Present	9	6

By the end of the survey period, there were 18 indexes measured (nine growth/value pairs), requiring agreement among six of the nine pairs for dominance.

Figure 3

For each index provider, the better performance of growth or value in the three size segments was determined. If at least six of the nine pairs agreed in direction, not degree, the month was classified accordingly. In this case, value dominated.

May 2001

	DOW JONES			RUSSELL			S&P/BARRA		
	Large	Mid	Small	Large	Mid	Small	Large	Mid	Small
Growth	-1.6034	0.048823	2.604391	-1.69	-0.47	2.32	0.237	**2.753**	1.138
Value	**1.980432**	**3.499721**	**3.873142**	**1.98**	**2.84**	**2.57**	**1.046**	1.979	**2.549**

Dominant style in boldface.

Figure 3 illustrates how May 2001 was scored to determine whether growth or value dominated during the month.

Of the 257 months tested, 44 (or 17%) did not show clear dominance by growth or value. There was a total of 98 growth (38%) and 115 value (45%) months during that time span. During the period that mid-cap growth and value indexes were included in the study, January 1994 through December 2000, only eight of 84 months (9%) did not show a clear growth or value dominance; there were 39 growth dominant months (43%) and 42 value dominant months (47%).

Conclusion

While growth and value trends do stretch over several consecutive months from time to time, the fluctuation of leadership or dominance is much more frequent than is generally realized. The vicissitudes of market mood seem to play a role in shifting investor expectations, which in turn influence the relative perceived appeal of growth and value. As a result, while the overarching trend may be either growth or value, the market more often than not reacts aggressively in opposite ways over the short term. Perhaps some investors could enhance their returns by placing less emphasis in their strategies on riding long-term growth or value trends and more emphasis on understanding the conditions under which the market tends to rebalance growth tilts with value reactions and value tilts with growth reactions.

Footnotes

1 Sharpe, William F., "Asset Allocation: Management Style and Performance Measurement, An asset class factor model can help make order out of chaos," ***Journal of Portfolio Management***, Winter 1992, pp. 7-19.

2 Dow Jones uses a six-factor cluster-analysis methodology to determine style. The factors are trailing p/e, forward p/e, trailing earnings growth, forward growth, dividend yield and price/book. Russell uses two factors, price/book and I/B/E/S projected growth rate, in a proprietary weighting scheme to determine style. S&P/Barra delineates half the market cap of the universe in question as growth and half as value when sorted solely by price/book. These methodological differences render direct comparisons of the indexes meaningless, which is why direction of index performance is chosen as the unit of measurement in determining style dominance.