SPECIAL REPORT

GROWTH VERSUS VALUE STOCKS

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The overarching conclusion is that value stocks are poised to outperform growth stocks over the next several years. History is clear that value stocks have significantly outperformed growth stocks during the early years of every economic recovery since 1970. While I have considerable conviction with respect to this forecast, it must be emphasized that the timing of a sustained rotation in leadership from growth to value is dependent upon concrete evidence that the economy has embarked on a solid and sustained growth path.

Equity market observers tend to characterize individual securities as either growth or value stocks. Although somewhat arbitrary, the classification of each category of stocks is straightforward and generally accepted. Stock market history depicts an alternating pattern of leadership with shifting relative performance over time. The focus of this Special Report is an analysis of the behavioral characteristics of these two categories of stocks in order to better understand the specific factors that determine relative investment performance.

- The definition of growth stocks is straightforward: *These are shares of companies that enjoy prospects for above-average long-term growth in revenues and earnings*. Superior growth typically derives from either the markets in which they operate or from business strategies specific to that company. These companies tend to be less cyclical than the average business, with greater stability of growth rates over time. They also tend to have a track record of consistently above-average returns on invested capital.

- *Value stocks trade at public market prices that are judged to be below the estimated long-term intrinsic value of their underlying businesses*. In both theory and practice, the intrinsic value of a stock is defined as its projected future stream of earnings and dividends, discounted back to the present. Value stock managers purchase these stocks when the discrepancy between public market value and estimated private business value is sufficiently large to create an opportunity for prospective excess returns.

- In terms of market metrics, growth stocks are always priced at higher valuations relative to value stocks based upon the following measures: Price-to-earnings (P/E) ratio, price-to-book value, and price-to-sales. Dividend yields for value stocks also always exceed those of growth stocks.

- Why does the public market price of a stock diverge from its long-term underlying intrinsic value? There are many factors at work, but the most common reason pertains to the varying ***time horizons among investors***. Needless to say, stock prices are extremely volatile and do not reflect the real-time present value of their businesses at all times.

- For example, in the short term, stocks often become undervalued when quarterly earnings fall short of expectations. While short-term traders might drive the prices of these stocks lower, patient long-term investors tend to view this temporary discrepancy between market price and intrinsic value as a long-term buying opportunity.

- What does market history reveal about relative performance between these two classes of stocks? Prior to the global financial crisis in 2008, long-term historical performance data unambiguously favored value stocks. However, *growth stocks have massively outperformed value stocks over the past 10 to 15 years*. Over the past 50 years, academic studies show that value stocks slightly outperformed growth stocks.

- Since 2007, the Russell 3000 Growth Index has outperformed the Russell 3000 Value Index by a factor of two — +11.5% annually versus +5.6%. This 13-year period is the longest outperformance on record by either stock group. Russell data on growth and value stocks are available back to 1995. Since that time, growth stocks have modestly outperformed value stocks, +9.4% to +8.1%.

- *A rigorous analysis of economic and market history reveals that relative stock market performance responds to very specific underlying economic conditions*. The three most important macroeconomic factors are GDP growth, inflation, and interest rates. History reveals that value stocks perform best during periods of rapid economic (and profit) growth, whereas growth stocks perform best during periods of sluggish growth.

- *Perhaps most importantly, stock market history reveals that relative performance is responsive to the stage of the traditional business cycle*. Over the course of a classic business expansion cycle, value stocks perform best during the first several years of an economic recovery. By comparison, growth stocks perform best when the expansion has entered its final stages.

- The logic behind this relative performance pattern is intuitively clear. By definition, growth stock earnings tend to be highly consistent and less vulnerable to swings in the economy. Consequently, these stocks are preferred when prospects for economic growth becomes more uncertain. Conversely, earnings of value stocks tend to oscillate more widely over the course of a business cycle. *These stocks perform best in the early years of a business expansion when GDP and profit growth is maximized*.

- This conclusion is fully supported by stock market history: ***Value stocks consistently outperformed growth stocks during the early years of the economic recovery of the mid-1970s and the early years of the business cycle expansions of the 1980s, 1990s, and 2000s***.

- The immediate aftermath of the internet bubble in 1999 was the period of maximum divergence. From 1999 through 2005, the Russell Growth Index ***lost*** a cumulative **30%** in value, while the Russell Value Index ***increased*** by a cumulative **30%**.

- Value stocks also outperformed growth stocks during the stagflationary 1970s. In the immediate aftermath of the painful 1973-74 recession, the Value Line Index rose by a cumulative 92% during the three early recovery years ending in 1977, compared with a gain of less than 60% in the S&P 500 Index.

- Although the rate of economic and profit growth is the primary determinant of relative performance, other macroeconomic factors are also important. *Value stocks tend to outperform growth stocks when interest rates and inflation are on the rise and when the yield curve is in a steepening trend*.

- *Value stocks also perform best when the thrust of Federal Reserve policy is highly expansionary*. The relative performance of growth stocks is most pronounced when inflation and interest rates are low and stable, when the yield curve is flat, and when the Fed is tightening policy. Finally, there is a strong correlation between equity market leadership and the direction of the US dollar: Value stocks (and economically sensitive stocks) perform best when the dollar is in a sustained downtrend.

- With respect to the outlook, economic and policy conditions should favor value stocks over the next several years:

    1. US GDP and corporate earnings should expand in both 2021 and 2022 at rates well above their long-term historical averages

    2. The Federal Reserve is likely to maintain a highly accommodative policy throughout 2022

    3. Market interest rates are likely to be in a modest but steady uptrend during 2021 and 2022

    4. The Treasury yield curve is currently in a moderate steepening process, a trend that should gather momentum as 2021 unfolds

    5. Inflationary expectations are currently depressed, but should begin to rise as the economic recovery accelerates later next year and in 2022

    6. The US dollar has already declined by 10% from its March 20th peak, with further losses expected over the next two years

- Current equity market valuations also favor value stocks. Calculated on the basis of current earnings per share (EPS), the P/E of 42x for the Russell Growth Index far exceeds the P/E of 22.5x for the Russell Value Index. The dividend yield for the value index (2.55%) is also superior that of the growth index (0.85%). Finally, the 10.5x price-to-book ratio of the growth index is fivefold the 2x ratio of the value index.

- The overarching conclusion is that value stocks are poised to outperform growth stocks over the next several years. History is clear that value stocks perform best during the early years of an economic recovery. History is also clear that the margin of outperformance can be large, especially following periods of extreme growth stock outperformance and massive disparities in valuation.

- While I have considerable conviction with respect to this forecast, it must be emphasized that the ***timing*** of a sustained rotation in leadership from growth to value is dependent upon a specific ***catalyst***. *The crucial catalyst will be concrete evidence that the pandemic is fading and the economy is embarking on a solid and sustained growth path*.

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Russell 3000 Growth Index: is a market capitalization-weighted index based on the Russell 3000 index. The Russell 3000 Growth Index includes companies that display signs of above-average growth. The index is used to provide a gauge of the performance of growth stocks in the United States.

Russell 3000 Value Index: is a market-capitalization weighted equity index maintained by the Russell Investment Group and based on the Russell 3000 Index, which measures how U.S. stocks in the equity value segment perform by including only value stocks.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

Value Line Geometric Index: is an equally weighted index based on approximately 1700 companies covered in the Value Line Investment Survey.

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