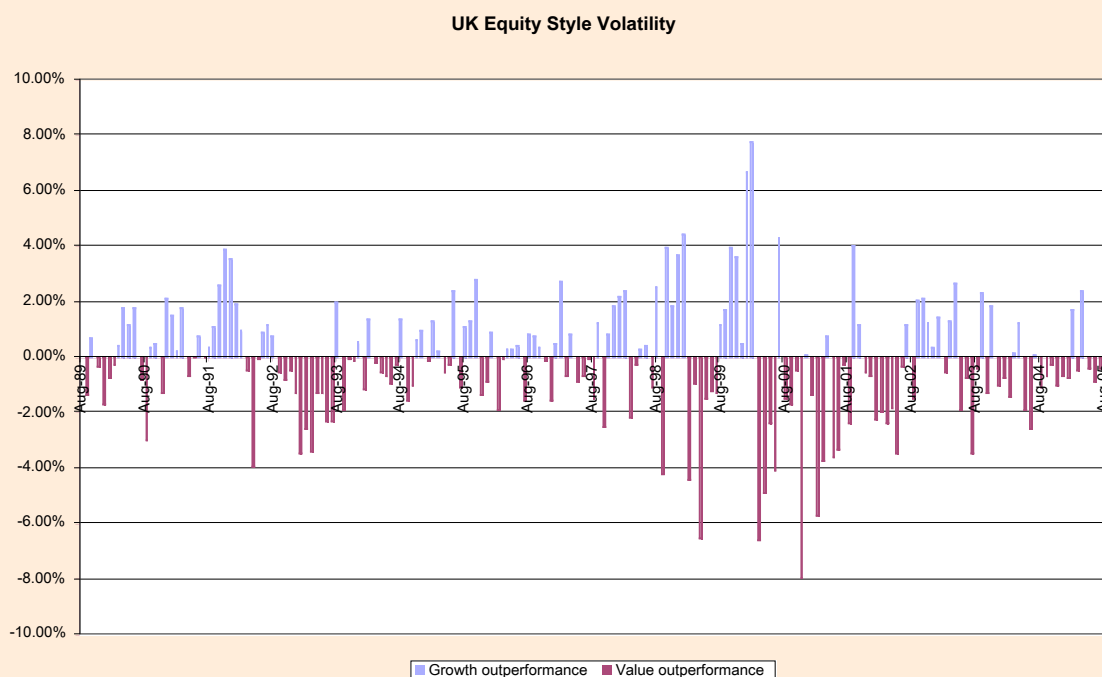


Holding the best of both worlds

Investors are better off holding both value and growth stocks, rather than trying to time the switch between them

In the thirty months to end August 2005, the BMI UK Value Index outperformed the BMI UK Growth Index on 20 occasions, measured on a monthly basis. This period is chosen simply because it coincides with the recent market recovery which began at the outset of the war in Iraq. Over the past sixteen years, the difference is less extreme. Nevertheless, during that period value has outperformed growth 56% of the time.

Throughout the 1980s and 1990s the term 'style' was used quite extensively to define and differentiate one investment process from another. The value and growth style definitions became quite popular largely because one was considered opposite from the other. If a value manager decided that he did not like the company he invested in anymore due to its lofty valuation, this is just the time when a growth manager may find interest. In contrast, shares that fail to meet the growth criteria are often unloved shares that value managers may find to be of interest. In equity markets we find that one single investment style rarely dominates the other and over the short to medium term the leadership in the market may be driven by either growth companies or value companies. This is illustrated in Chart 1 which shows the out performance of each style relative to the other on a monthly basis since 1989.



What do we mean by value and growth? First of all, it appears that no universally accepted definition of value and growth stocks exists.

Value investors seek investments in companies that are lower priced because they are not as strong as growth companies. Prospects for these companies may not be that clear and based on any fundamental ratio, are not as healthy as growth companies. An active value investor will then seek out those companies that possess stronger

fundamentals, including higher return on investment, comparatively solid balance sheets and stronger competitive positions. Additionally, they will be looking for some catalyst for a change in valuation, including revisions in earnings estimates, improving working capital trends or directors' buying. A characteristic of value shares is that they usually carry a high dividend yield.

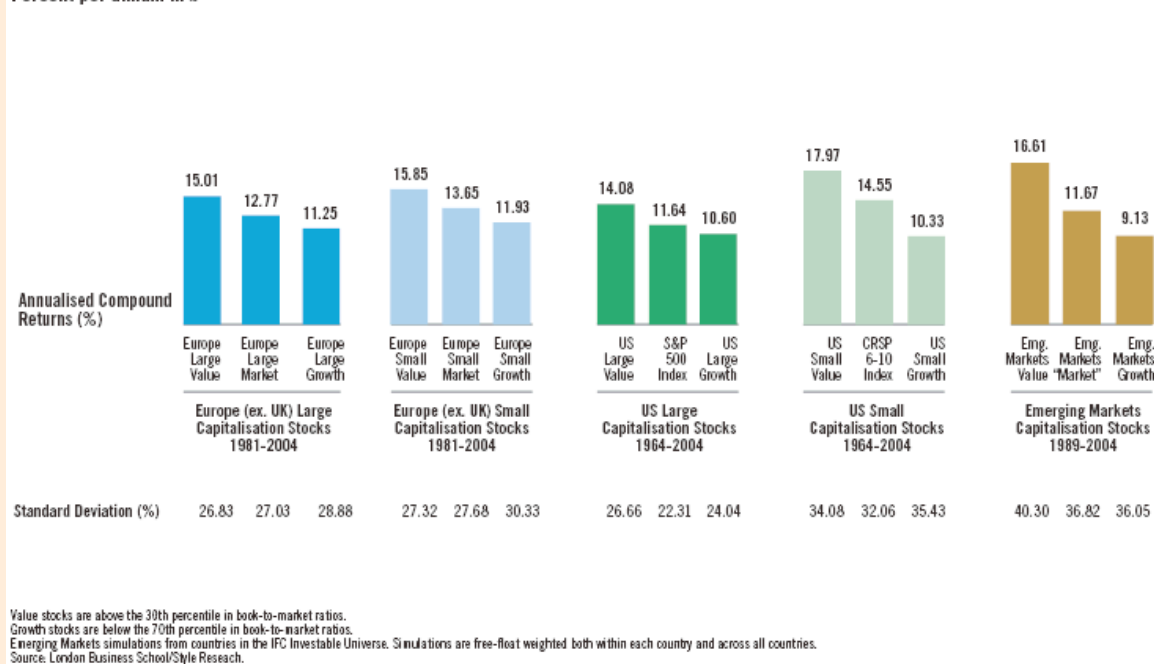
This description may be reasonably positive, but there will be good reasons why companies fall into this category. Shares may be unpopular if the companies are in mature industries and with modest growth prospects. There may be companies that are experiencing problems but are expected to recover.

Growth investors seek investments in companies perceived to have significant growth potential and are likely to out perform the market as a whole. One of the interesting differences between a value investor and growth investor is that the latter relies far more heavily on analysts' forecasts. In general, these investors seek companies that are experiencing rapid growth in earnings, sales or return on equity. Shares in these companies are usually associated with high price to earnings ratios and high market price to book value ratios. As an extreme example, one has only to think back to the dot com era when mainly technology stocks came to the market with stratospheric P/Es. The danger, as always, is to be lulled into believing there will be a 'paradigm shift' and that growth will continue unabated.

Historical Returns Around the World

Annual Data

Percent per annum in £



There is plenty of evidence to support the view that value investing provides superior returns over the long term. Chart 2 illustrates this very clearly. Equally, it shows that the evidence is even more compelling when applied to small capitalisation stocks, regardless of domain. Whilst the annualised compound returns of value shares in each market are greater than both growth shares and the market itself, there is divergence in respect of the volatility. In the main, the volatility of value shares has been slightly greater than that of growth shares. Some studies over both different and shorter

periods than those measured for Chart 2 have pointed to the opposite effect. It would be unwise to assume that value shares are generally more volatile than growth shares.

Are value stocks a bargain? Well, it depends on your definition of a bargain. As an asset class, the evidence appears to support the view that they can offer superior returns over the long term. But the shares in these companies are more risky. If you look at it from the companies' standpoint they are paying a higher price for capital than growth companies. This is evidenced by the fact that investors are prepared to pay a premium to hold shares in growth companies. That premium, from the companies' standpoint equates to a lower cost of capital. Equally, value companies need to pay away a greater proportion of their profits as dividends in order to first attract investors and then keep them on board. This erodes the level of retained profit that can be reinvested. Growth companies, by comparison, do not suffer from these constraints.

Investing in growth companies also carries risks. The greatest of these risks is not with the companies themselves, but with the accuracy of analysts' forecasts. Almost by definition, this is an impossible task, particularly over anything but a relatively short term. There are too many imponderables. Whilst knowledge of past growth is helpful in assisting predictions of future growth, it fails to identify the future success of companies in new sectors. The key to minimising these risks is to use forecasts that contain knowledge, obtained fully within the law, about the future beyond that which is generally known. How many investors in the early 1980s would have given their eye teeth to have known just how hugely popular personal computers would become. Had they known, they would have piled into companies such as Microsoft.

So far the focus has been on the broad characteristics of each style. Put in the context of investing through funds, rather than direct investment in individual companies, we need to consider a further dimension. An analysis of funds purporting to concentrate on investing in a particular style of company has shown that this is extremely difficult to maintain. For example, a fund investing in value companies will, in time, see an improvement in valuations to the point where the value tag no longer strictly applies. This may also coincide with a change in market sentiment towards growth companies. The manager, with probably more than half an eye on his position in the performance tables, decides to hang on to take advantage for the continued favourable market sentiment. Quite reasonable, you might think, except that if you have selected a value fund to form part of your clients' portfolios, then surely you would want it to perform as a value fund. This is referred to as style drift.

When style drift occurs your carefully constructed portfolio begins to look rather different. For example you may have started with a style neutral portfolio with the aim of minimising volatility. With a drift in style, the risk characteristics may change and become unacceptably high or inappropriate.

While value shares have generally beaten growth shares, should one simply ignore the latter? There are a number of very good reasons why this might not be prudent. There may be money to be made from style rotation. Sometimes the portfolio may be invested primarily in growth shares while at other times it may be weighted in favour of value shares. There have been times when value shares have underperformed growth shares for extended periods and vice versa. If the investor can get the timing right returns from style rotation activity can be greatly enhanced. Unfortunately, the

evidence also points to the fact that most investors fail miserably when it comes to timing. Not only does this often lead to poor returns, volatility is likely to be uncomfortably high.

Where does this leave us? A more satisfactory approach for most investors is to focus on a rational asset allocation. Mindful of the fact that it is difficult to predict the future, a more balanced approach of holding both growth and value styles at all times will remove many of the pitfalls associated with sticking primarily to one style. Within this approach, it may be appropriate to tilt the balance in favour of value in order to capture greater overall returns over the long term. By educating clients to accept that one style will always under perform the other, but with unpredictable timing, the investor is likely to enjoy a better investment experience than might otherwise be the case.

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