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Time to stock up on growth or value?

Growth stocks, particularly active growth managers, have enjoyed stellar performance so far this year, yet many investors have continued to pour money into exchange-traded funds (ETFs) and bonds. Others are cautious about the continued uptrend in stocks. This month, we examine the underpinnings for why investors choose growth and value stocks. We also observe that although fund flows may indicate a current lack of enthusiasm for stocks in general, the year-to-date growth stock story may persuade investors who missed out to take another look at stocks, and at active growth managers in particular.

Growth versus value. For many years, that was one of the central debates for investors, analysts, managers, and financial advisors. Growth and value stocks seemed to be the yin and yang of stock investing, with radically different characteristics that attracted investors with different temperaments. Growth, defined as companies measured on the strength of their earnings; value, defined as companies measured on the price of their stock relative to underlying assets. That is a simplistic distillation, but even that has faded in the past few years. Instead, the focus has been on larger questions of whether stocks overall are too dear, bonds still attractive, and markets stable.

This year so far, however, suggests that investors would do well to revisit the question of growth versus value, as well as the related conundrum of active versus passive, because the spread in how these various categories have performed has been quite dramatic, with wide differences in how

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investments have performed. If, going forward, returns are less correlated—that is, if stocks and bonds don't rise and fall en masse but instead result in large differences between individual stocks and bonds and among specific allocations—then questions like growth versus value will need to rise to the fore once again.

Growth versus value redux

Investing clichés are common. Some are wise, but are easy to implement only in hindsight: "Buy high. Sell low." Some are true only when they are true: "Markets climb a wall of worry." Some are relatively useless, "Buy the rumor. Sell the news." A few, however, can have some virtue: "When the herd goes one way, you go another." Well, this year the herd has been yanking money out of actively managed funds and pouring into ETFs and passive vehicles. With stock markets up decently and bond markets offering little drama, few have been complaining about their returns. But for the first three-quarters of this year, growth stocks have substantially outperformed value stocks (Figure 1). That is true for large caps and small caps, and it is also true for that much-benighted category: active growth stock funds. After some significant struggles relative to their benchmarks over the past years, active growth funds have had stellar performance compared to passive funds that mirror the entire market. The herd has not benefited.

One reason for the outperformance of large-sized growth companies has been the heavy weighting of technology giants, such as Alphabet (Google), Amazon, Facebook, Netflix, Apple and down the list. A good deal of skepticism remains about these markets, and many people are uncomfortable with the continued rise of stocks in general and valuations of some of the names that have propelled this multiyear rally. A recent headline stated baldly: "Why rising optimism should make stock-market investors nervous!" That was hardly an outlier.

Of course, forgotten in that mix are the various times over the past few years when stocks have pulled back sharply, including technology names, as they did in early 2016. In the first month and a half of 2016, the tech-heavy Nasdaq was off nearly 15% (Figure 2). The march has not been straight up, but memories are short, and fears of the past fade quickly in the face of the recent calm in domestic and global markets.

So, it's not as though tech stocks—let alone stocks in general—have been only up over the past years. This year has certainly had incredibly low volatility and a steady melt upwards of stocks. In addition, even as the Federal Reserve (Fed) has been embarking on a gradual tightening path, bonds have not been roiled as they were in November 2016 after the election, when prices dropped rather suddenly and sharply. The absence of volatility has calmed some, but it has also spooked others who see it not as stability but the proverbial calm before the storm. Seen through that lens, each day stocks do okay is one day closer to the day when they do not.

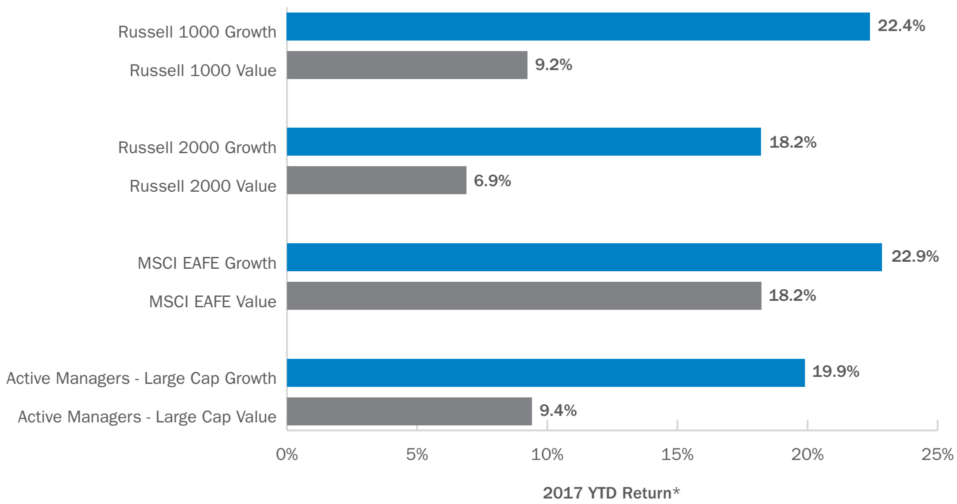
That may, of course, prove to be the correct lens. Pullbacks and crashes happen, and they usually take most people by surprise. This year, at least, the absence of a sharp retreat explains why many have missed out on the very strong performance of growth stocks. Not only are they dominated by technology names, but they are often pricey in terms of their multiple and valuation.

Growth stocks demand that investors have some real confidence in the future. Indeed, one thing that has long separated growth investors from value investors is temperament. Value investors have been seen as more conservative, more cautious, more aware of the vagaries that can quickly undermine the hot new name and the sexy new trend. Growth investors have been seen as flashier, more risk-prone, more focused on what could be than on what is. After all, you don't invest in a company growing quickly and innovating and disrupting if you don't believe that the future might be rosy and reward those who take risks.

Today, however, even as some companies are doing spectacularly, the general mood is cautious. According to regular polls by Gallup, most Americans see the country as a whole as being on the wrong track and are not confident that the world their children will inherit will be better than the present. You can't draw a specific line from those attitudes to the lack of enthusiasm for growth stocks, but that lack is evident from fund flows, which continue to see investors pouring money out of domestic US equity and into fixed income.

Add to that a general distaste for active investing. Index investors can capture much of the growth stock story, but this year many active funds have captured even more of it. Those funds can take even larger positions in high-conviction companies, as opposed to an index fund, which has fixed weightings (albeit periodically rebalanced). In

Figure 1:
Growth Outpacing Value in 2017 YTD*
US, International, and Active Management



Sources: Russell index data from FTSE Russell; YTD total return data through Oct 10, 2017. MSCI EAFE data from MSCI; YTD gross return data through Sept 29, 2017. Active manager data from Morningstar; median return data through Sept 30, 2017.

Figure 2:
NASDAQ, January 2016 – YTD 2017

Source: Yahoo Finance. Nasdaq represented by Nasdaq Composite (IXIC). Chart reflects adjusted close prices from 1/4/16 to 10/13/17.

some years, that doesn't work so well, as active managers take outsized positions (relative to the benchmark) that underperform. This year has been a good one for skilled active stock pickers, but a rough few years of late does explain why so many investors have been reluctant to put money with active managers, let alone with growth managers, and let alone with stocks. In order of confidence about the future and willingness to take risk, active growth managers are further along the curve. Yes, investors who pile into "safe," low-yielding fixed income are taking risks that their portfolios will not live up to retirement needs and expectations; psychologically, however, in uncertain times, the knee-jerk tendency is to default to what has been safe in the past, whether or not that is the most prudent decision going forward.

And so, we have a year that has rewarded active growth managers and anyone who has invested in growth stocks, passive or active. Given fund flows and sentiment, it is also a year that many people have missed. If investing clichés hold, it may be that more investors will turn to growth stocks going forward in light of how well they have done, which might be precisely when that outperformance fades. Who knows? The fundamentals of many of the companies in those growth portfolios remain strong, with potent revenue and earnings growth, and that, at the very least, suggests reasons for paying attention to an area of the market that has been performing strongly. ■

October Takeaway:

Growth stocks, particularly active growth managers, have had a good run this year, despite investors' continued overwhelming penchant for ETFs and bonds. Not all investors have benefited. Some are cautious, perceiving the lack of volatility as the calm before the storm, coupled with high prices for technology-dominated names, as rationalization for fund flows out of equities and into fixed income. But a proper focus on strong revenue and earnings growth fundamentals may justify paying close attention to growth companies going forward, and active growth managers in particular. Not following the herd may prove to be a good investment maxim over time.

INDEX DISCLOSURES: The **MSCI EAFE Growth Index** captures large and mid-cap securities exhibiting overall growth style characteristics across Developed Markets countries around the world, excluding the US and Canada. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend. The **MSCI EAFE Value Index** captures large and mid-cap securities exhibiting overall value style characteristics across Developed Markets countries around the world, excluding the US and Canada. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield. The **Russell 1000 Value Index** is a subset of the Russell 1000 Index and includes stocks with lower price-to-book ratios and lower expected growth rates. The **Russell 1000 Growth Index** is a subset of the Russell 1000 index and includes companies that exhibit higher price-to-book and forecasted earnings. **Russell 2000 Value Index** is a subset of the Russell 2000 Index and includes stocks with lower price to-book ratios and lower expected growth rates. **Russell 2000 Growth Index** is a subset of the Russell 2000 index and includes companies that exhibit higher price-to-book and forecasted earnings.

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