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Value vs. Growth

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Over the 10-years ending March 31, 2018, the Russell 1000 Value index returned 7.8% per year versus 11.3% for the Russell 1000 Growth index. In contrast, during the 10-years ending March 31, 2008, The Value index returned 5.5% per year versus 1.3% for the Growth index. Over the greater than 38-year life of these indexes, the annualized return for the Value index of 12.1% exceeds the Growth return of 11.4%.

So, what will happen over the next 10-years? Jason Zweig, author of The Intelligent Investor column for the Wall Street Journal, recently concluded an article by stating:

> *Assuming you do possess the necessary patience and composure, you should tilt your money toward value-oriented investments with low annual expenses that can capture the extra return the strategy is likely to achieve — eventually. What you shouldn't do is believe anyone who claims to be able to predict exactly when value investing is about to pay off.*[1]

Over the past several decades, many financial analyst have tried to identify fundamental factors that favor value vs. growth stocks. These factors include interest rate changes, inflation, and the level of economic activity. Zweig quotes Cliff Asness, co-founder of AQR Capital Management as stating that over the long run, "the value factor is not very correlated to macro stuff but works on average." But there's a lot of variation in that average, and the long run can be longer than many investors imagine. Along the way, the returns to value investing look "fairly random and unconnected to other things," says Asness.

We accept the unpredictable nature of when the growth vs. value style of investing will produce superior returns. Benjamin Graham characterized the market as a voting machine in the short-run and a weighing machine over the long-term. This analogy provides an explanation for why momentum works over the short-to-intermediate term and relative valuations over the long-term.

In today's environment, relative valuations favor value stocks over growth stocks. J.P. Morgan Asset Management publishes returns and valuations by style analysis. The March 31, 2018 analysis contains the following data.[2]

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[1] Zweig, Jason, Value Should Do Better. But When Is Anybody's Guess, Wall Street Journal, April 27, 2018.

[2] JPM Guide the Markets, U.S., 2Q 2018, as of March 31, 2018, p 9.

Current P/E vs. 15-year Average			
	P/E	**Value**	**Growth**
Large	Current	14.2	19.5
	15-year ave.	13.2	16.7
	Ratio as %	107.3%	116.2%
Small	Current	17.0	31.0
	15-year ave.	16.8	25.6
	Ratio as %	101.0%	121.3%
Source: Factset, Russell, S&P 500, J.P. Morgan Asset Management			

This table shows that large cap value stocks currently sell at 14.2 times earnings vs. a 15-year average of 13.2 times- in other words, 107.3% of average. In contrast large growth stocks trade at a 16.2% premium to average. Neither are "cheap" relative to the 15-year average, but the value stocks trade at a lower premium to average.

The difference for small cap stocks offers a greater advantage to the value style. Small cap value stocks sell at approximately 17 times earnings, which is near the 15-year average. Small cap growth stocks are priced at a 21% premium to the long-term average.

The long-term superior return for value vs. growth and the relatively more attractive valuations for the value style do not assure that value will outperform over the next decade. However, these factors do suggest that base case probabilities support a tilt toward value stocks in broadly diversified portfolios.

[i].

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