

"GROWTH" VERSUS "VALUE" INVESTING

There has been an ongoing debate for many years as to whether higher stock market returns can be achieved by investing for "growth" or by investing for "value." Investing for "value" means purchasing stocks at relatively low prices, as indicated by low price-to-earnings, price-to-book, and price-to-sales ratios, and high dividend yields. Investing for "growth" results in just the opposite—high price-to-earnings, price-to-book, and price-to-sales ratios, and low dividend yields.

"Growth" investors are more apt to subscribe to the "efficient market hypothesis" which maintains that the current market price of a stock reflects all the currently "knowable" information about a company and, so, is the most reasonable price for that stock at that given point in time. They seek to enjoy their rewards by participating in what the growth of the underlying company imparts to the growth of the price of its stock.

"Value" investors put more weight on their judgments about the extent to which they think a stock is mispriced in the marketplace. If a stock is underpriced, it is a good buy; if it is overpriced, it is a good sell. They seek to enjoy their rewards by buying stocks that are depressed because their companies are going through periods of difficulty; riding their prices upward, if, when, and as such companies recover from those difficulties; and selling them when their price objectives are reached.

Which strategy shows the better returns depends, in part, upon the periods over which they are compared. It has, however, been my impression, over the past several decades, that "value" investing has received the more hype. It is the purpose of this paper to set the record straight.

PERFORMANCE AND SAFETY IN INVESTMENTS

One of the most fascinating aspects of the current mutual fund craze is the buying public's utter disregard for the quality of the investments in the portfolios of the mutual funds it acquires. It is almost universally accepted that, if Fund A has gone up more than Fund B over some period of time, it is a better managed fund. How that performance was achieved tends to take a back seat to the performance numbers themselves.

How performance is achieved, however, can be of critical importance. The reason it can be important is that the stock market is fickle and, when it falls apart, it falls apart without warning. If a portfolio has achieved its performance by owning high-risk securities (e.g., small, less liquid companies with large amounts of debt, operating in highly cyclical, rapidly changing, or highly competitive industries) and/or using high-risk strategies (e.g., derivative securities such as

options, futures, or warrants), it is not well-prepared for those difficult times which unexpectedly rock the securities markets about every quarter of a century or so.

PREMIUMS FOR SAFETY

Let us recognize that we are naturally predisposed to pay a premium for safety. We stop and look both ways before we cross the street, in spite of the extra expenditure of time and energy it requires. We carry fire insurance on our houses, in spite of the improbability that our houses will burn down, and in spite of the many other things we might otherwise enjoy with all the money we pay for insurance premiums.

United States Treasury Securities are considered to be the world's safest investments. But securities of agencies of the United States Government cannot be far behind. Federal Land Bank, Federal Farm Credit Bank, Federal Home Loan Bank, Federal Home Loan Mortgage, and Federal National Mortgage Association bonds all carry Moody's ratings of Aaa. The former are considered safer because they are "legal" obligations of the United States Government, whereas the latter are only "moral" obligations of the United States Government. (The solvency of the Federal Deposit Insurance Corporation which insures our bank accounts, for example, is backed by a "moral," as opposed to a "legal," obligation of the U. S. Government.)

I ask my reader to contemplate a scenario in which the United States Government fulfills its obligations to pay interest and principal on its legal obligations but permits the obligations of its federal agencies (including FDIC insurance) to default. This, it would seem, would need to be an event more catastrophic than our republic has yet experienced, and certainly an event more serious even than the Great Depression of the 1930s.

Nevertheless, the marketplace pays a premium to own U. S. Treasuries, as opposed to Federal Agency bonds. A glance at the *Wall Street Journal* reveals that, for comparable maturities, bond buyers are willing to sacrifice between 1/2 of 1% and 1% in yield to own the former, rather than the latter. As improbable as it is that the incremental safety afforded by Treasuries over Federal Agencies will ever be needed, investors are willing to pay a substantial premium (sacrifice in yield) to own them.

The same situation exists with municipal bonds. In spite of the fact that the general obligations (GOs) of a state are backed by the taxing power of all of the assets within that state, Aaa state GOs yield less than Aa state GOs.

The differential between Aaa corporate bonds and Aa corporates provides still another example. The sacrifice in yield required to own a Aaa corporate versus a Aa corporate is of the order of

1/2 of 1%. Again, imagine the economic or monetary scenario in which Aaa corporate America meets its obligations, but Aa corporate America defaults.

Given that municipal bonds are considered less safe than U. S. Government bonds, that corporate bonds are considered less safe than municipal bonds, and that a company's common stock is always less safe than its weakest bond, should we not expect that the marketplace might be willing to pay a premium for safety (as well as for appreciation potential) in a common stock?

The important principle to understand is that, given two common stock portfolios, A and B, if Portfolio A is made up of higher quality issues—companies less apt than those in Portfolio B to go bankrupt in a period such as the Great Depression of the 1930s, the Great Credit Crunch of the 1970s, or an economic/monetary scenario more catastrophic than has yet been experienced—then, barring the occurrence of such a catastrophic event, and all other things being equal, Portfolio A should show a lesser return than Portfolio B. Portfolio A must pay an insurance premium for its added protection against catastrophic events, as improbable as their realization may seem. It should expect to pay this premium by accepting lesser total returns, in the absence of a catastrophic event.

NEW MORNINGSTAR DATA

The *Morningstar* mutual fund service is the most popular and most comprehensive of all the mutual fund rating services. Beginning in late 1996 and early 1997, the service modified the way it categorized mutual funds. Common stock funds are now divided into nine groups, according to whether they invest in large capitalization, medium capitalization, or small capitalization companies, and whether their investment styles are predominantly "growth" oriented, "value" oriented, or a "blend" of the two. For the first time, this data gives us an opportunity more easily to study, compare, and contrast the collective character of the portfolios, and the performance records, of large numbers of mutual funds using "growth" and "value" stock approaches as their investment strategies.

The data used for this analysis covers over twelve-hundred mutual funds with over \$1/2 trillion in assets. *Morningstar* makes such an analysis relatively easy because it publishes a page for each investment style which it calls an "Overview." On this page is a listing of the twenty-five largest holdings of all the mutual funds in each sector, the relative size of each position, and the collective performance data for the funds in that sector. By examining the quality of the twenty-five largest holdings of the mutual funds in a sector, we can get a pretty good picture of the character of the portfolios in that sector.

MEASURING THE QUALITY AND SAFETY OF LARGE-CAP PORTFOLIOS

The most popular, and probably the best, way to measure the safety of a common stock is to look at its *Standard & Poor's* rating. *Standard & Poor's* rates most large capitalization stocks, and a portion of the universe of mid-cap and small-cap stocks, on a scale of A+, A, A-, B+, B, B-, C, and D. These ratings are in no way meant by *Standard & Poor's* to be prognostications of performance in normal markets. They are meant more to serve as measures of the degrees of protection available in each security in a catastrophic market.

Based upon the twenty-five largest holdings in the collective portfolios of the large capitalization "growth" and large capitalization "value" sectors, a profile of each sector appears in the following table:

<u>LARGE-CAP STYLE</u>	<u>S&P QUALITY RATING AT OR ABOVE</u>		
	<u>A+</u>	<u>A</u>	<u>A-</u>
GROWTH	29.5%	34.4%	42.6%
VALUE	19.0%	22.8%	32.6%

An alternative measure of the ability of a company to withstand economic and/or monetary adversity can be found in its *Value Line* "financial strength" rating. This is essentially an assessment of the company's balance sheet. *Value Line's* rating scale is as follows: A++, A+, A, B++, B+, B, C++, C+, and C.

A breakdown of the financial strength ratings for the large-cap "growth" and "value" portfolios appears in the following table:

<u>LARGE-CAP STYLE</u>	<u>VL FINANCIAL STRENGTH RATING AT OR ABOVE</u>		
	<u>A++</u>	<u>A+</u>	<u>A</u>
GROWTH	37.5%	61.2%	86.4%
VALUE	13.7%	45.2%	73.3%

The implication appears to be that, at least for large capitalization portfolios, the quality is conspicuously higher, and so the safety significantly greater, in "growth" style portfolios than in "value" style portfolios.

Such a finding should not be surprising. "Growth" stocks represent companies that are currently thriving, while "value" stocks commonly represent companies in trouble. That is why the prices of the former are high and the prices of the latter are low. Companies that are thriving are apt to be in better shape to confront catastrophic conditions than are companies already in trouble, even before a catastrophe occurs.

Let us state again, however, that, for this incremental quality and safety, "growth" investors should expect to pay some price—such as the acceptance of a lower total return on their portfolios in normal times than they might enjoy if they were to sacrifice some of their quality and safety as in "value" investing.

MEASURING THE QUALITY AND SAFETY OF MID-CAP AND SMALL-CAP PORTFOLIOS

Standard & Poor's ratings are less useful for measuring the quality and safety of mid-cap and small-cap portfolios because there are so many such companies that *Standard & Poor's* does not rate at all. In contrast, the universe of securities given "financial strength" ratings by *Value Line* is about twice as large as the universe rated by *Standard & Poor's*.

A look at the relative "financial strength" ratings of "growth" and "value" mid-cap portfolios is provided in the following tabulation:

MID-CAP STYLE	VL Financial Strength Rating At or Above				
	A++	A+	A	B++	LOWER OR NR*
GROWTH	10.3%	24.6%	38.5%	73.7%	26.3%
VALUE	0.0%	16.1%	27.9%	50.5%	49.5%

*NR= Not Rated

Again, the evidence seems quite persuasive that mid-cap "growth" stock portfolios are generally of higher quality, and so would be better able to withstand catastrophic economic conditions, than would a typical "value" portfolio.

In the case of small-cap portfolios, the quality difference is far less pronounced. While small-cap "growth" portfolios were 28% invested in companies with B++ or better *Value Line* financial strength ratings, the small-cap "value" portfolios were 27% invested in this category. This is not surprising, however, since it is unlikely that any small-capitalization companies, whether "growth" or "value," would be very well insulated from the havoc of a catastrophic economy. Size alone confers some degree of comfort.

THE SO-CALLED "INVESTMENT ANOMALIES"

Investment strategists and writers frequently refer to what they call "investment anomalies." These are investment strategies that seem to show higher rates of return than they should, based upon the risks taken.

"Value" investing itself—investing in low price-earnings ratio stocks—and investing in small capitalization stocks are said by some to be anomalies. Another popular strategy said to produce

anomalous results is investing in the "Dogs of the Dow." This approach involves creating a portfolio out of the ten highest yielding stocks of the thirty stocks in the Dow-Jones Industrial Average and readjusting the portfolio annually, selling and buying to make sure the portfolio again conforms to the criterion of representing the ten highest yields in that index. A further refinement of this strategy consists of owning only the five lowest priced issues of the ten highest yields in the Dow. Investment trusts have even been marketed to implement the strategy for us. When the "Dogs of the Dow" strategy is back-tested over limited periods of time (and especially periods of declining interest rates), it produces rates of return that exceed those that would have been earned by owning all thirty stocks in the Dow-Jones Industrial Average.

The logic is flawed in most such comparisons, however. One cannot compare "apples to oranges." If one is going to own stocks with the lowest price-earnings ratios, stocks of the smallest companies, stocks with the highest yields, or stocks with the lowest prices, almost by definition, one is also going to own the stocks of companies most apt to go bankrupt in a catastrophic economy—an economy where Aaa bonds prove their worth over Aa bonds, where U. S. Treasuries meet their obligations but Federal agencies default, and where our savings account is salvaged only because our bank is FDIC-insured.

It surely would not be considered an anomaly to discover that investors (or speculators) made more money by investing in high-risk securities in stock market periods where high-quality was not needed. The owners of "junk" bonds may get higher returns on their bonds than the owners of high-quality bonds—as long as we do not have a serious recession or Great Depression. This is not considered an anomaly. Similarly, the possibility that owners of "junk" stocks might get higher returns than owners of high-quality stocks (as long as we do not have a serious recession or Great Depression) would come as no surprise.

To return to our insurance analogy: All other things being equal, the owner of an income-producing apartment building will earn a higher net return if he does not carry fire insurance on his building than if he does—as long as he does not have a fire, which he probably will not have. Such an observation, however, can hardly be construed as the discovery of an anomaly.

THE RECORDS OF PERFORMANCE

The inference, so far, is that, because "growth" investors enjoy greater protection against such perils as another Great Depression, they should expect, and should be satisfied with, lesser rates of return in normal times than those presumably enjoyed by "value" investors. To compare the rates of return of higher-quality "growth" portfolios with the rates of return of lower-quality "value" portfolios, in normal times, as we have said, is to compare "apples to oranges."

Though it may appear that "growth" investors should be content with lesser returns than those enjoyed by "value" investors, before reaching the conclusion that they actually do receive lesser returns, let us examine the following data—again from *Morningstar*:

<u>COMPARISON</u>	<u>RELATIVE ANNUALIZED 10-YEAR TOTAL RETURNS</u>		
	<u>LARGE-CAP</u>	<u>MID-CAP</u>	<u>SMALL-CAP</u>
GROWTH VS. VALUE	+2.85%	+2.79%	+2.95%
GROWTH VS. BLEND	+1.67%	+0.98%	+1.84%

As can be seen, whether the "growth" strategy is compared against the "value" strategy or a "blend" of "growth" and "value" strategies, over the past ten years, the "growth" strategy has produced the higher returns. Furthermore, depending upon whether we are looking at small-cap, mid-cap, or large-cap portfolios, this outperformance of "growth" over "value" or "blend" strategies has ranged from nearly 1% to nearly 3% per year.

AN IMPORTANT NOTE

In spite of the fact that we are using the abundant data made available by mutual funds and a mutual fund rating service to demonstrate the advantages of a "growth" investment strategy over a "value" investment strategy, I do not want our readers to conclude that I am endorsing investment in mutual funds that pursue "growth" strategies or any other strategies. Nothing could be farther from the truth.

Without belaboring the point here, let us simply note that, though "growth" funds appear to outperform "value" funds, not one of the nine groups of mutual funds examined here even matched the *Standard & Poor's 500* over the past ten years. The degrees of underperformance ranged from a low of 0.69% per year for small-cap "growth" funds to a high of 3.64% per year for small-cap "value" funds. As a general rule, domestic mutual funds underperform the markets in which they invest by about 3% per year, while foreign and international funds underperform their markets by about 4% per year. That is to say, mutual funds underperform randomly selected and unmanaged portfolios by these 3%-to-4% amounts, every year, year-after-year. Direct investment in common stocks is clearly the more efficient way to invest.

DO GROWTH STOCK INVESTORS GET A FREE LUNCH?

The foregoing data imply the paradox that "growth" investors both earn higher rates of return and enjoy greater safety than do "value" investors. "Growth" investors, however, do not really get a free lunch. They make two sacrifices. First, they must accept a greater part of their investment returns in the form of less predictable capital gains, as opposed to more predictable dividends. A

comparison of the dividend yields currently available for the various styles of mutual fund investing appears in the following table:

<u>STYLE</u>	<u>DIVIDEND YIELD</u>		
	<u>LARGE-CAP</u>	<u>MID-CAP</u>	<u>SMALL-CAP</u>
GROWTH	0.3%	0.2%	0.1%
BLEND	1.1%	0.6%	0.4%
VALUE	1.7%	1.2%	0.8%

It is important to realize that the performance figures presented in the earlier section are "total return" figures which combine both capital appreciation and dividends. The nature of the sacrifice made by "growth" investors illustrated in this last table is not in the amount of money they receive, but rather in a greater uncertainty as to when they receive it.

The apportionment of returns between dividends and capital gains for each of the nine mutual fund sectors over the past ten years appears below:

<u>STYLE:</u>	<u>% OF TOTAL RETURN FROM DIVIDENDS VERSUS CAPITAL GAINS (1986-1995)</u>					
	<u>GROWTH</u>		<u>BLEND</u>		<u>VALUE</u>	
	<u>DIVIDENDS</u>	<u>CAPITAL GAINS</u>	<u>DIVIDENDS</u>	<u>CAPITAL GAINS</u>	<u>DIVIDENDS</u>	<u>CAPITAL GAINS</u>
LARGE	10.2%	89.8%	19.1%	80.9%	24.4%	75.6%
MEDIUM	5.7%	94.3%	13.1%	86.9%	20.1%	79.9%
SMALL	2.6%	97.4%	7.4%	92.6%	10.9%	89.1%

On the basis of the foregoing data, it appears that "value" investors derived 11% to 24% of their rewards from dividends, and 76% to 89% from capital gains; "growth" investors, on the other hand, derived only 3% to 10% of their rewards from dividends, with 90% to 97% coming from capital appreciation.

The second sacrifice "growth" investors experience, in normal times, is a greater volatility in their portfolios. It is simply characteristic of high price-to-earnings ratio stocks that their day-to-day, week-to-week, month-to-month, and year-to-year price swings tend to be more violent than those of low price-to-earnings ratio stocks. The magnitude of this volatility is commonly captured in a yardstick called "Beta." "Beta" is a measure of the historical volatility of a stock or a portfolio, relative to the market as a whole. The market is defined as having a Beta of 1.00; stocks and portfolios that are more volatile than the market have Betas of greater than 1.00, and those less volatile than the market have Betas that are less than 1.00.

Morningstar provides the average Betas for each investment style, as reproduced in the following table:

<u>STYLE</u>	<u>AVERAGE BETA (VOLATILITY)</u>		
	<u>LARGE-CAP</u>	<u>MID-CAP</u>	<u>SMALL-CAP</u>
GROWTH	1.02	1.04	0.98
BLEND	0.94	0.90	0.82
VALUE	0.91	0.85	0.66

It appears from the foregoing that "growth" investors probably experience from 10% (in large caps) to 50% (in small caps) more volatility in their portfolios than that experienced by "value" investors.

These two sacrifices—having to accept more erratic capital appreciation in lieu of periodic dividend income, and having to accept greater volatility in the value of our principal—may be summed up in an esoteric concept called "equity duration." Duration is a term most commonly applied to bond investing as a measure of the sensitivity of the price of a bond to a change in interest rates. If, however, we define "duration" in more general terms as "a measure of the degree of uncertainty in the timing of our rewards," "growth" stocks tend to be "longer duration" investments than "value" stocks and so capitalism must pay us more to put up with them.

CONCLUSION

In summary, it appears that "growth" investors enjoy higher total returns than do "value" investors, and that they also have greater protection against calamitous events such as depressions, credit crunches, and other catastrophes such as we can only imagine. For these benefits, however, growth investors must be willing to accept a greater portion of their total returns in the form of irregular capital gains, as opposed to more regular dividends; and they must be willing to accept higher short-term volatility in the values of their portfolios.

Clifford G. Dow, Sr., CFA, ChFC, CFP®
Chief Investment Officer
1998

Securities offered through Delta Equity Services Corporation. Advisory services offered through Delta Global Asset Management, an SEC Registered Investment Advisor. 579 Main Street, Bolton, MA 01740 978.779.5361 FINRA SIPC MSRB