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What's in a Name?

Growth and value styles have more in common than plan sponsors would think.

Traditionally, growth has been defined as the inverse of value. In practice, these styles are not mutually exclusive. This reality is highlighted by an analysis of historic returns for international style variables and in the latest approaches adopted by style index providers.

Value investors typically aim to screen their universe and identify stocks that appear attractive on a current valuation basis. Then they hone in on those that offer genuine value. Growth investors look for companies that offer good growth prospects and then assess the extent to which this growth has been factored into the price.

By the very nature of their approaches, both types of investors will be attracted to stocks that are cheap and offer good growth prospects. From a conceptual viewpoint it is apparent there can be crossover between value and growth universes.

To assess the relationship between growth and value, it is necessary to analyze the performance of a number of growth and value variables over the last 11 years for an international ex-North America universe.[1] While the returns revealed a negative correlation between the growth and value variables, this relationship was relatively weak and doesn't support the traditional view of growth being the opposite of value.

The analysis also reveals that the impact of style was stronger in the second half of the period than in the first. One explanation for this is that style effects are becoming increasingly important in international markets.

All of the growth variables outperformed over the period as a whole, peaking at the end of 1999 and declining since then. All of the value variables also outperformed over the whole period, with a noticeable dip at the end of 1999 and strong outperformance since then.

The discovery that all of the growth and value variables have outperformed seems counter-intuitive. This is because investors have been conditioned to see growth as the inverse of value when, in practice, growth and value are independent concepts and it is not unreasonable for both to outperform at the same time.

Recently, the leading index providers have been reviewing their approach to style indexes. Both MSCI and FTSE appear set to join Salomon Smith Barney in introducing indexes that are based on a range of growth and value characteristics, as opposed to MSCI's original approach which equates growth with expensive stocks.

In developing style indexes, providers face a dilemma in balancing purity with practicality. The purest reflection of growth and value styles would result in some stocks being included in both indexes and others not included in either. However, this can result in biases at the total fund level. So far, Salomon Smith Barney and FTSE have opted for practicality over purity in their offerings, while MSCI's new approach is undecided.

For plan sponsors that appoint separate international value and growth managers, there is a temptation to benchmark them against the relevant style index. However, this approach may have undesirable effects such as encouraging managers to hold stocks that they do not like for 'risk reduction' purposes. A preferable approach to avoid style drift is to regularly monitor the manager's style biases using holdings-based analysis. Overall, care needs to be exercised when defining growth and value in the use of style indexes as benchmarks for investment managers. ■

1. The value variables used were book-to-price, cashflow yield, dividend yield and sales-to-price. The growth variables used were historic earnings growth, return on equity and sales growth. The returns for each variable were based on cap-weighted average returns for the top 50 per cent of stocks by that variable, rebalanced quarterly. Returns were calculated from December 1990 to May 2002.