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The Risks and Rewards of Investment Style

When investing globally, what are the risks and rewards of various styles.

The last few years have seen tremendous swings in the relative performance of value and growth styles, both inside and outside of Canada. Looking at the MSCI style indices, which define value and growth based on price-to-book ratio, the years from 1975 to 1997 saw quite consistent value outperformance. However, 1998-2000 saw some of the largest deviations ever in value and growth performance, with value stocks lagging sharply during the technology stock bubble. The risk of value also shot up as we saw one of the largest jumps ever in the annualized tracking error of the MSCI value index versus the standard world index.

How should investors respond to these events, keeping in mind that the world value index has outperformed the world growth index by 3.1 per cent each year for over 25 years? Clearly, over the long term, a value orientation has been more advantageous in global equity investing. But to have benefited from this, an investor would need to be able to stomach the volatility caused by occasional periods of steep value underperformance, such as that experienced in 1998-1999.

Country and industry differences are another consideration. In the period between 1991 and 2001, value defined by price-to-book outperformed by between 20 to 30 per cent in most major equity markets. (The exception, interestingly enough, is Canada, where value as defined by low price-to-book did not work well.) In sectors, value generally outperformed over this same period —though not in technology and finance companies. For those investors pursuing a value or growth approach, it pays to have some understanding of which sectors and markets are most susceptible to a particular valuation approach.

It is most helpful to look at the world in a multifactor context, constructing a ranking of companies based on a composite of growth and value-related measures. Looking at the performance of a range of valuation tools across the entire world equity market for the period 1997 to 2001, it can be seen that, during the peak of the bubble, analyst revisions and growth measures outperformed a multi-factor ranking, which includes value-oriented measures like price-to-book. But by the end of 2001, the multi-factor ranking had outperformed all single predictive measures. Earnings growth measures, based on consensus future earnings growth expectations, underperformed over this entire period despite the tremendous bubble in technology and large-cap growth stock in 1998 and 1999.

The following conclusions can be drawn:

1. Over long periods value has outperformed growth significantly in the world equity markets—but there can be periods where this pattern reverses dramatically. A structural overweight to value is probably appropriate only if an investor can tolerate such periods without "selling at the bottom."

2. It is important to understand your manager's style and the degree of that style when evaluating performance; otherwise, you could draw mistaken conclusions about her or his skill in adding value and make costly changes at the wrong time.

3. Value is not a simplistic concept best captured by price-to-book. A multi-factor approach is better at both explaining and predicting returns. A multi-factor value and growth index like Salomon Smith Barney's appears to be more consistent with the way most managers classify companies than the MSCI value and growth indices are.

4. There are meaningful differences in the way valuation factors behave across countries and industry sectors. If a manager uses valuation factors as predictive tools in evaluating securities, their ability to outperform will be enhanced if he or she has a good understanding of how these tools function in various sectors and markets. ∎