

Commentary

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Never going out of style

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Within equity investing, the two main investment styles are value and growth. Value investing typically consists of trying to buy companies “on sale” or picking stocks that have low prices in relation to factors such as earnings, sales, and the book value of the issuing companies. Growth investors seek capital appreciation in stocks that they believe will provide faster-than-average increases in share price in the future.

Relative performance between value and growth investment styles tends to oscillate in cycles. Recently, growth stocks have been outperforming value stocks and investors can’t imagine how that could ever flip. As a result, investors have continued to herd into these securities, pushing their valuations even higher. The same dynamics took place during the early 1970s bull market, the 1980s Japanese bull market, and the 1990s dot-com bubble. During these periods, growth stocks grossly outperformed value stocks. However, if we measure cumulative returns over the past 40 years, value holds the advantage.

In the 1970s, a group of stocks called the Nifty 50 reached extreme valuations. Investors thought companies like Polaroid, Westinghouse and Eastman Kodak would “grow” into their valuations. As the 1970s progressed, these valuations were no longer supported by market euphoria and the stocks experienced significant declines in the period that followed. In the 1980s, the Japanese stock market experienced a similar phenomenon, and has yet to return to its peak.

A more recent example is the dot-com era of the late 1990s. Investors valued companies based on clicks because they had no earnings. Some companies like Yahoo traded at hundreds of times their earnings. After the euphoria, hundreds of internet firms went bankrupt. Many of the firms that proved to be good companies, and are still around today, took years to recover. The NASDAQ Composite Index, a proxy for U.S. technology stocks, peaked in March 2000 and took 15 years to reach its previous high.

Today, markets are reminiscent of previous speculative periods. Since 2010, growth stocks have outperformed value stocks by a large margin. The increasing divergence has continued in the first half of 2018. While the S&P 500 Index, a proxy for U.S. equity market performance, has performed strongly this year, the returns were driven by a small number of stocks with higher-than-average valuations.

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A group of six companies nicknamed the “FAANG + M” stocks have emerged as key contributors to performance (Facebook, Amazon, Apple, Netflix, Google, and Microsoft). On a year-to-date basis, FAANG + M accounted for approximately 97% of S&P 500 returns (or 2.55% of the 2.62% total return so far this year), while the remaining 494 companies accounted for approximately 3% (or 0.07% of 2.62%). Since the S&P 500 is market-cap-weighted, index exposure to FAANG + M has increased and performance will be more dependent on this narrow group of stocks in the future. Growth style investment managers continue to outperform value style investment managers by a large margin, particularly growth style managers who believe this narrow group of stocks will “grow” into their valuations.

History has shown us that piling into funds managed by growth style investment managers while allocating away from those managed by value style investment managers has been costly. Those who concentrated allocations toward growth managers exposed investors to large potential drawdowns. Patient investors were rewarded as value managers outperformed growth managers over the subsequent five and 10-year periods following the previously mentioned examples of growth stock euphoria. Our portfolios are designed to provide exposure to each style across three major geographies, which minimizes some of the style swings that will otherwise occur over time in a portfolio with only one style. We aim to construct portfolios using a balanced approach to equity styles to help clients avoid large drawdowns and meet their financial goals with a higher level of consistency.

Fundamentals eventually matter, regardless of short-term swings in sentiment. Even fast-growing businesses eventually mature. When this happens, companies reach their market potential and growth rates decline. Excessive valuations decline, providing buying opportunities for the patient investor. While it’s impossible to know where markets will go in the short term, in the long term, stock prices reflect fundamentals. While investment style fads come and go, disciplined, diversified investing will never go out of style.

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