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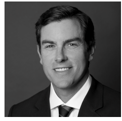

# The Convergence of Growth and Value

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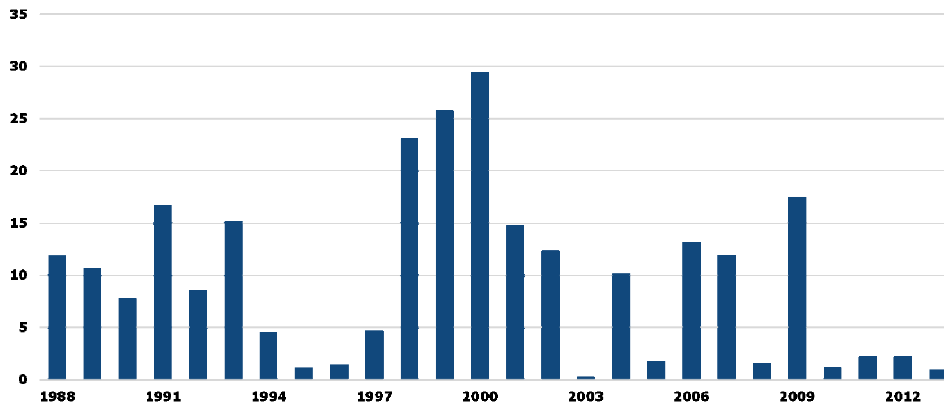
Of the many varied ways to categorize stocks, the distinction between growth and value has played prominently for managers in terms of investment philosophy and for investors in their asset allocation decisions. The return differences between Growth and Value stocks have historically exhibited a strong polarity, although, the period following the financial crisis has seen a convergence between both the returns to Growth and Value stocks and the indices that provide exposure to those styles.

Exhibit #1 illustrates the yearly return difference in absolute value between the Russell 1000 Growth (R1G) and the Russell 1000 Value (R1V) Indexes. The periods prior to the financial crisis displayed a fairly large variance in return between the two benchmarks with an annual average of 10%, while the last four years have had the smallest variance on record at less than 2%.

While this clearly illustrates a recent shift away from the growth and value cycles we see in the time-series of market

Exhibit #1: Absolute Value (+/- neutral) of Return Difference between Russell 1000 Growth and Russell 1000 Value Indexes




returns, understanding why this is occurring is a bit more complicated. The behavior of the indexes might be explained to some degree by changes in the relative exposures to Growth and Value characteristics that distinguish the benchmarks from each other. In exhibits #2 and #3 we look at the historical exposure to some of the more common style characteristics; 'Price/Earnings Ratio' and analysts 'Long-term Growth' forecasts. While there has certainly been a degree of convergence for the P/E multiples between the R1V and R1G, the long-term growth exposure appears to be fairly consistent over time. We believe it's unlikely that this would be the sole cause of the recent performance patterns.

Another possible explanation is that the returns to both value and growth stocks have somehow become correlated since the financial crisis. We examine this by measuring the correlation of returns to 'low P/E' stocks with the returns to 'high Long-term Growth' stocks in exhibit #4 on page 8.

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Exhibit #2: Trailing Price/Earnings Ratio

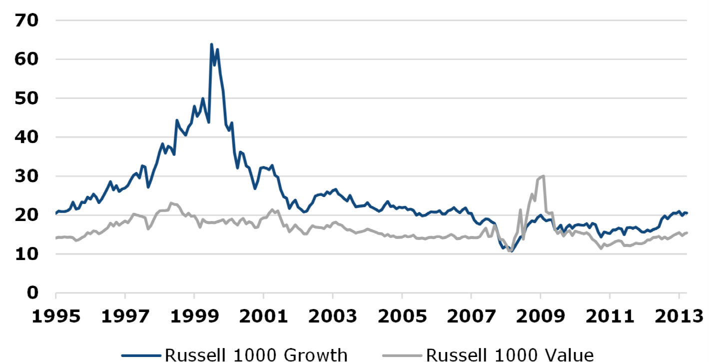
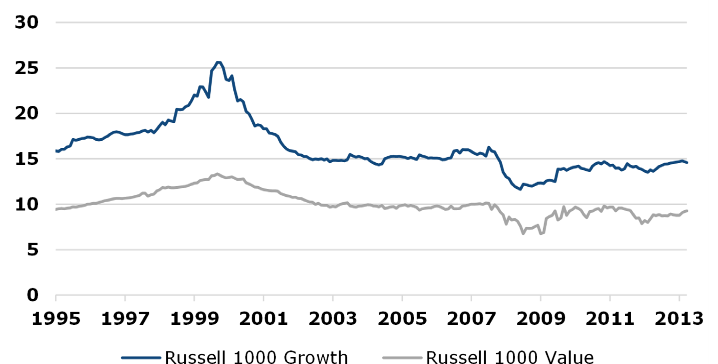



Exhibit #3: Weight Average Expected LT Growth



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As expected, the historical relationship between the two factors has been consistently negative. However, beginning in 2008 that trend began to break down and even briefly turned positive in 2013. In fact, 2013 was the only observation in our 20 year analysis where the return to both factors had ever exhibited the same sign as the return to both low P/E and high Long-term Growth each had around a +10% return last year. A detailed explanation of the reasons for this sudden convergence of two normally opposing factors is unfortunately beyond the scope of a mere newsletter article. But we do have a few thoughts as to what may be contributing to this recent phenomenon. Growth and Value stocks have traditionally been largely determined by their sector membership. For instance, in 2004 the 'Growth' benchmarks sported a Health Care sector weight of 25%, while the 'Value' benchmarks barely had any exposure. Today, Health Care companies have matured and are generally equally divided between the two style indexes. In addition, many Information Technology companies have matured from Growth stocks into Value stocks, such as Intel and Cisco. Interestingly, Apple was considered a value company in 2004, as it wasn't even represented in the Russell 1000 Growth index, but now it is in both indices.

Beyond just an interesting observation, this recent trend in the convergence of Growth and Value returns, if continued into the future, may lessen the need for investors to categorize their equity exposure along these specific style dimensions and focus more on the qualities of a particular manager when making allocation decisions.