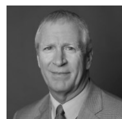


A Broken Value-Growth Cycle?

RICK VILLARS, CFA

Value and growth indices grew out of the realization that there was a rotation between investors focused on identifying growth stocks and those intent on identifying value. That rotation ebbs and flows over time. But the current growth cycle has been running for ten years, save a few brief respites in 2012 and 2016, and many are questioning if the cycle is permanently broken. One could postulate that maybe this time is different and stocks of "new economy" companies will perpetually outpace those of their "old economy" brethren.

On closer examination of the current growth cycle we find that not all growth is equally attractive to investors. For the first eight years of the current ten year growth cycle within large cap U.S. stocks, the most preferred growth has been high long-term (3-5 years) expected earnings growth, followed by high next 12-months earnings growth. Companies with high expected sales growth have modestly underperformed companies with lower sales growth expectations (Exhibit #1). However, this long-term pattern has been turned on its head over the past few years as highest expected sales growth has dramatically outpaced other growth metrics. This outcome has been especially pronounced in 2019/2020 (Exhibit #1). One way to interpret this result could be that investors are favoring companies that are maximizing sales growth to capture market share to be monetized into earnings growth down the road.

Using data back over even longer time periods (to the late 1990's), companies that have high sales growth expectations have a mixed record. About one-third of the time the top quintile (one-fifth) outperforms the rest of the universe and once again is negative for the full period. That result is indicative of a cyclical factor. For much of that period the return to the sales growth factor is random. Two notable exceptions are periods ending February 2000 and June 2008 (Exhibit #2). Data for this fundamental factor are thin prior to late 1990's but better in the final six months leading up to February 2000. During each of those months the top quintile outpaced the other 80% of companies, with a massive +26% gap in the final month. However, those same stocks reversed in the following 12 months; underperforming the remaining universe by -57%. The 13 months to June 2008 was also a standout period for the factor with the top quintile showing positive price discrimination in 11 of 13 months and with a +13% cumulative performance over the rest of the universe. But once again those stocks reversed course and lagged the rest by -38% over the following 12 months.

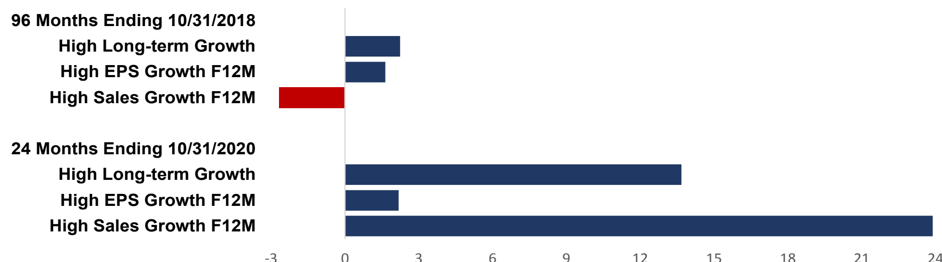
Exhibit #2

Russell 1000 Q1 to Rest Spread
High Sales Growth F12M

Time Period	Length of Period	Pct. Months Outperforming	Cumulative Out / Under Performance
Sep. 1999 - Feb. 2000	6 months	100%	+89%
Mar. 2000 - Feb. 2001	12 months	25%	-57%
Jun. 2007 - Jun. 2008	13 months	85%	+13%
Jul. 2008 - Jun. 2009	12 months	25%	-38%

These two periods are related to turning points between bull and bear markets, but not in a consistent way. The reversal of returns to high sales growth in 2000 led the March peak by about a month but the market did not begin its selloff in earnest until August of that year, while the positive returns of the factor in the second instance started about the time the market was peaking in mid-2007 and lasted for the early stages of the bear market. Clearly not a market timing tool then, nor one for the current market.

There are clear differences between those episodes and the current cycle. The interest rate environment is notable for being different in all three cases. With current rates near zero, valuation models can justify some crazy multiples. Rates were rising in 1999 and most valuation models had just been thrown out the window. In 2007/2008 rates were flat then falling for most of the period of outperformance. ***But investors seem to favor expected sales growth more highly during a slowing earnings growth environment for the broader market and toward the end of a growth stock outperformance cycle.*** This is a commonality. Each case has been during a period of significant change in growth drivers that segregate "new economy" companies from the "old economy." In the 1990's it was the dot.com boom, in the mid 2000's it was globalization of supply chains, and in the late



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2010's the catalyst was cloud computing and the swap of physical location-based activities to a remote environment (the latter being accelerated by a pandemic). Arguably, today's "new economy" companies are more seasoned than Webvan, Pets.com, eToys.com and TheGlobe.com of dot.com fame. Back then companies were judged by the number of user looks instead of earnings. Today there are tangible earnings streams. So while history is not being replicated there are plenty of reasons to not over commit to the mantra of "growth at any price." A strong reminder of the cost of "growth at any price" is the stock price of Microsoft for the period 2000 – 2010. During that period Microsoft saw its operating earnings increased by more than 120% but its stock price was halved as it price/earnings multiple fell from 75x to 12x.

Diversification is the other consideration when thinking about a portfolio of high expected sales growth companies. The top quintile currently is dominated by Information Technology, Health Care, and Communication Services. The new economy theme is alive and well in this environment. It will be interesting to see how market factor returns evolve as recovery stocks start to see a significant shift in their sales growth outlook. This is especially true in light of the current valuation gap between growth and value indices. Over the past 20 years the valuation divide between U.S. large cap growth and value stocks has reached two standard deviations only twice - during the height of the dot.com bubble and today.

Our intent is not to throw cold water on the exciting growth stories of today's growth darlings, we have found some that fit our criteria. It is just to provide a voice of moderation to the discussion. Over time companies that exceed expectations are rewarded. But there are two components to that equation, actual and expected results. Expectations rise for companies as they become more popular. Eventually those expectations become harder to beat. In today's market investor expectations have increased for a narrow group of companies. Additionally, those stocks also tend to trade at premium valuations. But at some point those expectations will not be met and the positive feedback loop will be broken.

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