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Equity styles

When you buy stocks, are you looking for growth or for value? For the uninitiated the question may seem nonsensical—everyone wants both growth *and* value, and large portions please! But these terms have a specific meaning to professional investors. The terms imply dramatically different risk profiles and expectations for rates of return on investments.

The traditional "value" investor seeks to invest in companies at relatively low valuation levels. These bargain hunters of the investment world typically search for low ratios of stock price to earnings (the price-earnings ratio, or P/E), or the book value (price-to-book value ratio, or P/B). They are hoping to discover investment opportunities "overlooked" by other investors, by the market as a whole. Very often these companies are out of favor on Wall Street and may be undergoing a restructuring or other transformation expected to "unlock" great future value. Patience is an attribute most often associated with value investors. Their patience may be rewarded with higher dividend yields and lower risk of disappointment.

Growth investors, residing at the other end of the spectrum, generally pursue explosive growth of sales and earnings with little regard to price. The companies in which they invest typically sport high P/E's, P/B's and multiples of sales because their superior past records are well established. These Wall Street favorites can offer excitement and above-market rates of return, and they tend to be younger firms in the fields of technology, communications and pharmaceuticals. However, these characteristics tend to be accompanied by greater price volatility and risk of loss, especially when earnings soften.

Value investors are generally thought to be more conservative, accepting lower returns in exchange for more stable prices. Growth investors, in taking greater risks in search of superior rewards over a shorter time frame, are thought to be more aggressive.

Which approach is really better?

There have been a number of indices developed over the years to compare growth and value investments. Eugene Fama and Ken French developed the Fama-French Index, the results of which are published annually in the *Ibbotson SBBI Classic Yearbook*. In the Fama-French index, book value is divided by market capitalizations, with some adjustments. Value companies have a high book-to-market ratio, while growth companies will have a low ratio. The 30% of companies with the highest ratios constitute the value index, and the 30% with the lowest ratios will be the growth index. The middle 40% is considered a blend of the two styles.

Over the past ten years, growth has slightly outperformed value, with a compound annual return of 8% versus 7.5%. However, if one begins the examination in 2000, when the Internet bubble collapsed, the picture changes. From 2000 through 2013, value stocks had an annual compound return of just 0.3%, but that was far better than the -1.8% of growth stocks.

One would expect that growth stocks would have higher highs and lower lows than value stocks, but this assumption has been wrong in recent years. Value stocks had their worst single year in 2008, with a loss of nearly 50%. But they handily beat the growth stocks in both 2012 and 2013, making up for the loss.

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