Yanni Partners
Delivering the Promise

Measuring Up

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Style Diversification: Value and Growth Equities

In This Issue

How to incorporate investment style into a portfolio strategy.

"Since August of 1998, the Tiger funds have stumbled badly and Tiger investors have voted strongly with their pocketbooks, understandably so. During that period, Tiger investors withdrew some $7.7 billion of funds. The result of the demise of value investing and investor withdrawals has been financial erosion, stressful to us all. And there is no real indication that a quick end is in sight."
– Julian Robertson (March 2000)

In his final, almost prophetic, letter to shareholders closing the famed Tiger fund, Julian Robertson's dilemma epitomized the conundrum felt by many of his value investing cohorts, including Warren Buffett. From its inception in 1980 through March of 2000, the Tiger fund had posted an annualized return of 31.7%. Such long term track records were being thrown by the wayside, as investors clamored to shift their assets into the "new paradigm" of investing. Value investors were labeled stodgy and out of touch with the markets. Investors not levered to the Technology, Media, and Telecom industries were deemed to be missing the boat. Growth oriented investment managers were posting annual returns exceeding 100%, dwarfing those of Tiger and other historically strong investment managers. The thought of maintaining exposure to value stocks had almost become heresy.

Figure One
Russell 1000 Value and Growth Indices

Now nearly seven years removed from the "Era of Irrational Exuberance," those investors brave enough to have maintained their allocations to value stocks have been handsomely rewarded. Historically "stodgy" value sectors like Energy and Industrials have benefited from a secular trend in the global economy. Financial distress, increased competition, and market saturation have resulted in significant headwinds for former growth bellwethers – Technology and Telecom. The tables have once again turned as investors ponder whether they should dedicate portfolio allocations to growth stocks.

While recent history may portray an extreme scenario, the moral of the story remains true. Diversification is an investor's primary defense against such extreme market movements. Our Spring 2007 *Measuring Up* seeks to provide further insight regarding how to incorporate investment style into a portfolio strategy.

Value and Growth Stocks

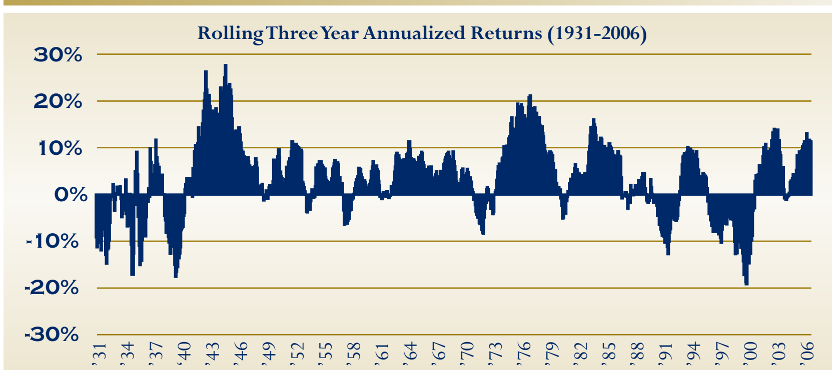
While there does not seem to be a universal definition for value and growth stocks, there are attributes that are commonly associated with each market segment. Academic studies have tended to emphasize discrete quantitative metrics in order to facilitate ease of analysis. For instance, in their seminal work, "The Cross-Section of Expected Stock Returns," scholars Eugene Fama and Kenneth French[1] defined value stocks as companies with a high ratio of book-to-market equity (i.e, low price-to-book). Index providers have also emphasized simple classifications. For instance the Russell series of indexes classifies stocks based on price-to-book value (P/B) and the forecasted earnings growth rates. Other metrics commonly used to analyze value and growth stocks include price to earnings (P/E), price to sales (P/S), price to earnings relative to growth rate (PEG), price to cash flow (P/C), and dividend yield.

Building on the book-to-market framework one can begin to understand the delineation between the two camps. By focusing on the book-to-market ratio, Fama and French were able to link a company's balance sheet information (assets less liabilities equals owners' equity) with its market price. The price represents the market's consensus appraisal of each company's future earnings and/or cash flow prospects. From this appraisal, value stocks typically receive a lower premium relative to their book value when compared to their growth counterparts. Analysts contend that investors forecast superior business and earnings growth prospects for growth companies, and they are more pessimistic about the prospects of value-oriented stocks.

[1] Fama, Eugene F., and Kenneth R. French, 1998, The Cross-Section of Expected Stock Returns, Journal of Finance 47, 427-465.

FIGURE TWO

Historical Returns (Large Cap Value versus Growth)



In an effort to extend beyond simple valuation metrics, one must also consider qualitative attributes of each market segment. Fama and French argued value stocks tend to be lower quality businesses with higher earnings volatility. Value stocks are typically labeled as "out of favor," as the companies tend to be plagued by near term skepticism stemming from poor operating performance, industry headwinds, competitive threats, and headline events. The businesses tend to be more cyclical and commodity driven resulting in a greater sensitivity to the economic cycle. Historically value stocks have been associated with the Energy, Industrials, and Utilities sectors.

Growth stocks tend to exhibit more favorable earnings prospects, resulting in premium valuations. Growth businesses typically boast strong operating track records within higher growth industries. Their businesses tend to have strong competitive positions, unique products/services, and are generally more immune to the economic cycle. The Technology, Healthcare, and Consumer Discretionary sectors have historically been labeled growth sectors.

Value and Growth Stocks' Historical Performance

Empirical studies in the academic community have reached a general consensus that value stocks have outperformed their growth counterparts on average, over the longer term *(See Figure Two)*. The chart highlights value returns minus growth returns on a rolling three-year basis dating back to 1931 for large cap stocks. A historical portrayal of small cap stocks would portray an even more substantial return advantage for value relative to growth. The value and growth return series were established utilizing the aforementioned framework of Eugene Fama and Kenneth French.

While value has demonstrated an ability to outperform over the longer term, there have been periods when growth stocks have significantly outperformed relative to their value counterparts.

Unfortunately, investors have not been able to devise a "black box" that can properly time when a specific style of investing may fall in or out of favor. Furthermore, incorrectly timing such events could prove costly for portfolios. For this reason, we continue to recommend that investors maintain exposure to both growth and value stocks.

Value and Growth: Incorporating Style into Portfolios

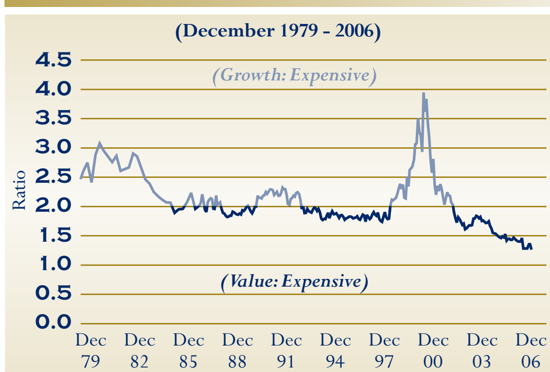
In light of value's continued strong relative performance, Yanni Partners spent much of 2006 revisiting our bias toward value and general approach to domestic portfolio structure. We decided to take a more qualitative view of the markets recognizing the rationale for value's historical outperformance. We considered the current market environment in terms of sentiment and valuation, as well as a risk versus reward assessment of maintaining a style tilt on a forward looking basis.

We first endeavored to assess both the arguments for and against maintaining a style tilt toward value. The arguments for style tilts can be summarized as follows. Eugene Fama and Kenneth French contend that value stocks earn a return premium that is commensurate with the higher risk profile of value companies. They offer that value companies tend to have lower quality businesses and higher earnings volatility. Louis K.C. Chan and Josef Lakonishok[2] cite behavioral and agency considerations regarding value versus growth stocks. From a behavioral standpoint, investors tend to overprice growth stocks by erroneously extrapolating growth stocks' historical growth rates. Their analysis provided evidence that premium valuations provide little predictive power when forecasting future growth. The result is that high priced stocks from a multiple perspective tend to disappoint leading to inferior results. Chan and Lakonishok also provide an agency consideration whereby investment managers and plan sponsors tend to favor growth or "glamour" stocks. They suggest such agency considerations force investment managers to avoid career risk associated with holding a portfolio of tainted problem stocks, instead gravitating toward more established performers. Finally, from a pure economic standpoint, Thomas Phillips[3], in his Theorem of Growth Equality, hypothesizes that the same economic forces apply to both value and growth companies resulting similar earnings growth rates over the longer term. Phillips suggests that the style offering the highest dividend yield will likely outperform.

The arguments against a value tilt typically take into consideration the notion of efficient markets and risks inherent in lower quality companies. Efficient market theorists suggest that if the market is aware of an anomaly, such that value stocks outperform their growth counterparts, investors will arbitrage away value's superior performance. They also suggest that the data may be spurious due to survivor bias and pricing errors. Moreover, there is no assurance that investors could have traded in volume, based on certain historic price quotes. Theorists also suggest that given the lower quality nature of value companies and volatile nature of earnings, there may be severe downside risks not frequently manifested in historic data.

FIGURE THREE

Russell 1000 Growth vs Value P/S



A current assessment of the overall market utilizing Russell data suggests that valuations are at or slightly outside of normal ranges depending on the selected metric. From a forward P/E perspective the

2 Chan, Louis K.C., and Josef Lakonishok, 2002, Value and Growth Investing, 1-16.

3 Phillips, Thomas K., 2002, Growth and Value Investing, CFA Magazine, Vol. 17, No. 4, 38-48.

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premium of growth stocks relative to value stocks is in line with its historical average, providing little support for a tactical tilt in either direction. A similar observation of P/S and P/B provides moderate evidence that value's run may be extended as the relative premium of growth versus value has contracted below 95.0% or 2 standard deviations from its historical norms *(See Figure Three)*. In his paper entitled the "The Trouble with Value" GMO Strategist Ben Inker[4] suggests that value has enjoyed significant multiple expansion relative to its growth counterparts (especially in large cap) since the inception of the Russell Series. An observation of price to sales suggests that value stocks are approaching parity with that of growth stocks in terms of valuation. One might argue that it is a conceptual challenge to assume that "value" stocks could trade at an absolute premium or even in line with growth stocks.

Finally, through our ongoing discussions with the investment management community, we are able to gain insight regarding current market sentiment. Many investment managers are suggesting that after nearly seven years of underperformance, growth stocks may be poised to outperform their value counterparts. They point to the notion that in a slower growth economy investors would likely gravitate toward growth stocks placing a premium on scarce growth opportunities. Most tend to favor stocks of high quality companies with consistent earnings growth at reasonable prices. The emphasis on quality and valuation is designed to protect investors from a significant valuation contraction that could afflict higher growth names in a down market environment. Proponents of value investing stress a long-term view of the markets, emphasizing the notion that even great companies can be poor investments if investors ignore the price they pay. They would argue that a discipline focused on asset protection and a margin of safety provides investors with a superior risk versus reward scenario over the longer term.

Conclusion

Yanni Partners continues to advise clients to diversify among investment styles. The historical data reveals that value has outperformed over the longer term. Historical data also reveals that style cycles can be abrupt, resulting in periods of extended outperformance by growth stocks. Yanni Partners will work with each client to establish a strategic portfolio strategy that is consistent with its unique long-term goals.

[4] Inker, Ben 2005, The Trouble With Value, GMO, 1-6.

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