

Growth is in Vogue

Suggestion of style's limited utility proves false, as style endures as a useful tool for assessing investment risk.

by Travis Pascavis, CFA | 30 June 2009

Style Turnabout

"Growth and Value don't matter anymore."
"Style is dead." Such were the common refrains recently from many consultants, advisors, and other professional investors. The market no longer operates with such broad headwinds, the thinking went, and future winners would be more broadly dispersed among style classifications and capitalization ranges. Instead, the conventional wisdom stated that investors should think of their equity portfolios in terms of core and satellite or long-only and alternative, rather than style-box categories. These new concepts grabbed headlines; predictably, they don't offer much insight for an investor trying to navigate the market.

Interestingly, style is once again demonstrating its usefulness as a tool in evaluating the U.S. market. Growth stocks are handily in the driver seat, trumping value so far this year. The Morningstar US Growth Index is up 15% after two quarters in 2009, compared with the Morningstar US Value Index's 4% loss over the same period. This rela-

tive performance is a sharp turnabout compared with the annualized performance over the past 10 years: The Morningstar US Growth Index lost 5% while the Morningstar US Value Index gained 1%.

No Constant in the Battle of Styles

As numerous studies¹ have found, and as Figure I demonstrates, the two investing styles move in cycles of varying length. Several sustained growth and value cycles have occurred since style-based investing gained prominence in the early 1980s. Indeed, before value stocks had their amazing run in recent years, growth stocks had a dramatic rally from 1998 through 2000. While these styles clearly go in and out of favor over sustained periods, the turn of any given cycle is difficult to predict.

Go Go Growth

The recent resurgence in growth has been led by technology companies in the hardware and software sectors. Fear of additional liquidity crunches and the sharp drop in stock prices has held back

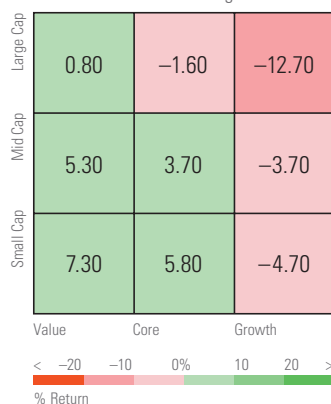
many firms with debt-laden balance sheets and highlighted the clean balance sheets of technology firms. Investor concerns have focused on the U.S. deleveraging cycle, which has made new debt offerings difficult and expensive. The types of technology firms that have benefited the most are those that are capturing market share despite the U.S. recession, such as Apple, Google, and Cisco. Plus, these companies did not start out that expensive, and they became really cheap throughout 2008. Just one example, AAPL was trading at a 7 times price/cash flow in January, less than half the stock's five-year average multiple, making it cheap by historical standards.

Growth continues to look attractive based on where we are right now. As Figure II shows, the difference between the Morningstar Large Value Index and the Morningstar Large Growth Index's price/earnings (P/E) ratio has been declining ever since the technology-driven bubble burst in 2000. The difference hit a low of 3 as of Nov. 30, 2008, and is still at a historically low level of 6.

Moreover, growth stocks still have higher earnings growth, which has traditionally allowed the group to trade at a premium P/E multiple over time. The average projected long-term earnings growth rate for companies in the Morningstar Large Value Index was 7%, as of May 2009, versus the Morningstar Large Growth Index's rate of 13% for the same period. Although the expected growth rate has been hurt recently for both styles due to the U.S. recession, the gap between growth and value is still significant. Indeed, the gap between growth and value is at historically high levels, suggesting that there is no reason to believe the P/E premium should evaporate.

Morningstar Market BarometerSM

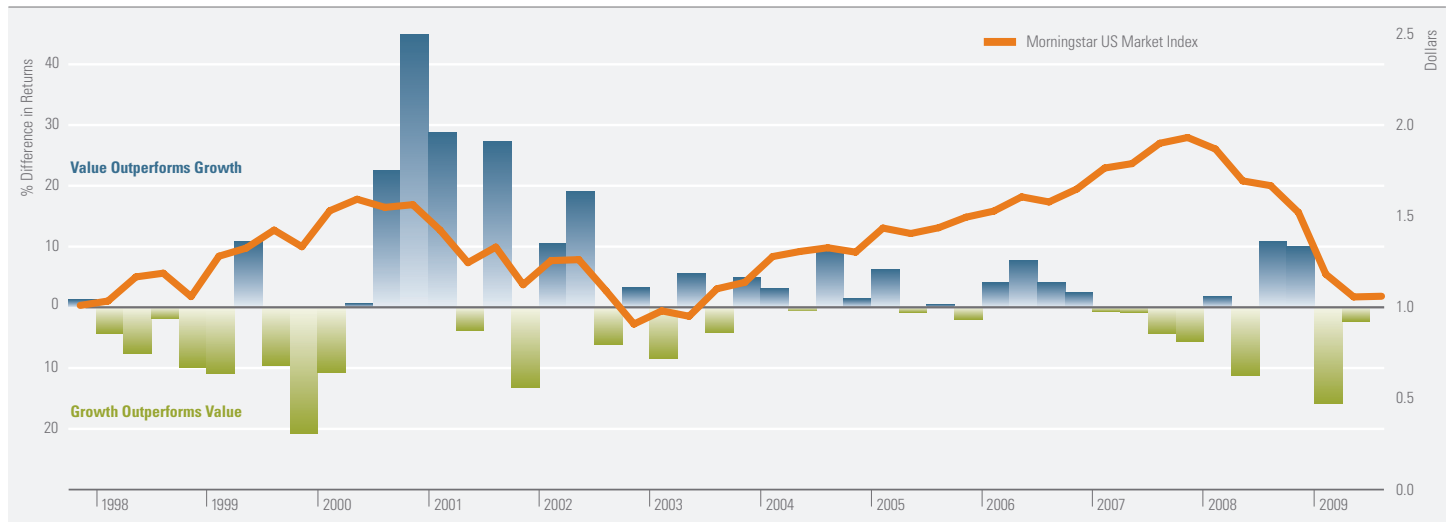
Performance Jan 2000 through Dec 2008



January 2009 through June 2009



Figure I: Quarterly Percentage Point Difference in Returns Between Morningstar Large Value Index and Morningstar Large Growth Index



Data as of June 2009.

A Balanced Approach

Despite the strong fundamentals for growth stocks, it would be a mistake to put all of your eggs in one basket. Over both the five-year and 10-year periods, value has dominated. Moreover, every style ended 2008 poorly, but the Morningstar Large Value Index outperformed the Morningstar Large Growth Index in three out of four quarters, and it ended the year up 7 percentage points over growth.

A look over the past decade of market history shows just how useful style diversification can be. The dominant style reversed twice in the past four quarters, as shown in Figure I. Plus, this figure shows several multi-quarter stretches where one

style was in control. From 2000 through 2006, large growth suffered a brutal bear market while large value fared just fine. Clearly, diversifying across the style box can help investors build better portfolios.

The Importance of Style Purity

Morningstar's style indexes offer viable and powerful tools for investors to make tactical and strategic style allocations. Morningstar uses a comprehensive 10-factor methodology that separately measures the value and growth characteristics of each security, using both historical and forward-looking factors. For example, Morningstar doesn't define growth stocks merely as those lacking cheap valuations. Instead, in order to

qualify for the Morningstar US Growth Index, a stock must demonstrate significantly higher-than-average rates of earnings, book value, cash flow, and sales growth. Another defining feature of the Morningstar Style Indexes is that stocks without dominant value or growth characteristics are assigned to a "core" category. These differences results in value and growth indexes that are more precise and stylistically pure than some other comparable indexes.

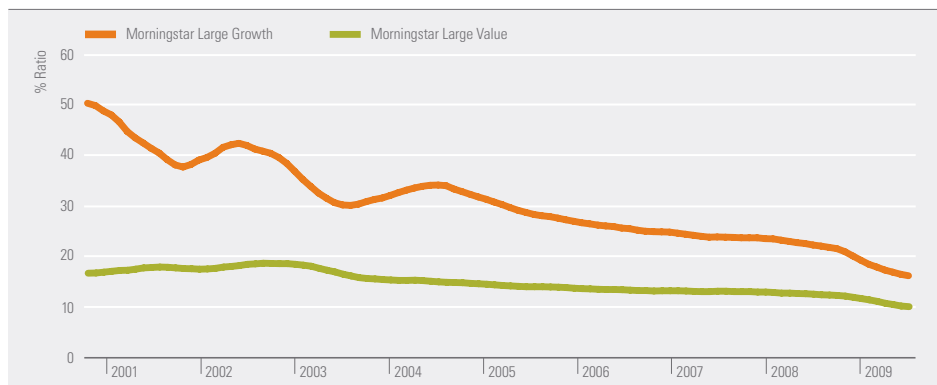
Conclusion

We know that style and capitalization often explain much of the performance differences in the market. While it is true that growth may have had a difficult run over the longer term, fundamentals provide justification that this side of the style box can not be ignored. Building portfolios to take advantage of this information provides a better investor experience through improved risk estimation and diversification. Indeed, the suggestion of style's limited utility proves false, as style endures as a useful tool.

1) Martellin, L., N. Amenc, P. Malaise and D. Sfeir. "Tactical Style Allocation—A New Form of Market Neutral Strategy." *The Journal of Alternative Investments*, Summer 2003.

Barclays Global Investors offers exchange traded funds based on Morningstar Style Indexes. For more information, visit www.ishares.com or see below.

Figure II: P/E Ratios: Rolling 12-Month Average



Data as of May 2009. Price/Earnings ratio is based on the past fiscal year's earnings

The tickers are: iShares Morningstar Large Core (JKD), iShares Morningstar Large Growth (JKE), iShares Morningstar Large Value (JKF), iShares Morningstar Mid Core (JKG), iShares Morningstar Mid Growth (JKH), iShares Morningstar Mid Value (JKI), iShares Morningstar Small Core (JKJ), iShares Morningstar Small Core (JKK) and iShares Morningstar Small Value (JKL).

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