Growth vs. Value: A Prolonged History of Leadership Trends

When investing in stocks, individual companies are classified by many characteristics including size, sector, and financial valuation. This allows investors to hone in on specific types of companies which interest them. Within this piece, we'll discuss the difference between companies categorized as growth and value.

The Different Indexes

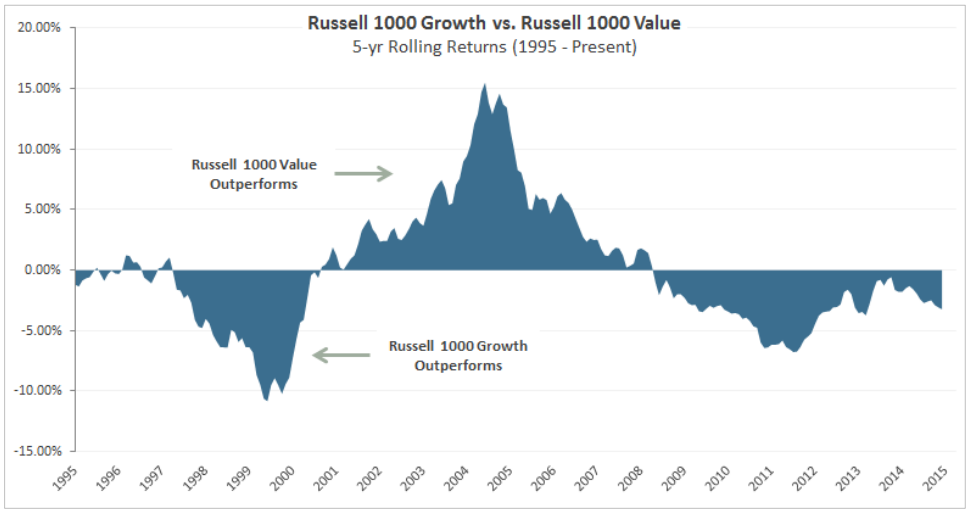
The Russell 1000 Growth and Russell 1000 Value indexes represent growth and value stocks, respectively. Starting with growth, the Russell 1000 Growth Index contains companies that tend to trade at higher valuations (higher Price-to-Earnings or PE ratios). The expectation is that they will grow faster than the average firm within the market. Additionally, growth companies typically reinvest their earnings back into their business rather than paying them out in the form of dividends. Sectors within this index include consumer discretionary, technology, and health care. Examples of specific companies within the index include Apple, Microsoft, and Amazon.com.

Conversely, the Russell 1000 Value Index contains companies that are trading at a discount to the market (lower Price-to-Earnings or PE ratios). Their lower valuation suggests they are mispriced or have lower growth expectations. These types of companies tend to pay out their earnings in the form of dividends rather than plowing them back into their underlying business. Financial Services and Energy are the two largest sectors within this grouping. Specific companies include: Exxon Mobile, General Electric, and Wells Fargo.

A Short History Lesson

Historically, each of these indexes has gone through cycles of leadership. Chart 1 illustrates these leadership cycles over the last twenty years. Diving in deeper, we can identify what drove the returns of each index.

Chart 1



Source: Russell Investments, St. Louis Federal Reserve.
Data as of 09/01/2015.

Starting in the late 1990s, the technology boom and bust is the obvious explanation for the performance of the Russell 1000 Growth Index. From there, the early to mid-2000s was driven by a commodity cycle linked to emerging market growth. This caused the Russell 1000 Value Index to outperform due to its high exposure to materials and energy companies. Around the mid-2000s, the U.S. housing market began to slow and negatively impacted financial stocks. This caused the value index to start lagging its growth counterpart. Soon after, the Great Recession came and value continued to struggle. Since then, consumer discretionary and health care stocks have led the way and bolstered the Russell 1000 Growth Index's strong outperformance.

More recently, the dispersion between growth and value has been very wide, especially within large cap stocks. Chart 2 illustrates this through the first three quarters of 2015. Most of growth's leadership has come from consumer discretionary stocks such as Amazon.com, Netflix, and Starbucks. On the flip side, value has lagged due to its exposure to energy and materials. Companies such as Exxon, Chevron, and DuPont have underperformed and dragged down the value index. However, investors can avoid this bifurcation by allocating to a broad market index. An index such as the S&P 500 consists of a blended mix of companies classified as both value and growth and avoids the potential of over investing in the wrong style or sector.

Chart 2

	Value	Blend	Growth
Large	-9.0%	-5.3%	-1.5%
Mid	-7.7%	-5.8%	-4.1%
Small	-10.1%	-7.7%	-5.5%

Source: JP Morgan.
Data as of: 09/30/15.

Potential for Changes in Leadership

Looking ahead, Chart 1 suggests that the leadership cycle may be close to a turning point. Many sectors within each index have experienced bouts of good and bad returns over the last 5 years. Health care and consumer discretionary stocks have vastly outperformed the broad market. On the other hand, energy and materials have underperformed over the same period. Using history as a guide, one might assume that a rotation into these "undervalued" sectors may be looming. However, there are no hard and fast rules which dictate that this must occur and growth may continue leading.

Only Time Will Tell

In conclusion, investors have many options when it comes to stocks. Companies are categorized by their size, sector, and financial valuation. The Russell 1000 Growth Index contains more expensive firms with higher expectations of financial progress, while the Russell 1000 Value Index includes companies trading at a discount due to mispricing or lower growth expectations. Over time, these indexes have experienced rotating cycles of leadership and outperformance. Looking forward, a change in leadership from growth to value may be upon us, but only time will tell.

As always, please feel free to contact us with any questions you may have.

William Kring, CFP®, AIF®
Chief Investment Officer

Matt B. Bailey, CFA®, CMT®
Portfolio Manager

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