Topix

MELVILLE JESSUP WEAVER
CONSULTING ACTUARIES TOWERS PERRIN ALLIANCE PARTNER

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Growth versus Value

1. Summary

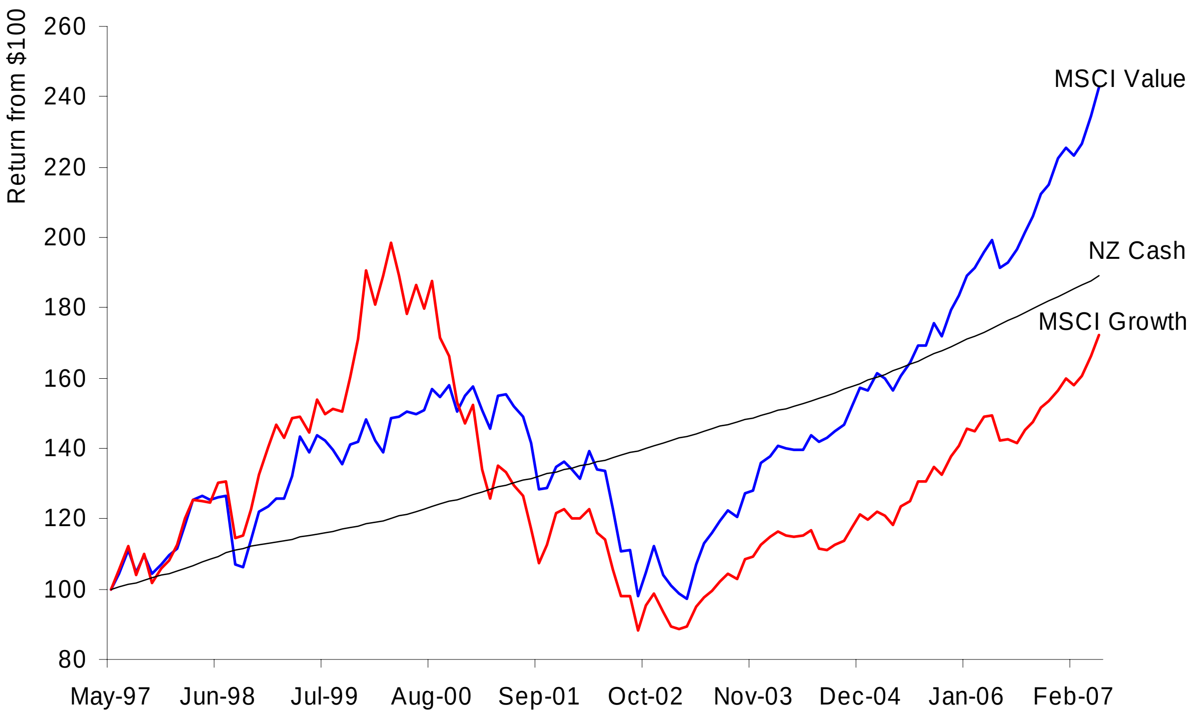
There is a high level of interest in how the overseas share returns of value style funds compare to those for growth style funds. This is currently heightened with value style funds having a long period of outperformance and so trustees holding growth funds are wondering whether to switch or hang in there. The current interest in multi manager funds, which seek to combine high performing managers with different styles to achieve a style neutral plus return, raises questions on whether one style is better than another and what the combining of different styles really achieves. In this article we explore these issues.

Our conclusion is that the diversification benefit of combining different styles is important to capture.

2. Introduction

When investing in shares, there is often the choice to go with a value-style or growth-style manager. Value investors aim to buy shares that look underpriced in terms of some measure, e.g. price to earnings ratio. These tend to be “cheap” shares. Growth investors will try to own shares that show above-average growth, however, since some of this growth may already be priced in these shares can appear “expensive”.

Recent history has seen value investors do very well. But note that in 1998-2000 growth investing seemed to be the superior strategy.



This strong value performance has led to talk of the “value premium,” which we crudely define as the difference between the two indices. Thus the premium is positive when the MSCI Value outperforms the MSCI Growth.

However, a word of caution. The growth results are heavily influenced by the MSCI growth universe automatically including those stocks which are by definition expensive and which do not deliver strong long term growth. A good growth manager will be looking to avoid these stocks. To illustrate a comparison of the Alliance Capital Growth Fund and Bernstein Value Fund show similar returns since inception in the 1990’s.

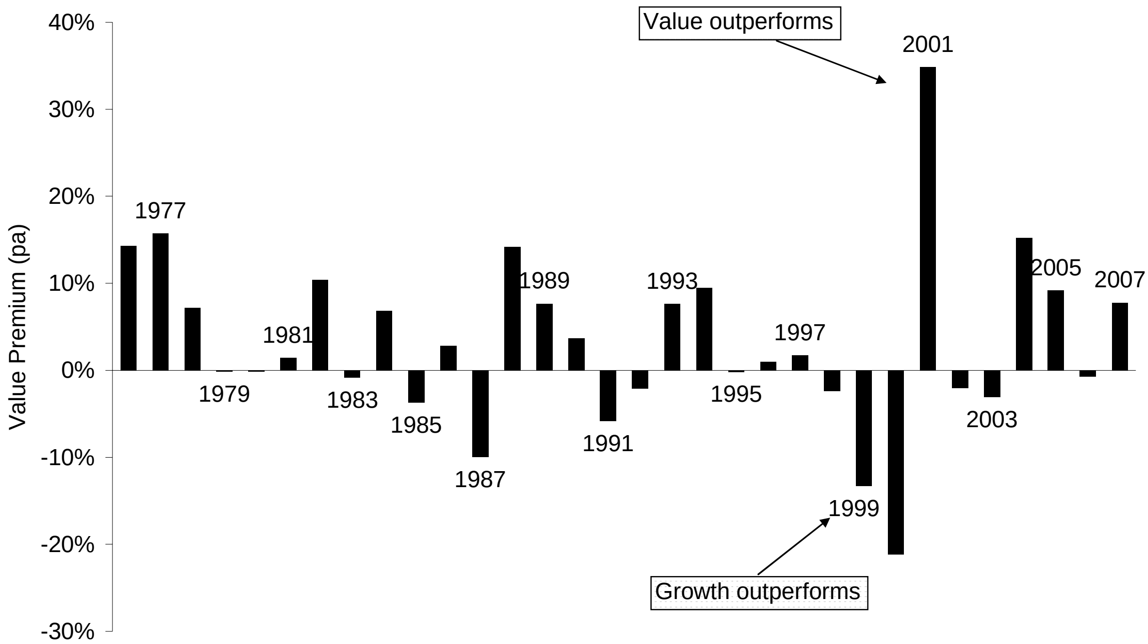
AMP Chambers Level 5 187 Featherston Street
PO Box 3109 Wellington 6140 NZ
Tel: +64 (4) 499 0277 Fax: +64 (4) 499 0488
wgtn@mjwactuary.co.nz

www.mjwactuary.co.nz

General Buildings Level 3 29-33 Shortland Street
PO Box 4014 Auckland 1140 NZ
Tel: +64 (9) 300 7155 Fax: +64 (9) 300 7199
akld@mjwactuary.co.nz

3 The value premium

How does style vary over the long term? Below we plot the value premium for the years ending 31 March. We can see the variance during the dot-com bubble and subsequent bust.



Through the bust, value came out on top, and over the long term value is the clear winner. But there have been periods where it has paid to be a growth investor.

Additionally, switching between styles can be risky. Consider the value investor who switches into growth the start of 2001 after seeing the strong growth returns of the last 3 years.

4 Diversification

Instead then, one could adopt the strategy of being style neutral (50% growth and 50% value). This has the advantage that equal exposure is gained to value and growth.

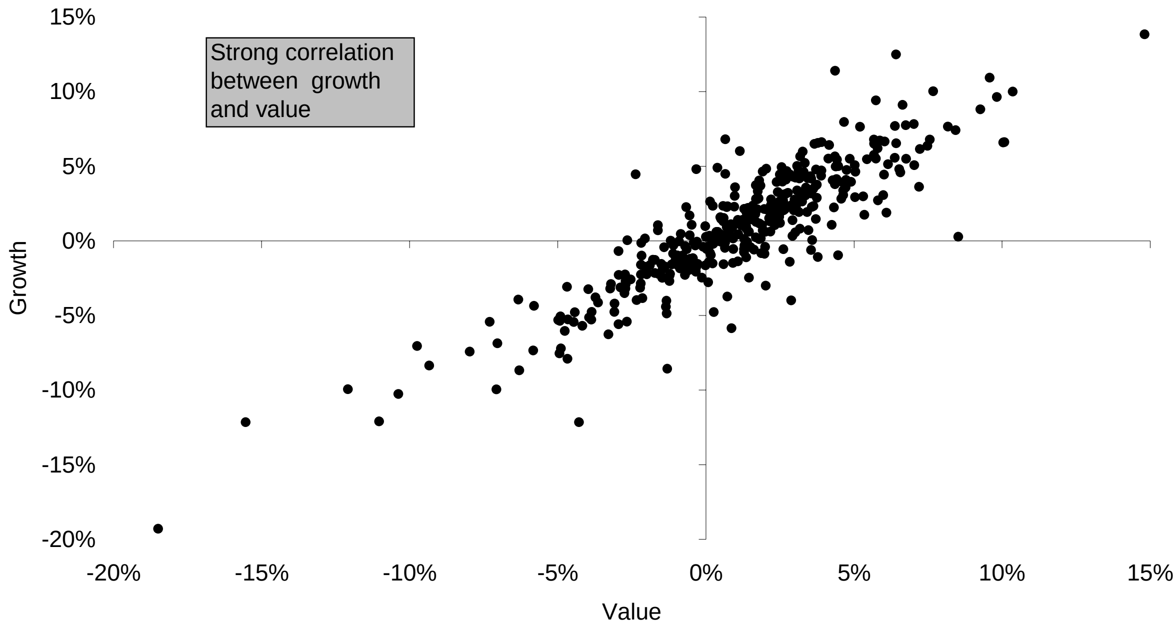
Diversification like this is used in long-term asset allocation setting to reduce risk. Generally, the weaker (or more negative) the correlation between asset classes the stronger the diversification benefit.

For example, consider two asset classes with almost zero correlation. If the first asset class experiences a weak month the other should not be affected. However, if a strong positive correlation exists, it is likely the woes of a poor return from the first class would be compounded by the weak returns from the second class.

The search then is always for the negatively correlated asset class, so that managers can reduce overall risk without impacting on the expected long term return.

5 Correlation between growth and value

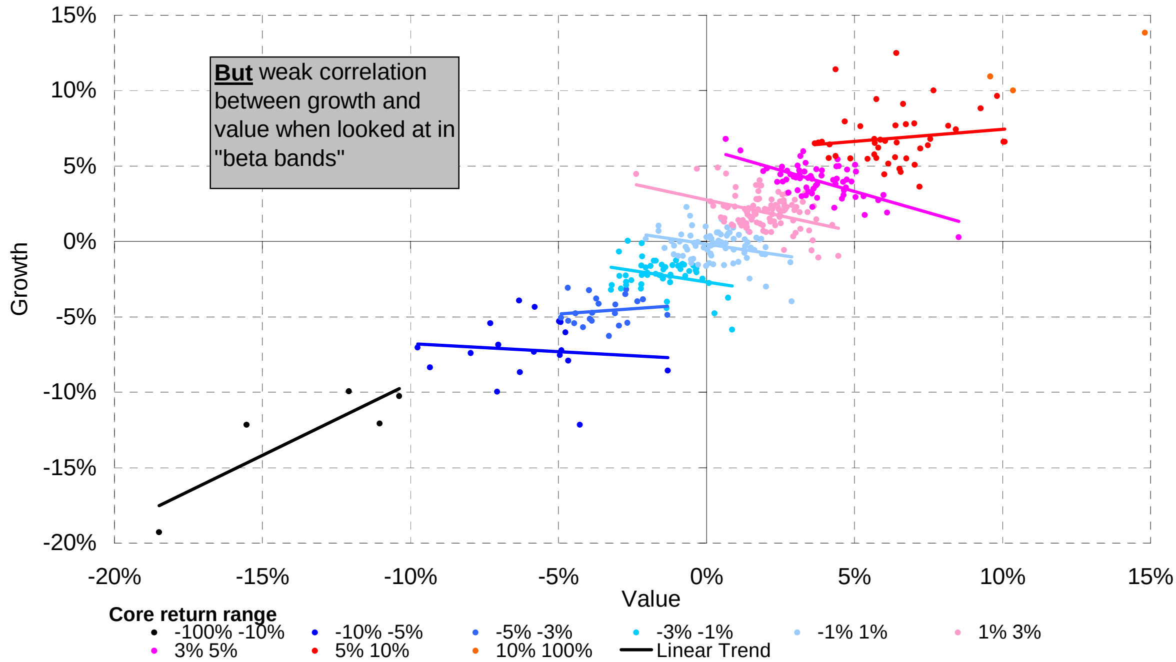
The question then is whether value and growth funds are positively correlated. The graph shows the overall correlation between the 2 styles by plotting monthly returns for the period 1976 to 2007.



In fact the graph buries the diversification argument and shows there is a strong correlation between the returns from the MSCI Growth and MSCI Value. It is very rare for one section to be negative while the other is positive (top left and bottom right sectors of the chart).

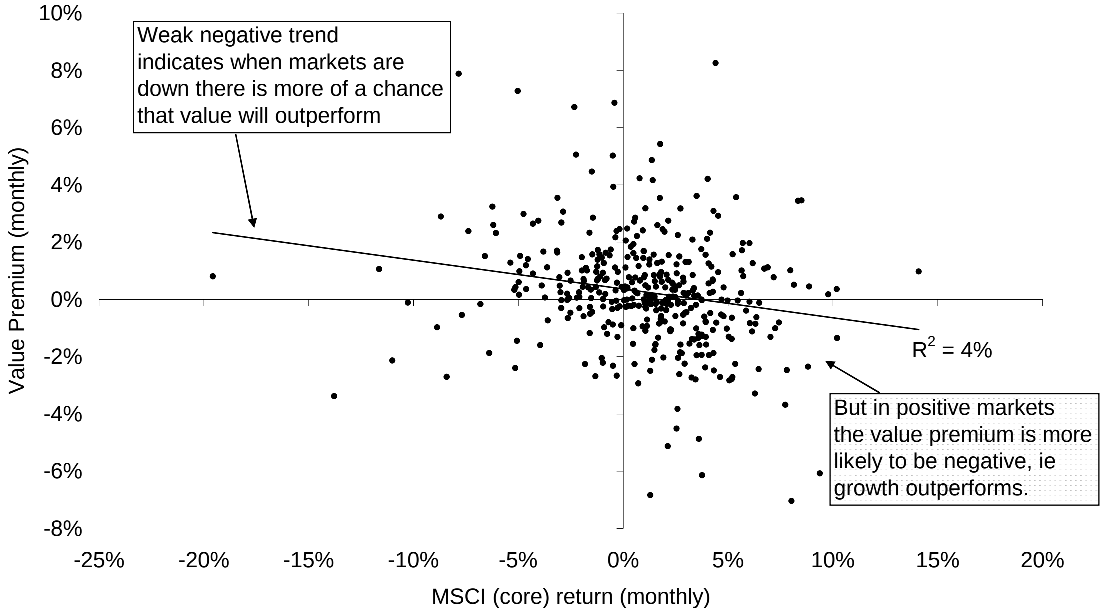
This makes intuitive sense as when the market has a strong month, one might expect both value and growth to do well too.

But we now consider the correlation between growth and value for different ranges of market return as measured by the MSCI Core *i.e. we are using this as a proxy to take out the impact of the market return (the beta).*



We now see a different result and when looking at most of the bands individually, we do not see the same strong positive relationship between value and growth. In fact ignoring the periods of very high and low returns there is on all but one case a weak negative correlation. This important relationship was masked by the strong correlations between growth and core, and value and core.

This is further illustrated below where the value premium is plotted on the vertical axis while the market return is plotted on the horizontal axis. We can see the value premium is not universally positive.



As noted by the boxes when the markets are down value tends to outperform growth. And in bull markets growth tends to outperform value.

6 Conclusion

While overall returns seem to be strongly correlated, after adjusting for the market return growth and value styles are very lowly correlated. With our data, there is even evidence of slight negative correlation between growth and value.

This is food for thought given the strong value run we've seen of late. This should be considered before decreasing exposure to "underperforming" growth managers.

On the other hand, as seen in the final chart above, in bear markets value is generally the place to be. This could be influenced by the last bubble being fuelled by growth stocks but never-the-less many commentators are predicting returns not to be as rosy as previous years. So perhaps value could still continue to outperform growth.

A point not to miss is that while diversifying styles is important, as is manager selection, it remains the strategic asset allocation which will ultimately drive the long term returns for a fund.

ABOUT MELVILLE JESSUP WEAVER

Melville Jessup Weaver is a New Zealand firm of consulting actuaries. The areas in which we provide advice include superannuation, employee benefits, life insurance, general insurance, health insurance, asset consulting, accident insurance and information technology. The firm was established in 1992 and has offices in Wellington and Auckland.

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For further information please contact:

Bernard Reid *09 300 7163 bernard.reid@mjwactuary.co.nz*

Mark Weaver *09 300 7156 mark.weaver@mjwactuary.co.nz*

Ian Midgley *04 499 0277 ian.midgley@mjwactuary.co.nz*

Ben Trollip *09 300 7154 ben.trollip@mjwactuary.co.nz*