INVESTOR

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Understanding value and growth stocks

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Do you have value or growth stocks in your equity portfolio? Do you know? Should you know?

You've probably heard these terms but may not know exactly what they mean. And you may not know the impact each may have on your portfolio.

As the global economy emerges from the deep recession sparked by the COVID-19 pandemic, it may be valuable to have insight into the types of stocks that benefit in a recovery, which do better when the U.S. dollar is weakening (or strengthening) against the Canadian dollar, and which are likely to gain when interest rates go up (or down).

First, let's define the terms:

Value stocks are undervalued in the marketplace compared to the earnings potential of the companies.

They generally trade at lower multiples to earnings, which means the price of the stock in relation to the company's earnings per share is relatively low. They tend to be "cyclical," meaning their prices rise and fall in line with the economic outlook. Examples of value stocks include energy companies, banks and grocery stores. This makes intuitive sense. When the economy is doing poorly, there is less demand for business loans and people tend to spend and invest less. Companies may reduce production, and with lower consumer demand, there is less energy consumption used to transport goods.

Growth stocks are from companies that have shown stronger-than-average earnings growth.

They generally trade at relatively high multiples to earnings, mainly because the company's earnings are widely expected to grow at a faster pace than other types of companies. They often don't pay dividends, as profits are reinvested in the business for future growth. Growth stocks generally include companies in the consumer discretionary, technology and biotech sectors. This also makes intuitive sense. These are companies that may be launching new and/or innovate products that consumers desire. One important consideration is that growth stocks may be volatile, as their higher price-to-earnings* (P/E) ratio makes them vulnerable to any negative news.

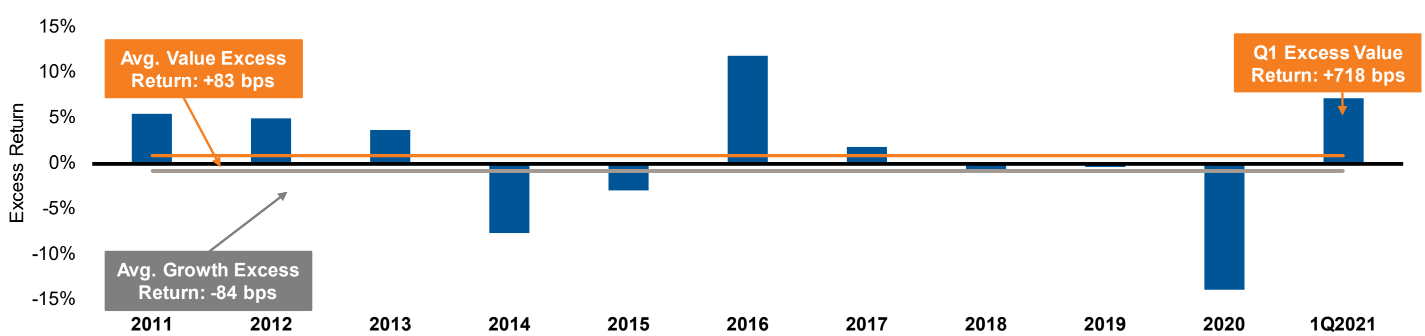
In recent years, growth stocks have handily outperformed value stocks. There are a number of reasons for this. First, the global economy was either growing slowly or not at all, which means earnings growth for companies in general was fairly low. So any company that *was* growing commanded a premium.

The chart below shows the relative performance of value and growth stocks in Canada from January 1, 2010 to March 31, 2021. Over the long term, value has outperformed growth even with the decline seen in 2020. During most of the year, the global economy contracted as governments shut down numerous business sectors to combat the spread of the COVID-19 virus. But in the first quarter of 2021, as the rollout of vaccines brought some economic revival, value stocks began taking the lead.

* A ratio that compares a company's current stock/share price to its earnings per per share.

> *Value investing guru Benjamin Graham argued that an undervalued stock is priced at least a third below its intrinsic value.*
>
> Library of Congress. "Value Avatar: Benjamin Graham," Page 3. Aug. 2020.

Canadian Equity: Value outperforms over time / MSCI Canada Value Index Vs. MSCI Canada Index



Source: Morningstar Direct. As of March 31, 2021. In CAD. BPS=basis points. A basis point is 1/100 of a percent. Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. Indexes are unmanaged and cannot be invested in directly.

The growth factor is dominated by technology and healthcare stocks – which have done well in the COVID-19 pandemic – and these stocks hold a heavy weighting in the S&P 500® Index of U.S. large-cap stocks. The rest of the global market – including Canada – has more of the financial and cyclical stocks that make up the value factor.

The dominance of technology and healthcare in the key U.S. market index is the reason U.S. equities have handily outperformed other regions over the past decade. That dominance is even more pronounced now. Technology companies were among the big beneficiaries of the pandemic as government-mandated restrictions on most industries forced many activities online – from schools to government services to financial industries to the arts. Indeed, a handful of key technology names – Amazon, (Alphabet) Google, Facebook, Apple and Microsoft – propelled the majority of the U.S. market gains in 2020.

However, over the really long term, value stocks generally outperform growth stocks. Indeed, a seminal study by Fama and French found that the value “premium” can lead to long-term outperformance.[1] Their 1992 research piece found that value had outperformed growth between 1963 and 1992 (with a value premium of 4.3% annually). Although in follow-up research published in 2020, they found the value premium had shrunk to 0.6% annually,[2] the principle that lower relative prices lead to higher expected returns remains true. On average, value stocks have outperformed growth stocks by 4.54% annually in the U.S. since 1928.[3]

Value or Growth?

In an economic recovery

For the most part, when earnings-per-share (EPS) growth is strong across the market—as when the economy is expanding—value stocks tend to benefit. With less growth scarcity, there tends to be less of a premium for growth stocks. This is often the case when an economy begins to emerge from a recession. The post-recession boom is traditionally the period in which value stocks shine brightest, as cyclical industries are generally the first to recover.

U.S. dollar

The U.S. dollar is the currency of choice for international commerce and as such, its value is closely tied to the economic cycle. It’s considered to be counter-cyclical, meaning it strengthens when the business cycle slows (because it becomes less available) and weakens when the economic outlook improves. A weaker U.S. dollar means global financial conditions ease as servicing U.S.-denominated debt becomes less onerous. And that in turn boosts international equities over U.S. equities. International equities are far more tilted towards value, so that a weaker U.S. dollar and a stronger global economy generally benefits value over growth.

Interest rates

Another factor to consider in evaluating value and growth stocks is the role of bond yields in their performance. Bond yields generally follow the direction of the Bank of Canada’s benchmark interest rate and the economic outlook. If investors believe the economy will improve in the future, longer-term interest rates may rise faster than shorter-term rates. This is called the steepening of the yield curve and is usually a good sign for equities.

The technology stocks that now dominate the growth sector are considered long duration because their expected earnings are further out into the future, making them more susceptible to rising financing costs via higher interest rates. Interest rates are also an important variable for measuring the present value of future cash flows. When bond yields rise, the interest rate at which those future earnings are discounted rises, which lowers the present value of those cash flows. Value stocks are also impacted by higher rates, but not by a similar magnitude since their earnings profile is not as far out. Additionally, the value sector is dominated by financial stocks, whose profitability improves when the spread (or difference) between short-term interest rates and long-term interest rates widens.

The most famous value investor of our time is Warren Buffett. He’s known for buying stocks that have solid fundamentals (the factors such as cash flow and return on assets that help determine the quality of a company’s financial status) and holding them for a very long time. Two of his most cited quotes can sum up his philosophy:

> *Whether we’re talking about socks or stocks, I like buying quality merchandise when it is marked down.*
>
> *Only buy something that you’d be perfectly happy to hold if the market shut down for 10 years.*
>
> Source: Business Insider https://markets.businessinsider.com/news/stocks/warren-buffett-21-best-quotes-2019-2-1027944381

INVESTOR is published quarterly by Russell Investments.
Please direct comments or questions to your financial advisor.

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[1] Fama, E. and French, K. – The Cross Section of Expected Stock Returns. Journal of Finance 47, June 1992.

[2] https://review.chicagobooth.edu/finance/2020/article/value-stock-premium-shrinking

[3] Dimensional Advisors. "When It's Value vs Growth, History is on Value's Side." July 2020

IMPORTANT INFORMATION

Date of first publication: April 2021
RETAIL-03120 [EXP-04/2023]