INDEX INSIGHTS

Value & Growth: The Beatles *and* the Stones

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Key points:

- Investments based on growth and value styles are important components within the core equity portion of a diversified multi-asset portfolio.
- Including allocations to both growth and value styles within a portfolio allows an investor to strategically tilt toward one style or the other according to their investment beliefs, while also offering the ability to make tactical shifts in style allocations over time.
- Growth and value investments tend to move through extended cycles of leadership and have historically exhibited significant performance differences annually and over time, providing meaningful diversification benefits for investors.

"The Beatles or the Stones?" This classic question is often posed lightheartedly (sometimes dead seriously) to assess a person's tastes and personality, forcing a decision between two of the most recognized, highly influential rock bands of all time. Some jump like a flash to the Stones, while others come together with the Beatles. But for most of us, the decision is more challenging. How does one choose between "Let It Be" and "Gimme Shelter"? Choosing between the value and growth investment styles is a similar decision. While some of us might lean one way or the other, most of us want to experience both styles.

Within the equity portion of an investor's core multi-asset portfolio, traditional value and growth investments have long provided broad exposure to stocks with different characteristics and significant diversification benefits over time. Growth and value stocks tend to move through extended cycles of performance leadership, with meaningful differentiation between the two styles over time.

By allocating to both growth and value, investors can benefit from diversification while also having the ability to make a strategic tilt toward a particular style based on their long-term investment beliefs. Additionally, including separate allocations to each style gives investors the ability to make shorter-term tactical adjustments to their style allocations over time based on their market views.

Equity portfolios that include allocations to both value and growth styles can help to ensure that investors have exposure to whichever style is leading in performance at a given point in time while also ensuring they have exposure to its counterpart when the style leadership cycle changes. This style diversification has historically helped deliver more consistent returns over time, which is especially important because style investments are often at the core of investors' portfolios.

This paper examines:

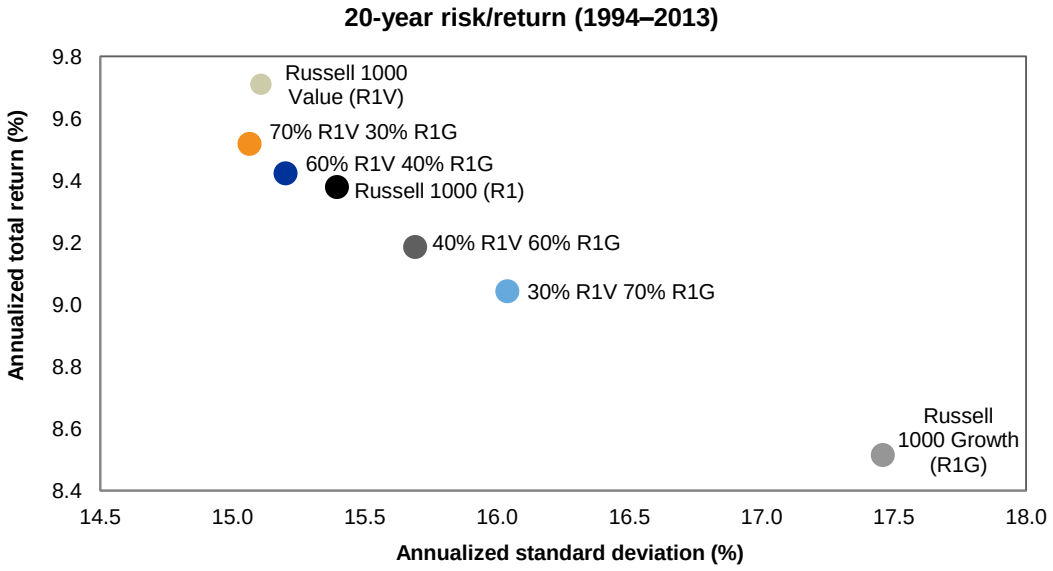
1. How various allocations to growth and value styles can influence the long-term performance of a core investment portfolio.
2. How growth and value leadership tends to alternate through extended cycles, with meaningful differentiation in performance between styles over time.
3. How blended portfolios with allocations to both growth and value have delivered more consistent returns over time, by giving investors the flexibility to strategically tilt toward their preferred style and make tactical adjustments over time.

How style exposures can influence long-term core portfolio performance

Figure 1 illustrates the long-term performance of a set of hypothetical blended style portfolios. For the sake of brevity, we have focused on the U.S. large cap market segment in this paper, but similar results extend to the small cap segment as well. Over the 20-year period 1994–2013, the Russell 1000® Value Index delivered an annualized total return of 9.7% vs. 8.5% for the Russell 1000® Growth Index. The value index also exhibited lower volatility over this period, with an annualized standard deviation of 15.1% vs. 17.5% for the growth index. Over the period studied, blended portfolios tilted toward value stocks would have produced better risk-adjusted returns than those tilted toward growth stocks.[1]

Given the long-term outperformance by value, an investor might conclude that an all-value portfolio is superior, and that growth stocks can simply be discarded. However, such a conclusion ignores the fact that style leadership has varied over time. As the following section illustrates, growth has outperformed value over extended periods as well, so including both growth and value stocks within the core of a multi-asset portfolio would have potentially reduced risk and increased returns, depending on the mix.

Figure 1: Value has historically outperformed growth over the long term…



Data as of December 31, 2013.

[1] Hypothetical blended style portfolios are for illustrative purposes only and are not intended as recommendations.

Growth and value styles can each lead over extended periods

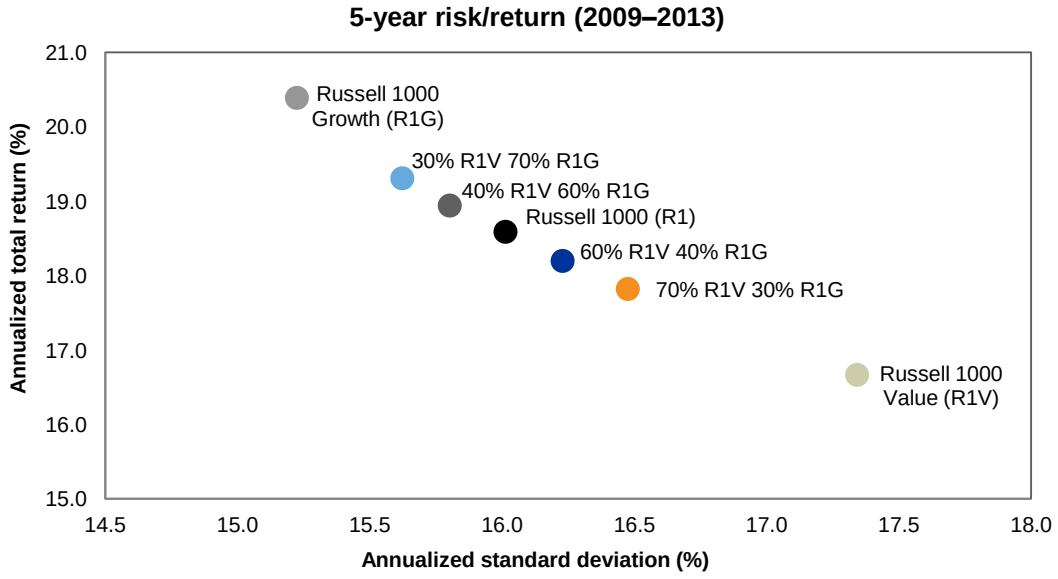
While a wide body of academic research has found that the value style has outperformed over the long term,[2] growth stocks have punctuated value stocks' long-term run with their own periods of outperformance. As illustrated in Figure 2, the Russell 1000 Growth Index meaningfully outperformed the Russell 1000 Value Index over the most recent five-year period, 2009–2013. The growth index delivered an annualized total return of 20.4% over the five-year period vs. 16.7% for the value index. During this period, the growth index also experienced lower volatility than the value index, with annualized standard deviations of 15.2% and 17.3%, respectively.[3]

In this case, the hypothetical all-value investor from the previous section might have experienced significant regret due to the lack of exposure to the better-performing asset class during this period. This regret might lead the investor to decide to reallocate the portfolio at precisely the wrong time in response to shorter-term market movements.

By contrast, an investor who included exposure to both growth and value would likely have avoided that regret from having had exposure only to the underperforming asset class during the five-year period. For example, the dark blue marker in Figure 2 shows a hypothetical investor who maintained a preference for value from 2009 to 2013, using a 60/40 value/growth mix. This investor would have achieved a better risk-adjusted return than the investor with a portfolio exposed purely to value, over the five-year period.

That second investor, having concluded that growth was poised for stronger performance, could have made a tactical shift toward growth and realized an even stronger risk-adjusted outcome. Structuring the core equity portfolio with allocations to both styles may be expected to produce a more balanced return distribution over time.

Figure 2: …but growth can outperform value over extended periods as well



Data as of December 31, 2013.

[2] Basu, Sanjay, "Investment Performance of Common Stocks in Relation to Their Price-Earnings Ratios: A Test of the Efficient Market Hypothesis," *Journal of Finance*, 1977; Fama, Eugene, and Kenneth French, "The Cross-Section of Expected Stock Returns," *Journal of Finance*, 1992, and "Common Risk Factors in the Returns on Stocks and Bonds," *Journal of Financial Economics*, 1993.

[3] We examined five-year periods because they represent extended holding periods that are meaningful for a core portfolio and also help to illustrate how returns can differ over time from long-term index performance.

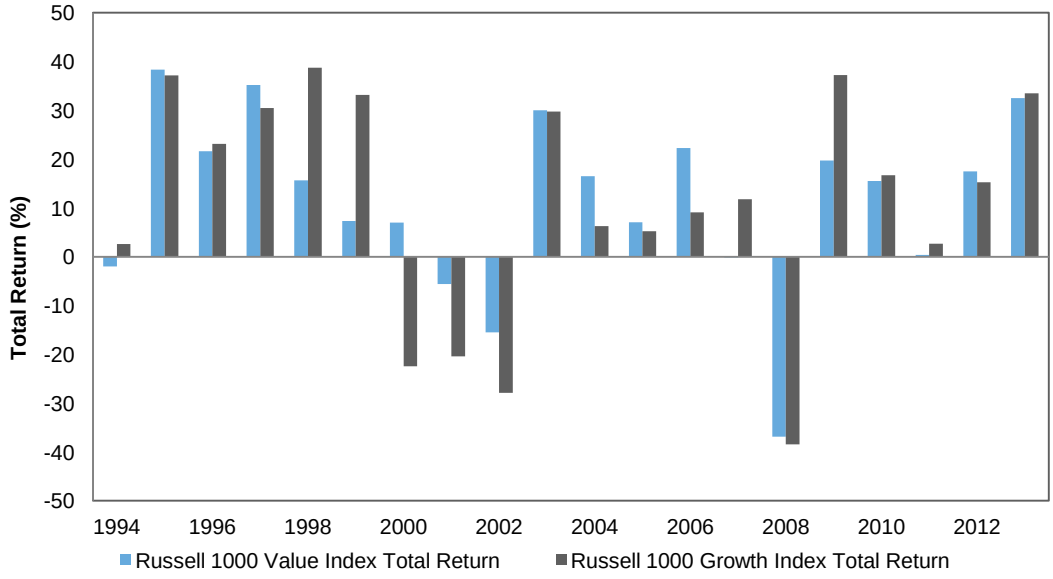
Style mix is highly important, because the path of returns is critical for investors. While core portfolio allocations should generally serve as strategic long-term investments, few investors actually experience the long-term performance of an index. Investors' outcomes are determined by when they enter and exit the market. If investors find themselves needing to sell positions or liquidate their portfolios at a time when a particular asset class is out of favor, they could experience outcomes that are much different from the longer-term returns for a given asset class. According to Morningstar, ill-timed decisions have caused the average mutual fund investor to underperform the average mutual fund by approximately 2.5% annually over the 10-year period ended December 31, 2013.[4] Additionally, an investor who makes tactical shifts in style allocations over time could experience a very different outcome – either better or worse – than the long-term index performance.

Value and growth styles have historically delivered meaningfully different returns

It's also important to recognize that both value and growth styles have historically moved through extended cycles of leadership and shown meaningfully different performances over time. As illustrated in Figure 3, differentiation between value and growth can be significant in any single year. Over the 20-year period 1994–2013, this differentiation ranged from a low of 0.3% in 2003, a year in which both styles saw exceptionally high returns of approximately 30%, to the largest spread, more than 29%, in 2000.

Attention has been given to the narrow return difference between value and growth in 2013, when the return gap was 0.9%. Notably, however, this was again a year in which broad market returns were exceptionally robust, with each style index delivering returns of more than 30% for the year. Furthermore, 2013 was just the second time in the 20-year period when the annual return difference was less than 1% – the last having been 2003. The difference between growth and value returns widened significantly in years after 2003, with a double-digit difference in four of the following six years.

Figure 3: Growth and value styles show significant differentiation over time



Data as of December 31, 2013.

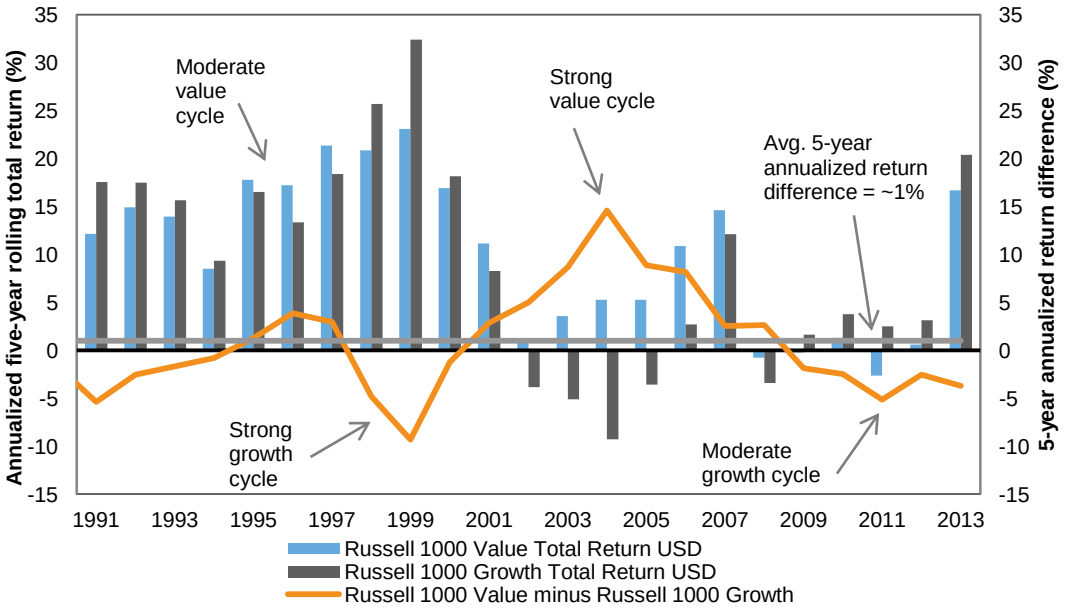
[4] Morningstar magazine, "Trends," April/May 2014, pg. 19.

Style leadership tends to move through extended cycles

Cycles of value and growth leadership can be seen clearly by examining rolling five-year annualized total returns over the 27-year period 1987–2013. As illustrated in Figure 4, growth has shown moderate leadership in recent years, following an extended period of strong value leadership. The late 1990s were a period of strong growth leadership, following a relatively brief cycle of moderate value outperformance in the mid-1990s.

The annualized difference in growth and value total returns over the 23 rolling five-year periods from 1987–2013 ranged from 0.8% for the five-year period ended Dec. 31, 1994, to more than 14% for the five-year period ended Dec. 31, 2004. Return differences have tended to narrow as a leadership cycle shifts from one style to the other, and then to widen as a particular style's leadership cycle sets in. In eight of the 23 five-year periods, or nearly 35% of the time, the annualized five-year return difference was at least 5% – with an average five-year difference of approximately 1%.[5]

Figure 4: Growth and value styles show significant differentiation over time



Data as of December 31, 2013.

Table 1, below, presents the annualized five-year rolling total returns for each of the style indexes and two of the hypothetical blended portfolios – one 60% value and 40% growth, the other 40% value and 60% growth. As the table illustrates, the Russell 1000 Value Index's five-year annualized total returns over the period ranged from +23.1% to -2.6%, with three periods of negative returns. Over the same period, the annualized five-year total returns for the Russell 1000 Growth Index saw a wider range, from +32.4% to –9.3%, with five periods of negative returns.

For the value-tilted portfolio, annualized total returns ranged from +27.0% to -1.8%, with four five-year periods of negative returns. While this blended portfolio had one additional period of negative returns than did the all-value portfolio, the largest positive return was larger, and the largest negative return was smaller, than in the all-value portfolio.

[5] We arrive at the average five-year return difference between the Russell 1000 Value Index and the Russell 1000 Growth Index by first calculating the five-year geometric average over the 23 five-year rolling periods for each index. The difference between two geometric averages is calculated as (1 + geo1) / (1+geo2) - 1.

For the growth-tilted portfolio, annualized total returns ranged from +28.8% to -3.3%, with four five-year periods of negative returns. In this case, the blended portfolio had one less five-year period of negative returns than did the all-growth portfolio. The largest negative return was smaller than in the all-growth portfolio, and in this case the largest positive return was also smaller.

Table 1: Rolling 5-year annualized style index total returns (January 1, 1987–December 31, 2013)

5-YEAR PERIOD	R1V TOTAL RETURN (%)	R1G TOTAL RETURN (%)	TOTAL RETURN DIFFERENCE	60% R1V + 40% R1G	40% R1V + 60% R1G
1987–1991	12.2	17.6	-5.4	14.4	15.5
1988–1992	14.9	17.5	-2.6	16.1	16.6
1989–1993	14.0	15.6	-1.7	14.8	15.1
1990–1994	8.5	9.3	-0.8	9.0	9.1
1991–1995	17.8	16.5	1.2	17.4	17.1
1992–1996	17.2	13.4	3.8	15.7	15.0
1993–1997	21.4	18.4	3.0	20.2	19.6
1994–1998	20.9	25.7	-4.8	22.9	23.8
1995–1999	23.1	32.4	-9.3	27.0	28.8
1996–2000	16.9	18.2	-1.2	17.9	18.2
1997–2001	11.1	8.3	2.9	10.5	10.0
1998–2002	1.2	-3.8	5.0	-0.3	-1.3
1999–2003	3.6	-5.1	8.7	0.5	-1.2
2000–2004	5.3	-9.3	14.6	-0.4	-3.3
2001–2005	5.3	-3.6	8.9	1.8	0.0
2002–2006	10.9	2.7	8.2	7.6	6.0
2003–2007	14.6	12.1	2.5	13.7	13.2
2004–2008	-0.8	-3.4	2.6	-1.8	-2.3
2005–2009	-0.2	1.6	-1.9	0.6	1.0
2006–2010	1.3	3.8	-2.5	2.4	2.9
2007–2011	-2.6	2.5	-5.1	-0.5	0.5
2008–2012	0.6	3.1	-2.5	1.6	2.2
2009-2013	16.7	20.5	-3.7	18.2	18.9

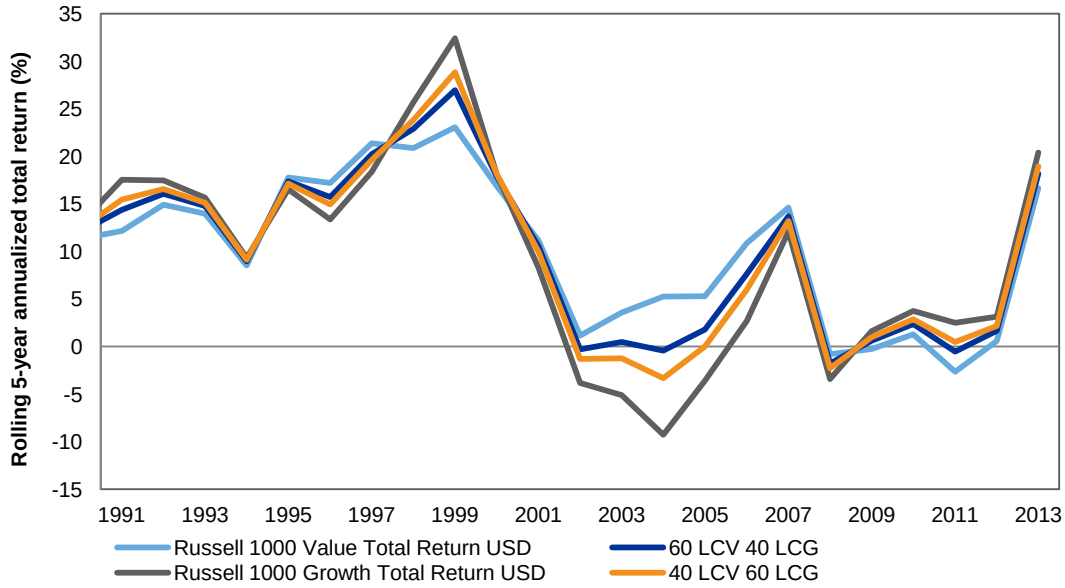
Source: Russell Investments, Morningstar Direct, as of December 31, 2013

Blended core style portfolios historically delivered smoother returns over time

As illustrated in Figure 5, a blend of growth and value styles produced more consistent portfolio performance over time than did either style index alone. In our historical simulations, this was true for both the value-tilted portfolio and the growth-tilted portfolio. Which style tilt delivered outperformance relative to the other style tilt was time-period dependent, with each exhibiting leadership in different market environments.

By including both growth and value investments within a portfolio, investors can help to smooth return patterns over time by ensuring that they have exposure to whichever style is leading at a given point in time. This is especially important in the core portion of an investor's portfolio, which should provide for diversified exposure to broad styles and asset classes.

Figure 5: Blending styles helped deliver more consistent portfolio performance over time



Data as of December 31, 2013.

Conclusion

The goal of a core multi-asset investment portfolio is generally to give an investor diversified exposure across broad asset classes and investment styles. Within the equity portion of an investor's core portfolio, traditional value and growth investment styles have long provided significant diversification benefits over time. Growth and value styles tend to move through extended cycles of leadership, with meaningful differentiation between value and growth style performance over time.

As our research shows, investors would have benefited historically from diversifying between both growth and value styles within their core portfolio, while also providing an opportunity to strategically or tactically tilt the portfolio toward a particular style based on their investment beliefs and market views. Using a blended portfolio diversified across value and growth styles ensures that investors have exposure to whichever style is in favor at a given point in time while also ensuring that they have exposure to its counterpart when the style leadership cycle changes. This style diversification has historically helped deliver more consistent returns over time, which is especially important for a core investment portfolio.

Just as in choosing between the Beatles and the Stones, allocating among value and growth stocks is not a question of "or" but rather of "and."

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