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## ANALYST SPOTLIGHT

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### **Investment Styles: Value versus Growth**

*Understanding the differences in these styles is key in building a portfolio*

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In building and managing diversified portfolios, we maintain exposure to both “value” managers and “growth” managers. However, as some environments favor growth stocks and some favor value stocks, we will tilt our portfolios in favor of one style over the other depending on our view of market and economic conditions.

In deciding on this “tilt” it is important to understand just what each style of manager is seeking in a stock, what other characteristics those stocks possess, and into what kinds of industries that naturally leads them. In addition, value and growth investors each come in two distinct “flavors.” Within value, you have absolute value and relative value players, and within growth, you have GARP (growth at a reasonable price) investors and momentum investors.

You often hear value investors described as those who look for “undervalued” companies. While this is true, it is not really a distinction. All managers, whatever their stripe, are trying to buy companies whose stock prices do not reflect their true values. There aren’t any managers out there (other than short-sellers) looking for overvalued stocks!

The primary difference between value and growth managers is how they define “undervalued.” In simplest terms, value managers look for companies that are priced below the value of their business today, whereas growth managers look for companies that are priced below what the value of their business will be in the future. Growth managers are willing to pay a “premium” price (high P/E) for a company now whose earnings are growing fast, because that high price will be “cheap” a year or so out based on much higher earnings.

### **Value Investing**

The classic definition of value investing really describes the absolute value investor. In this sense, a company is undervalued if its “intrinsic” value per share is less than its stock price. Again in the classic definition, a company’s intrinsic value is the amount its assets (inventory, real estate, patents, etc.) would fetch if the company was broken up and sold. However a broader definition of intrinsic value also includes what a private acquirer might be willing to pay in a takeover.

Some examples of absolute value investors are the team at Longleaf Partners and Marty Whitman of Third Avenue Value.

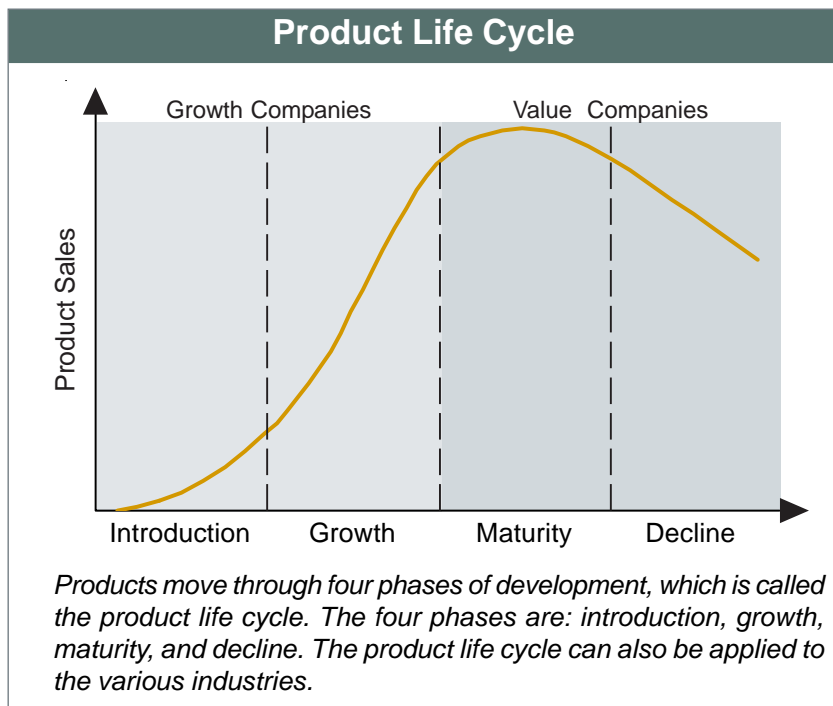
The value of a company’s net assets (assets less liabilities) on its balance sheet is known as its book value, and while this measure is certainly imperfect, classic value companies will typically

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have low price to book value (P/B) ratios. There are a number of ways in which a company’s book value can understate the true value of its assets and most absolute value investors spend more time analyzing a company’s balance sheet than its earnings statement.

Value stocks also typically have low price to earnings (P/E) and price to sales (P/S) ratios. This is because value companies are often established firms in mature industries that are no longer able to sustain higher levels of earnings growth. Earnings growth rates in these companies closely resemble the overall rate of growth in the economy. You are probably familiar with the product life cycle chart below, the same phenomena can be applied to industries as a whole. Some examples of mature industries are airlines, insurance companies, and utility companies.



Value stocks can become “cheap” relative to their asset or takeover values for a variety of reasons. For example, their industry could be out of favor, such as energy was several years ago with oil around \$20 a barrel, or some temporary factor could be hampering their business. Value investors will typically hold a company until its stock price reaches their assessment of the company’s intrinsic worth.

**Absolute versus Relative Value**

As opposed to absolute value investors, relative value investors don’t need a company to be “absolutely” cheap (i.e. selling for less than its asset value), but expand their universe to include companies whose P/Es or P/Bs are “relatively” cheap when compared to a benchmark (for example the Russell 1000 Value Index), the company’s own historical levels, or its industry

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peers. A relative value investor may be interested in an energy stock if it historically traded at much higher P/Es.

Some examples of relative value investors are Greg Golden and Jeff Moser of Phoenix Relative Value, Jeff Markunas of STI Classic Large Cap Relative Value, and Basu Mullick of Strategic Partners Relative Value.

One of the appealing features of value stocks is that they tend to have high dividend yields. Because these companies are not expanding as rapidly as growth companies, they tend to pay out more of their profits as dividends rather than reinvesting them into the business. This dividend yield offers a cushion against stock price fluctuations in a weak earnings environment.

In terms of portfolio construction, the differences between absolute and relative value investors can be significant. In a bull market, absolute value investors may lag for several years, while they wait patiently for the market to “come around” to their holdings. However, the fact that they are buying these companies for less than their breakup value offers a great degree of downside protection when the market turns nasty.

Relative value investors, on the other hand, may “ride the market up” a bit better if valuations are rising across the board. While the absolute investor will have to turn away from a stock whose P/B (or P/E) has simply gone too high, the relative value investor can still justify buying the stock as long as its valuation remains below its peers.

While not bad, in and of itself, this strategy can sometimes be stretched too far, particularly when the markets get frothy. One need only to remember the mid- to late-90s when some relative value investors were justifying P/Es of 60x because that was a lot cheaper than the P/Es of 200x some Internet stocks were sporting.

### Growth Investing

As noted, growth investors look for companies whose sales or earnings are growing at an above-average rate or have the potential for such accelerated earnings growth. The most common measure of growth companies is thus their current and (more importantly) expected EPS (earnings per share) growth rate. Since much of the focus for growth investors is on the future potential of the company, they are not that concerned with the current valuation (P/E) of the stock. Because

### Value versus Growth Characteristics

(As of 8/31/05)

	Russell 3000	
	Value	Growth
Price/Book Ratio	2.07	4.19
P/E Ratio	14.70	21.80
Dividend Yield	2.4%	1.0%
5 Year Earnings Growth	10.1%	14.9%

Source: Russell

*Comparing the characteristics of the average stock in the Russell 3000 Value Index to the average stock in the Russell 3000 Growth Index, clearly reveals the major differences between the two types of stocks.*

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these companies are growing earnings so fast, investors are willing to pay a higher price for those companies compared to firms with modest or slow earnings growth, so P/Es on growth stocks tend to be much higher than on value stocks.

Growth companies often reinvest almost all of their profits back into their business to help finance additional growth. The expectation is that reinvesting in the business will earn a strong return and will be a cheaper source of financing than either new stock or bond issuance. As a result, dividends are usually small or non-existent.

Growth stocks tend to do well in bull markets and underperform in bear markets. Some typical growth industries are technology, e-commerce, and biotechnology.

#### GARP versus Momentum

As with value investing, there are two different styles to growth investing, GARP (growth at a reasonable price) and momentum. GARP combines elements of both growth and value investing. Someone following a GARP discipline looks for companies that have solid sustainable growth potential, but they are also concerned about the stocks current valuations and won't simply pay "any price" for growth. Typically, GARP investors aren't looking for really high growth rates such as 25-50%, which tend to command the highest P/Es, preferring instead, the safer and more realistic growth rates of 10-20%. Peter Lynch was a famous practitioner of GARP investing.

Momentum investors are looking for stocks that are moving at high speeds, hoping to ride the stock as its price climbs, and sell before the stock crashes. Momentum investors typically look for three things: a strong price chart, very rapid earnings growth, and positive changes in earnings-growth forecasts. In other words, they are looking not only for companies that are growing fast, but whose rate of growth is also accelerating.

Momentum investors do not spend much time scrutinizing the fundamentals. They search for companies they believe will deliver an earnings surprise or other favorable news to drive up the stock price hoping to buy before a positive earnings announcement and sell before it has any negative news. They typically hold a stock for a few months. As such, momentum-oriented

#### Top Five Industries: Value versus Growth

(As of 8/31/05)

Russell 3000	
Value	Growth
Financial Services	Technology
Utilities	Health Care
Integrated Oils	Consumer Discretionary
Consumer Discretionary	Financial Services
Health Care	Consumer Staples

Source: Russell

*Comparing the top five industry sectors in the Russell 3000 Value Index to those of the Russell 3000 Growth Index, shows that while several industries are represented in both, their relative importance is different. In addition, because a sector such as Health Care is so broad, embracing both mature, slower growing pharmaceutical companies as well as small, fast-growing biotech firms, it is easy to see how different parts of industries can fall into different caps.*

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growth funds will typically have the highest turnover ratios. One of the well-known momentum managers is Garrett Van Wagoner, manager of Van Wagoner Emerging Growth. The managers of MFS Emerging Growth also follow this strategy.

While this strategy is typically the highest returning in the later stages of a bull market, and you will often find the funds that follow this approach at the top of the performance charts, this is also the most volatile (risky) strategy, and those same funds are also often found at the bottom of the performance rankings. The difference in risk between a momentum growth investor and a GARP investor is actually larger than the difference in risk between a GARP investor and a relative value investor.

Because value and growth investment strategies perform best under different market and economic conditions, a well diversified portfolio will have exposure to both. But it is important to know what kind of value or growth exposure you are buying, so your portfolio is properly aligned with your own risk profile.

-- Rachel Zibrak