GROWTH VERSUS VALUE: DÉJÀ VU IN 2018

REGIONS
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It's beginning to feel a lot like 1999. During that time, the value style of investing had seemingly been abandoned forever for the growth style, and Technology stocks felt like the only area of the market going up. We all know how that ended, and right now we are looking at a similarly huge discrepancy between Value and Growth stocks. After the technology bubble burst, it took many years for the information technology sector to rebound, but now nearly 20 years later it is once again in vogue. The companies today have much stronger earnings profiles than did their Internet-era predecessors, but the similar fixation on one sector of the market cannot be denied.

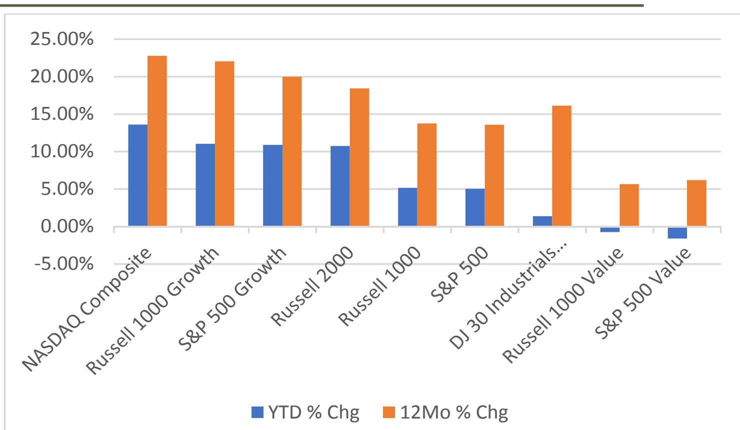
According to Ibbotson, growth stocks are beating value stocks to a degree not seen since the Great Depression. The investment implications cannot be overstated as portfolios with value characteristics and income-oriented mandates struggle to keep up with the broader markets. It is hard to maintain a disciplined investment philosophy when one sees the shares of companies with little earnings to speak of soaring, but nine years into a bull market, that is exactly what one must do to preserve wealth and income for the future. Valuations and expectations do matter, and a balance between value and growth is a good way to smooth returns in the ups and downs of the market.

In this piece we will look at the causes of the divergence between growth and value, the implications of a narrowly-focused market and the reasons why diversification across market sectors could be more important now than ever before.

The Divergence between Growth and Value

Year to date and over the last twelve months, the growth-oriented and Tech-heavy NASDAQ, Russell and S&P Growth indices have dramatically outpaced the Dow Jones Average, the Russell and S&P Value indices and the broader S&P 500 average itself (see Figure 1.) For balanced investors and active managers, this has made comparisons to benchmarks difficult. Similar to the Tech bubble of the late 1990s, Information Technology stocks (both the sector itself as well as large internet-oriented companies such as Amazon and Netflix within the Consumer Discretionary sector) have dominated the market's returns over the last few years. The valuations of these companies have continued to grow along with expectations, and their growth has not disappointed. These companies truly are leading the way in terms of innovation, growth, market dominance and expansion worldwide, so they are successful for a reason. Nevertheless, as other areas of the market have lagged, one has to believe that some of this divergence will ultimately be corrected, favoring value stocks once more. Determining the timing of this is impossible, but knowing that a recovery in economic activity in a rebound from a recession has historically favored value stocks (including Financials and Energy sectors) it makes sense to have exposure to this area of the market as well.

Figure 1: Stock Market Price Performance



Source: FactSet Research Systems

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While S&P 500 earnings growth rates have been robust in 2018 to date, global economic activity has slowed, making investors' willingness to "pay up" for growth even more pronounced. In times of low economic growth rates and technological advances, investors become fixated on certain areas of the market at the expense of others – they will pay increasingly high multiples for growth because it is perceived as scarce. This is where we find ourselves right now in the current environment. For years, the Consumer Discretionary and Information Technology stocks have led the markets, and the discrepancy between Growth and Value indices has once again become extremely pronounced. For investors with more of a focus on conservative, dividend-focused companies with low but steady growth rates, it has been painful to compare one's portfolio to that of the broader markets.

Implications of a Narrow Market

The market is extremely narrow, with Technology the only sector where the majority of the stocks are beating the market. Even though Consumer Discretionary is leading the market as well, one look under the surface will reveal that the reason is the outperformance of Internet and Catalog Retailing stocks. Traditional "value oriented" sectors with high yields such as Utilities, Telecommunication Services and Consumer Staples are dramatically underperforming "growth" sectors with little to no yield such as Information Technology (see Figure 2.)

Figure 2: The Divergence Between Sectors

S&P 500 Sector	Div Yld	PE Multiple	YTD %Chg	12Mo %Chg
Telecommunication Services	5.82	7.06	-11.97%	-2.96%
Utilities	3.53	16.06	-1.40%	-2.48%
Real Estate	3.48	40.07	-1.62%	0.06%
Consumer Staples	3.11	18.3	-8.30%	-5.08%
Energy	2.84	20.79	3.59%	15.25%
Materials	2.04	18.76	-3.96%	5.11%
Industrials	1.99	20.32	-2.49%	5.86%
Financials	1.77	16.49	0.00%	12.68%
S&P 500	1.77	--	5.02%	13.56%
Health Care	1.72	27.04	5.21%	7.49%
Consumer Discretionary	1.26	22.47	13.47%	22.92%
Information Technology	1.18	30.74	16.06%	29.42%

Source: FactSet Research Systems,Regions Investment Management

When markets become narrow, investors often discount factors that in a different environment might be construed as attractive. In the late 1990s, heavy industry, old industry and dividend-paying stocks were shunned by many investors in favor of companies with little to no earnings because the prospect of excessive growth was so much higher. It naturally ended badly for those investors, with growth stocks declining by a factor of two times that of value stocks. That is the risk investors take when investing in areas with high multiples and high expectations. By owning value stocks as well, it would have helped to cushion the blow from the selloff.

The importance of Diversification

We are nine years into a bull market. The run has been tremendous off of the lows witnessed in March of 2009, brought on by the unraveling of financial and housing excesses. The last big downturn before that was precipitated by excessive valuations and expectations in Information Technology stocks. Déjà vu?

Diversification is critical in investing, and rebalancing to harvest gains and reinvesting in underperforming sectors is an important element of asset allocation decisions. When any one area of the market becomes extended, we have seen time and again that the trend can continue for many years to come. Nevertheless, maintaining an appropriate balance of growth and value stocks within one's equity portfolio will help to make sure one is exposed to an appropriate mix of income and growth.

Investment Conclusion

Understanding what is driving market returns is important for investors, and having confidence in a well-researched approach to company selection is key when investing in "heady" times. Growth is always something deemed an attractive investment characteristic, but the price one pays for that growth and the longevity of those growth rates are also important factors to keep in mind. As markets become extended, inevitably investment returns will be impacted, with the highest-flying sectors hit the hardest when downturns take place. A well-balanced approach to investing will help protect long term goals of growth and capital preservation, and while we believe that growth styles will continue to do well as investors seek growth and innovation, we also advocate for exposure to value and dividend oriented strategies for long term investors seeking income and capital preservation in all types of markets.
