HFG WEALTH MANAGEMENT

INSIGHT

PERSPECTIVES FOR THE GOAL-FOCUSED INVESTOR

FALL 2018

Value vs. Growth
Styles Make Fights

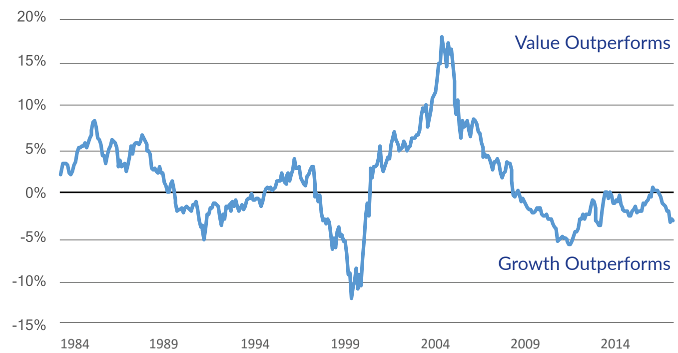
I have been a boxing coach for over 20 years. One of the more popular sayings in boxing is “styles make fights”. Although it has several meanings, the most common interpretation is that what makes a fight interesting is not necessarily the individuals involved, but the clash of their different fighting styles. Sometimes boxers win because they are more talented than their opponent, and sometimes they win because their style prevails over an otherwise more talented opponent.

Similar to boxers, investment managers have different styles. In 1987 Russell Investments created the first growth and value style indices to help investors understand the differences between investment managers’ returns.

Prior to the creation of the style indices, most managers were measured against the same broad index, often the Russell 1000 or the S&P 500. However, some managers primarily bought stocks that were considered cheap relative to their current value, which they could then hold until the full valuation was recognized (value stocks), while other managers bought primarily stocks that were considered expensive relative to their current value, but offered prospects of significant future growth (growth stocks). Depending on the economic environment at the time, one group of managers might significantly outperform another, not necessarily because they are better, but because their style of investing was in favor. By delineating the Russell 1000 by style, investors are better able to decipher which managers are good at what they do, versus those that just happen to be doing well because of their style.

“Similar to boxers, investment managers have different styles.”

Growth vs. Value - 5 yr Rolling Returns (1979-2018)



Source: Morningstar

Which Style is Best?

The graph illustrates the difference in monthly 5-year rolling returns from January 1, 1979 to December 31, 2017 between the Russell 1000 Growth Index and the Russell 1000 Value Index. Any point on the graph above zero means value beat growth, and any point below zero means growth beat value. As you can see in the short run (since the great recession in 2008), growth has steadily outperformed value. In fact, as of 9/1/2018 the Russell 1000 Growth Index was up 16.4% year to date, vs. the Russell 1000 Value Index’s return of 3.71%. However, the long term historical record favors value. Since 1979 the average annual return for the Russell 1000 Value Index was 12.2% vs. the Russell 1000 Growth Index return of 11.4%. Moreover, the Russell 1000 Value was subject to less volatility over that time frame, thus offering better risk adjusted returns than growth. Although the investment landscape is always subject to change, and past performance is never a guarantee of future results, history and academic research supports a tilt towards value for the long term investor.

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Simple not Easy

The Case for International Diversification

The two simplest tenets of sound investing are often the most difficult. Those tenets are 1) don't put all of your eggs in one basket, and 2) buy low, sell high. In finance, we call the first tenet "diversification". Harry Markowitz won a Nobel Prize in 1990 for his work demonstrating the benefits of diversification, finding that it can reduce overall risk and increase potential return. While pretty much everyone agrees with the idea of diversification, the real world application of it is much more challenging.

Often, a correctly diversified portfolio will have at least one asset that is underperforming, possibly losing value. Typically, when investors see an asset in their portfolio dropping in value while others are rising, their instinct is to sell that asset and buy more of what is going up. However, in doing so, they are violating both tenets 1 and 2.

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The key is to recognize that a portfolio is akin to a football team. Football teams are sub-divided into offense, defense, and special teams. Each sub-division has a specific purpose and is comprised of people with unique skills that when combined as a whole, offers the team the best opportunity to win. Although, certain positions, such a quarterback, get more glory than others, one would not want a team comprised solely of quarterbacks. Moreover, as a coach, one wouldn't bench the quarterback because the defense isn't playing well. Similarly, each position in a portfolio needs to be judged against what it is supposed to do, not against the other positions in the portfolio.

The U.S. bull market has been going for almost a decade, and with it have been strong returns far outpacing other asset classes. This strong past performance has investors wanting to violate the two tenets above, and invest more into the U.S. markets. However, the U.S. economy is now towards the later end of the cycle, and investment valuations are higher relative to international counterparts. Looking at forward P/E ratios as of the end of September as a proxy for market valuation, U.S. stocks appeared to be more expensive, with the S&P 500 Index at a forward P/E ratio of 16.9, while developed international and emerging market stocks were cheaper with the forward P/E ratios of the MSCI EAFE Index, and the MSCI EM Index at 13.63 and 11.26 respectively.

International economies are still in the early cycle, meaning they may offer more upside potential moving forward as their central banks remain accommodative, and their stock prices are relatively more attractive. The international markets recent underperformance is not a reason to allocate away from them. The underlying benefits and rationale for international stocks still apply: their economic upswing is still new, their stocks are a better value, and they still provide the benefit of diversification. And unlike the temptation to increase investing in U.S. markets, investing in international markets could help investors remain consistent with both tenets by remaining properly diversified, and by buying low and selling high.