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It's All Relative!

With another year of outperformance by value stocks in the books, investors are questioning whether a meaningful turning point towards growth stock leadership could be at hand. To address this question, it is useful to go back to early in the year 2000 when value stocks began their dramatic reversal to the upside. In the late 90's, these stocks were all but forgotten as investors chased the strong performance delivered by high growth names. In fact, with many of the "value" companies' prospects for low earnings growth, there was very little reason to be interested back then. And yet value stocks have now outperformed growth stocks for seven consecutive years—quite a long time by investment cycle standards. What happened?

First, value stocks had become very cheap even considering their low growth prospects; and conversely growth stocks had become very expensive. Second, analysts' forecasts were overly pessimistic for many of the value companies and far too optimistic for the growth companies. As we have discussed in these letters before, Wall Street analysts tend to extrapolate recent growth trends into the future when very often the trends are not sustainable. The sentiment at the time was that the New Economy stocks were going to leave the Old Economy stocks in the dust.

The reversal in growth stocks began in the spring of 2000 with a steep decline in technology stocks as many of these companies failed to meet increasingly lofty expectations. Several factors had driven technology earnings growth to unsustainable high levels including tremendous inflows of capital into technology stocks and spending on Y2K conversions. There was also a great deal of what proved in hindsight to have been excessive tech spending by a number of companies fearful of being left behind. So the first part of the relative outperformance of value was simply a decline in tech relative to other sectors of the market.

The second phase of outperformance did not really start until 2003, when the economy began to awaken following two years of depressed growth. Looking back, analysts significantly underestimated the growth potential that many value companies were capable of delivering. Old Economy companies began to benefit as their own spending on technology positioned them for increased productivity and substantial operating margin improvement with the economic upturn. Adding more fuel to the fire, the current U.S. economic cycle has been extended as a result of the tremendous growth underway in developing countries. One of the effects of this strong global growth has been upward pressure on the prices of a number of commodities, most notably crude oil, causing both Energy and Materials stocks to meaningfully outperform in this phase of the cycle.

Now we appear to be at another crossroads. Global economic growth is slowing to a more moderate pace and relative valuations of the more cyclical value companies are stretched. On a P/E to expected growth ratio, the Russell 1000 Value Index appears to be about 70% more expensive than the Russell 1000 Growth.

As of 12/31/06	Calendar P/E 2007	Consensus EPS Growth 07 vs 06	P/E to Growth
Russell 1000 Growth	18.9	17.1	1.1
Russell 1000 Value	14.4	8.2	1.8

But more importantly, we believe that earnings estimates are likely to fall for many of the value companies as it should prove difficult to sustain their recent growth rates. Conversely, the greatest earnings growth this year is expected to come from the two largest sectors in the growth index—Technology and Consumer Discretion.

As of 12/31/06 SECTOR	EST. EARNINGS GROWTH 06 VS 05	EST. EARNINGS GROWTH 07 VS 06
Consumer Discretion	15%	14%
Consumer Staples	6%	11%
Energy	21%	1%
Financials	24%	7%
Health Care	7%	11%
Industrials	15%	13%
Information Technology	8%	19%
Materials	28%	2%
Telecommunications	16%	5%
Utilities	9%	12%
Traditional Growth Sectors		
Traditional Value Sectors		

At this time, our screens are identifying a growing number of high quality large cap growth companies that are experiencing positive earnings estimate revisions, giving us more confidence that growth should start to outperform.

Following a strong run-up that began back in July and has continued steadily since, the market is likely to consolidate near-term. Sentiment remains too optimistic and both monetary and valuation factors are currently neutral for the equity market. However, with the Fed appearing to be at the end of the rate tightening cycle and the economy relatively healthy, we see an opportunity for further gains as we move into the year.

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A copy of our Form ADV, Part II is available upon request.
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