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Growth vs. Value Revisited

Late last summer, we wrote a monthly letter suggesting that the extreme outperformance "Value" stocks had enjoyed over "Growth" stocks for the last five years was likely coming to an end. In the fourth quarter Value and Growth performed much more alike than in most recent time periods, with Value up just over 10% and Growth up just over 9%. In this letter we want to expand on this theme, using the Russell 1000 Growth Index as a proxy for Growth stocks in general and the Russell 1000 Value Index as a proxy for Value stocks.

The chart to the right shows the performance of these indices for periods ending in June of 2000, after a prolonged period of outperformance by Growth stocks. For the five-year period the Growth Index returned almost 11% per year more than the Value Index. Clients were under all kinds of pressure to put all of their funds into Growth.

Russell Style Indices: Returns through June 2000

	1 Year	3 Years	5 Years	10 Years
Russell 1000 Growth	25.65%	28.08%	28.67%	20.11%
Russell 1000 Value	-8.92%	10.94%	17.78%	15.24%

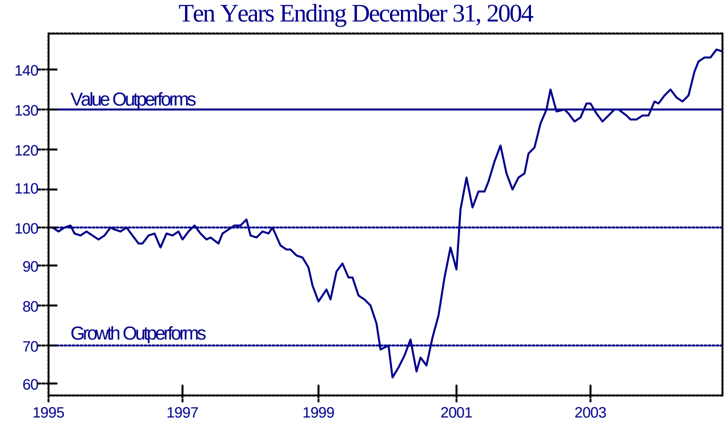
Russell Style Indices: Returns through December 2004

	1 Year	3 Years	5 Years	10 Years
Russell 1000 Growth	6.30%	-0.18%	-9.29%	9.59%
Russell 1000 Value	16.49%	8.57%	5.27%	13.83%

The chart to the left shows the performance of the Growth and Value indices for periods ending in December of 2004. For that five-year period the Growth Index underperformed Value by some 14% per year. Clients are now under severe pressure to put all of their funds into Value.

This chart shows a very clear picture of the relative performance of these two styles over the last ten years. Two observations are in order. First, the relative performance of Value for the last five years has more than offset the performance of Growth in the late 1990's. Second, prior to the big bubble in valuation in Growth stocks in the late 1990's, performance differences between Growth and Value were relatively small. I think we are getting back to that type of period today.

Russell 1000 Value vs. Russell 1000 Growth
Ten Years Ending December 31, 2004



Source: Frank Russell Co., DHJA Research
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A copy of our Form ADV, Part II is available upon request.
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Although markets can be inefficiently priced over short time periods if expectations get out of hand, in the long run they are more rational. It now appears that reality has returned to valuations in the stock market.

	December 31, 1999			February 8, 2005		
	P/E	Expected Earnings Growth	PE/G	P/E	Expected Earnings Growth	PE/G
Russell 1000 Growth	55.2	22.4%	2.5	21.5	14.3%	1.5
Russell 1000 Value	19.6	12.3%	1.6	15.9	9.6%	1.7

The chart above shows that not only were future earnings expectations of Growth stocks irrationally high at year-end 1999, but price/earnings multiples reflected far too much exuberance. Dividing the price/earnings ratio by expected earnings growth is a valuation methodology used by many on Wall Street to determine what the market is paying for future growth. At a 2.5 times ratio of price/earnings to expected growth, Growth stocks were clearly enjoying bubble type valuations in 1999. Today however, growth expectations and price/earnings multiples are much more reasonable, especially when compared to past history. In fact, the price/earnings to growth ratio of the Russell 1000 Growth Index is now actually lower than that of the Russell 1000 Value Index. The bubble has been corrected, and then some.

On top of this, I would also like to point out that almost half of the Value Index consists of interest-sensitive stocks such as banks, insurance companies, utilities, REIT'S, etc. All of these groups have enjoyed extremely favorable macroeconomic conditions for the last several years, as the Federal Reserve has held interest rates down. In that environment, these companies were able to borrow money in the short-term money market and lend it out at longer rates with extremely high net interest margins.

Now that the Federal Reserve has been raising short-term rates, the yield curve has flattened. The spreads available from borrowing short and lending longer are essentially back to "normal." Tougher comparisons and potentially disappointing earnings growth are to be expected from this very large interest-sensitive segment of the Value Index.

Our conclusion remains the same: The relative underperformance of Growth versus Value is coming to an end.

Robert C. Davis, CFA
March 1, 2005

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