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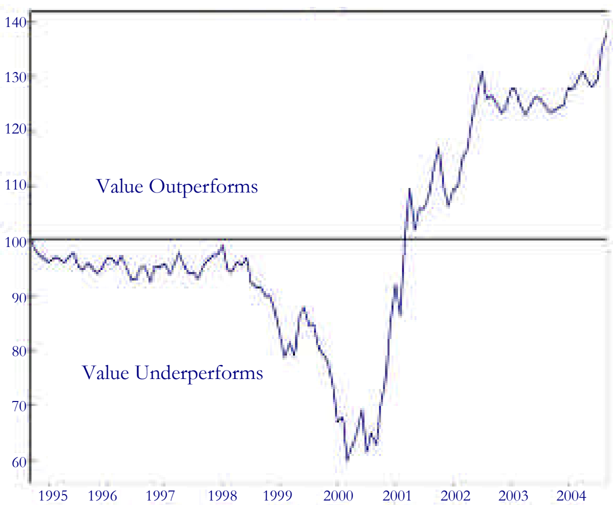
A Picture Is Worth a Thousand Words

In March of 2000, I gave a speech to a large group of public retirement fund trustees. As the chart below shows, that was a time when the "Value" investment style had underperformed both the S&P 500 and the "Growth" style for many years.

Russell 1000 Value vs. Russell 1000 Growth
Ten Years Ending August 2004



Pressure was intense for trustees to fire so-called value managers and put more money in the growth style. The point of my talk was to advise the group against that move. It was the bottom of the relative performance of that investment style.

The point of this letter is to advise against firing so-called growth managers. I don't know if it is the end of the relative underperformance of that style of equity investing. Just as in March of 2000, I can't predict the future. However, I think probabilities no longer favor Value over Growth.

One major tenant of investing that professionals generally agree on is that, in a relatively efficient market like the U.S. Stock Market, mean reversion works. That is, individual stocks, sectors, styles, etc. revert to average market returns over longer periods of time. Over shorter periods, emotions come into play as they did in the late 1990's when speculation made Growth spike to unreasonable valuations.

After a period of almost five years, and an outperformance of Value versus Growth of over 130% from the relative bottom of the value index in 2000, I believe that the probabilities that Value continues to outperform Growth have diminished considerably.

I also believe that this is borne out by the relative valuation of the largest industry groups in the so-called growth world. In the spring of 2000, technology was ridiculously overvalued. Forecasts for the forward growth rate of the sector were insanely optimistic. Valuations had risen to the point that two-thirds of the growth index was Technology. The S&P 500 Technology weighting had risen to 35%. Currently, valuations of technology stocks have shrunk to the point that they are 26% of the growth index and about 15% of the S&P 500. This percentage of the S&P 500 is just about where it started before the big run in technology stocks in the late 1990's.

Currently, the technology stocks in the Russell 1000 Growth Index are selling at a Price/Earnings ratio of about 20x with an expected average earnings growth rate of 16%. This compares to a P/E ratio of 16x for the entire S&P 500 with an expected growth rate of 10-12%. The current relative multiple of the technology sector is not unreasonable, considering the growth rate differential versus the overall market.

A similar situation exists in one of the other large sectors of the growth world. Healthcare is close to 25% of the Russell 1000 Growth Index and has a P/E of about 17x and an expected growth rate of 15%. This is one of the lowest relative multiples the sector has sold at in the last ten years. In fact, large capitalization pharmaceutical companies make up 13% of the index, and are selling at relative valuations not seen since 1993 when they were under attack by the Clinton Administration. That proved to be a great buying opportunity.

Unlike 2000, Wall Street expectations for future earnings growth for these two important groups now seem reasonable. The relative valuation could even be considered a bit low.

We are growth stock managers. When I gave my talk in March of 2000, I was trying to be objective and give our clients my best advice against putting more money into Growth when expectations and valuations for growth stocks were way too high. Now that expectations and valuations are more "normal," my advice is not to move out of Growth. Returns will revert to the mean. Growth will come back.

Robert C. Davis, CFA
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A copy of our Form ADV, Part II is available upon request.

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