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Investing: Value Versus Growth

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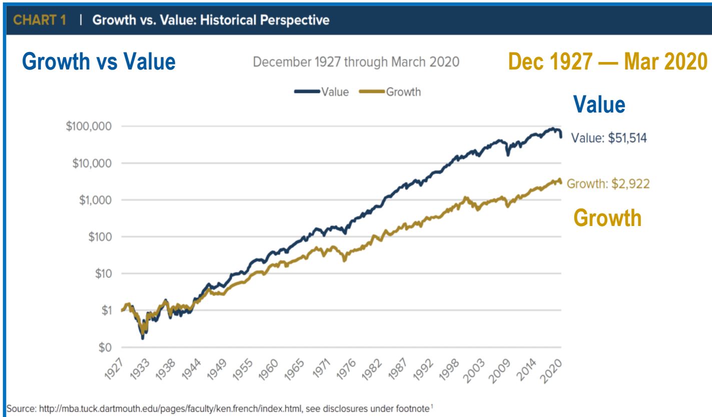
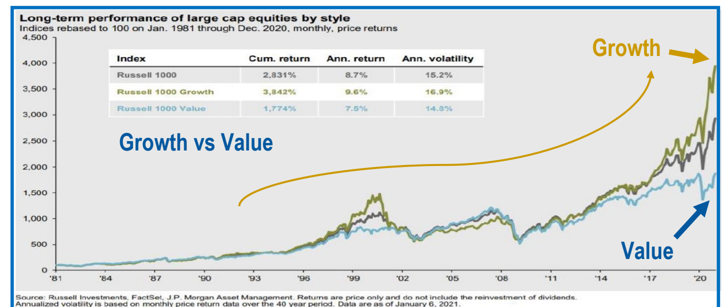
What is the difference? How do we define these terms? According to Forbes Advisor: "Value investing seeks to invest in companies that are undervalued relative to the market. Valuation can be measured in multiple ways, including price-to-earnings and price-to-book. In contrast, growth investing aims to invest in companies that are rapidly growing revenue, earnings and cash flow."

Over the long-term, value has dramatically outperformed growth. For example: $1.00 invested in an index of growth stocks in December of 1927 would have increased to $2,922 by March of 2020 whereas, $1.00 invested in an index of value stocks would be worth $51,514 during that same time period – almost eighteen times as much (see graph below).



Now, we do realize that most people's investment time horizon is somewhat less than ninety-three years; therefore, we have to use other data to determine whether one category should be emphasized over the other.

Observing a shorter time frame (40 years) indicates a significant outperformance by growth over value. This is in sharp contrast to the dramatic outperformance by value over the longer time period, but more outstanding is growth's superior numbers over the last 10 years especially during the Covid recessionary period that began in March 2020. Interestingly, the following graph



Index	Cum. return	Ann. return	Ann. volatility
Russell 1000	2,831%	8.7%	15.2%
Russell 1000 Growth	3,842%	9.6%	16.9%
Russell 1000 Value	1,774%	7.5%	14.8%

shows that during the first thirty of those forty years, growth, value and the composite of both show almost identical returns from 1981 through 2011 with some variations but always coming back together. Does that mean that growth is due to underperform in the near future to come back in line with value and the composite index?

The answer is yes and no. *Yes*, the two indices will come back into line but, *no,* not necessarily beginning soon. There is an old adage on Wall Street: "markets can remain irrational longer than you can remain solvent" which means that a seemingly sensible strategy may not come to fruition until long after you have lost your money. Therefore, even though it seems that we are approaching a good time to invest in value, diversification is still the prudent approach although tilting a little more toward value appears to be an intelligent move.

The Covid pandemic has provided a great opportunity for a unique blend of growth investments that have profited greatly from this health disaster. Such as: Zoom for audio and video teleconferencing, Docusign for transacting business and signing documents electronically, Shopify and Amazon for shopping from home, and others. The question that remains is, *Will the rollout of the vaccines and the decline of the pandemic cause these stocks to lose their luster, or has the way Americans conduct business changed forever?* We suspect that the answer is some alteration but not complete change. Therefore, these growth stocks probably will not crash and burn but may not perform as well in the near term as their value brethren.

We are currently contemplating the addition of more value investments to our portfolios on an incremental basis while still adhering to the fundamental principle of diversification. It is important to remember that growth investments are the ones that generally provide the breakthroughs for human progress and increasing standards of living (think Apple, Microsoft, Amazon, etc.). However, sometimes there is more opportunity in cyclical or value investments that might be currently less highly valued (think JP Morgan, Proctor & Gamble, Verizon, etc.).

OUTLOOK

To begin, let's look back at 2020. In January, the market was building on the great gains of 2019 and everything seemed to be heading in the right direction even through mid-February. Then the Covid Pandemic hit and the market experienced one of the most rapid declines in history. The market suffered approximately a 35% drop from the February intra-day high to the March intra-day low. At that point, the federal government and the Fed committed to inject trillions of dollars to fight the effects of the pandemic fallout, and the markets did an about face. They began rallying which has continued through the first week of January 2021.

The powerful phrase, "Don't fight the Fed" was proven to be valid once again. In possibly the most dramatic example of money (in massive amounts) moving the markets, we witnessed a stock market that ignored endless amounts of bad news in its relentless climb upward. The pandemic raged throughout the year with thousands of deaths and numerous flare-ups, social unrest was rampant with many US cites experiencing arson and looting, political partisanship was more intense than ever – impeachment and political infighting rather than a unified approach to pandemic relief and the effects of economic shut downs and school closures; then the culmination was the election which turned out to be bitterly contested. Further, the Biden Administration is promising to raise taxes and increase regulation. Despite all of this negative input most segments of the market enjoyed double-digit gains for wild year 2020.

2021 has begun in the same mold as 2020, that is: bad news (the Capitol Building being ransacked and Congress threatening to impeach Donald Trump with only nine days left in his term), and yet the market recorded a strong first week. The question is: *Has the government and the Fed found the magic formula for permanent prosperity by creating and spending never ending trillions of dollars?* Unfortunately we believe the answer is no because inflation eventually shows up.

The lessons of the past have been forgotten and the focus has been on the period starting with the Great Recession of 2008. That was the time when vast amounts of money creation was utilized to get us out of that disaster, and it worked. Furthermore, there was no big inflationary effect; therefore, when this crisis came along they did not hesitate to use the same remedy in much larger doses. Inflation in the early stages actually benefits the market because companies can charge more for their goods and services. Inventory, plant and equipment as well as other assets appreciate in value. However, the party comes to an end when stagflation (persistent high inflation along with high unemployment and stagnant demand) takes over. Those of you old enough to remember the 1970's experienced it. You probably also remember the bitter medicine administered by Ronald Reagan and Fed Chairman Paul Volker. Interest rates were raised to the point where money market funds were paying over 20% and 30 year mortgage rates were in the upper teens. The nation went into a recession and many companies in the Midwest part of the nation dubbed "the rustbelt" went into bankruptcy,

We are not expecting inflation to be a big problem in 2021. We are saying that the policies discussed by the incoming Administration indicate a need for large amounts of money – much more than can be taken in through the taxation that they have talked about. Consequently, much of it will need to be borrowed. Joe Biden has said that the $900 billion stimulus relief bill that was passed is "only a down payment," and also a large infrastructure bill will be coming. We believe that 2021 will be a positive year because lots of money will be created by the Fed and spent by the government along with several vaccines and the re-opening of the economy. A positive year does not mean that we will not experience one or more normal 10% corrections in the interim, and remember, the market is fully valued – it is not trading at bargain prices. The time frame on inflation emerging as a problem is unknown, but we are thinking 2022 or beyond. We must, however, continue to be vigilant because no one knows for sure.

If you have questions or need more information, please contact us.

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