Volatility: A Yogi For The BARRA's?

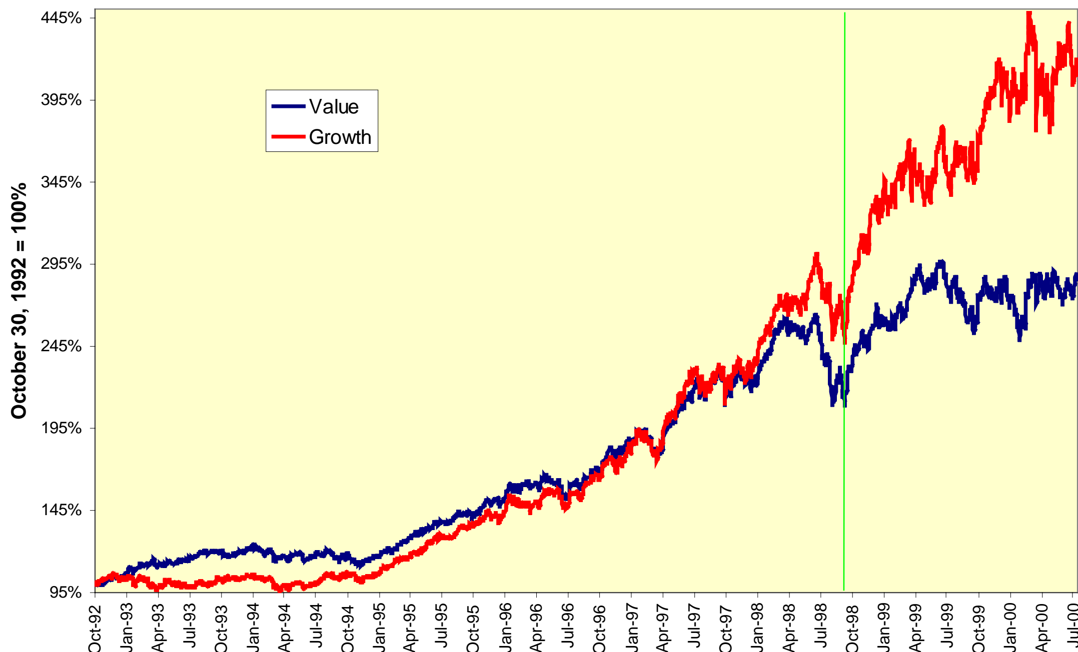
It's an age-old question for investors: Do we buy low and hope to sell high, or do we buy high and hope to sell higher? Of course, there is no quick and simple answer in this debate between relatively cheap "value" stocks and the more expensive "growth" stocks. Sometimes stocks are cheap for very good reasons, and buying them low may prove unrewarding. At other times, say Chrysler in 1980 or IBM in 1991, buying a beaten-down company turns into a home run trade. Growth presents an opposite problem: We often need to pay a price far in excess of fundamental valuation in order to participate in a winning trade. Investors in Microsoft or Dell during the 1990s never bought the company cheaply, and never had an obvious exit point on the trade.

Successful growth investing depends more on adroit timing than does successful value investing. This can be illustrated in the extreme with the 1999 Internet boom that ended so unceremoniously this past spring. The shorter time horizons and greater anxiety levels of growth investors should be accompanied by higher implied volatility, which represents the market's price for uncertainty. Will a return to value investing, with the greater margin of safety inherent in these issues, be accompanied by a general decline in volatility?

Index Comparisons

The investment analysis and technology firm of BARRA, Inc. has created benchmark indices for growth and value stocks. While these indices function mainly as performance benchmarks for managers, they are the bases for thinly traded index futures at the Chicago Mercantile Exchange as well.

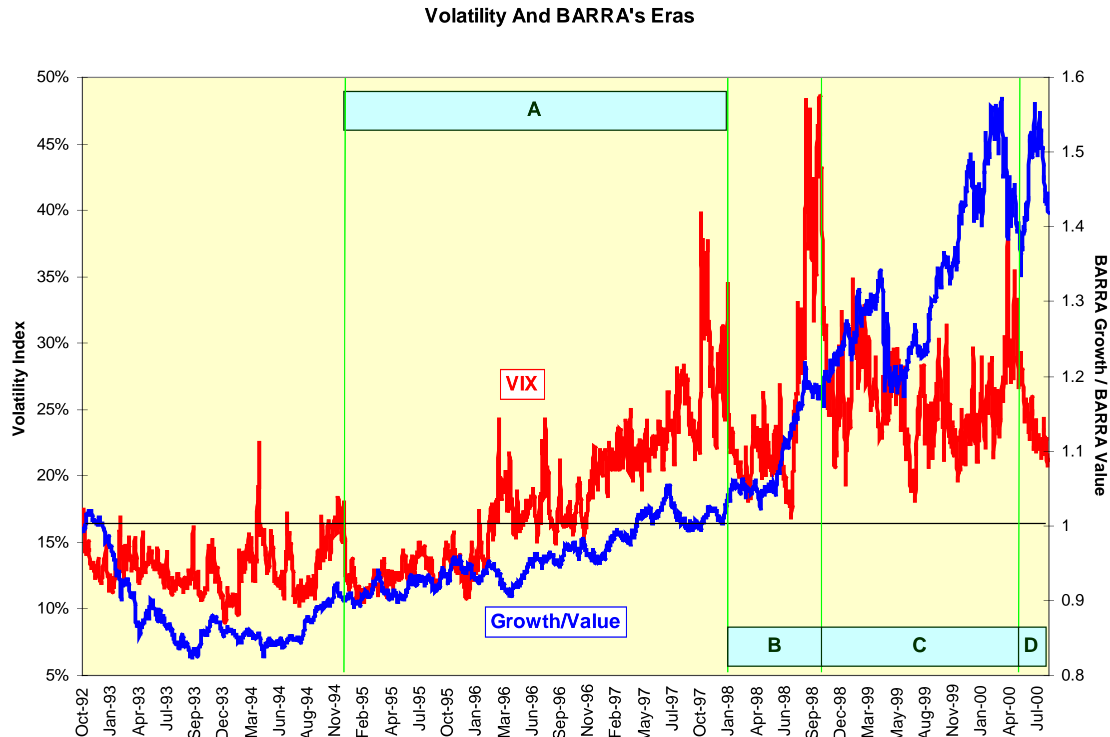
Relative Performance Of BARRA Growth And Value



As hard as it may be to recall, value outperformed growth for much of the mid-1990s, and the divergence between the two indices did not expand significantly until mid-1998. We have noted the relationship between this divergence and interest rates (see "High Rates And A Strong NASDAQ Don't Go Together," December 15, 1999). We also have suggested that the S&P 500 may start to outperform the NASDAQ 100 if the economy slows and interest rates rise (see "The Converging Divergence, August 8, 2000). Similarly, we should expect value to outperform growth in a slowing economy.

Growth, Value, Rates, And Risk

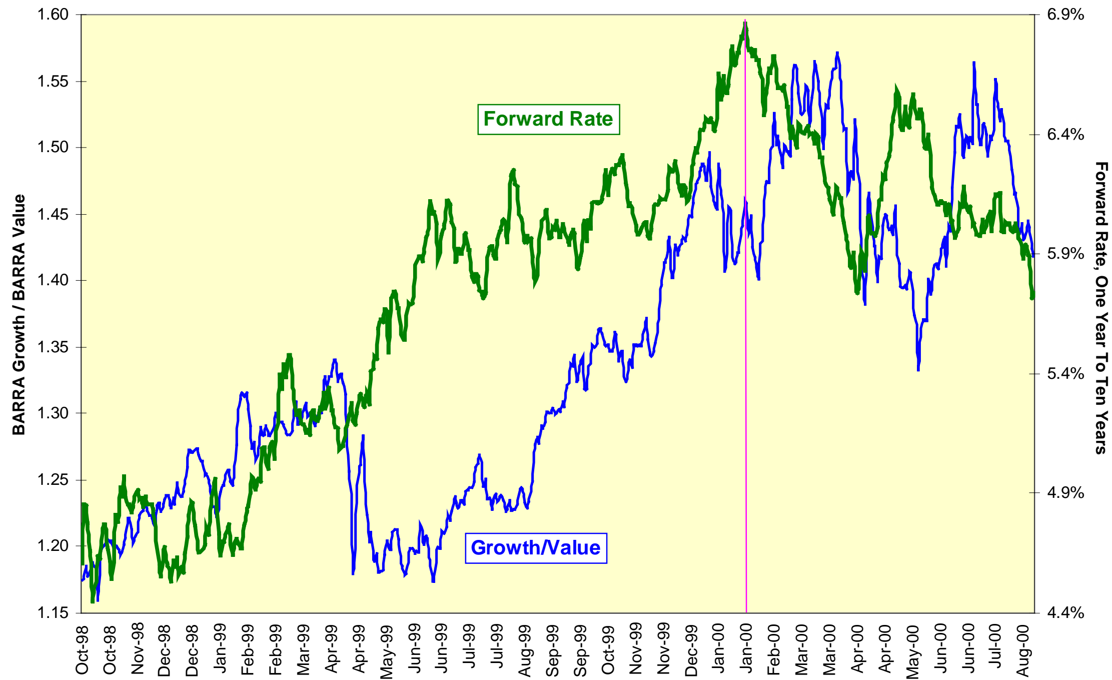
Together, the growth/value relationship, interest rates, and the Chicago Board Options Exchange's Volatility Index (VIX) have produced four distinct regimes of note since October 1992, as highlighted in the graph below. In "A," the VIX started to rise steadily as growth began to outpace value in a steady, but not spectacular fashion. Interest rates were declining in general throughout this period. In "B," growth started to outpace value strongly. The VIX shot higher and interest rates plunged during the 1998 financial crisis. In "C," growth greatly outpaced value. Interest rates rose, but the VIX indicated a great deal of market complacency: We had become acclimated to the great tech stock rally in the face of rising interest rates. In "D," all three measures are declining. Interest rates are falling, value is outperforming growth, and the VIX is signaling comfort with the whole state of affairs.



What makes Regime D so different from Regimes A-C is the distinct possibility, not yet confirmed, of an economic slowdown. For the first time since the start of this sample we have falling interest rates not as a function of slow growth and/or financial crisis elsewhere in the world, but as a function of slowing growth in the U.S. More important, we may just be starting on the macroeconomic aftershocks of the dot-com bubble's demise. Many of the billions in venture capital and IPOs that went into financing on-line ordering of dog food and other necessities of modern life have disappeared without a trace. This cannot help but influence the prospects of the first-rate Internet infrastructure firms whose equipment and services were purchased by the techno-riffraff.

Since interest rate expectations peaked in January, bonds have outperformed stocks, especially growth stocks. Just as the BARRA growth/value ratio has two peaks, one in March and one in June, the implied forward rate of interest between the one- and ten-year horizons has two peaks, and these led the ratio peaks by about two months.

BARRA Growth/Value Ratio As A Function Of Interest Rate Expectations: Regimes C & D



The outlook for further rate declines should bode well for value relative to growth, for bonds, and for a much quieter, less volatile market than we've seen in years. Sectors such as banking, insurance, tobacco, energy, food and beverages, and basic manufacturing aren't going to give you a 5% return over your lunch break, but they're unlikely to drop 40% in a month, either. And performance does arrive: The 17% rally in the Dow Jones Utility Index since April 14 is starting to look pretty good, isn't it?