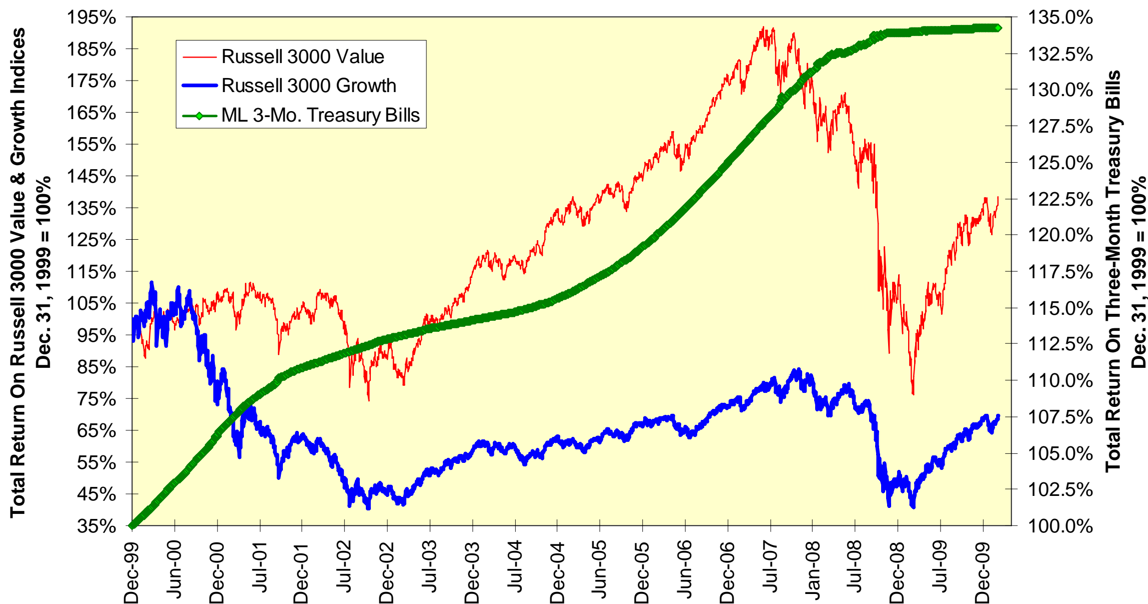
Growth And Value, Ten Years After

The decade recently passed certainly served to debunk a lot of existing myths while creating new ones. Ten years ago, as the great bull market of 1982-2000 ended, would anyone have believed three-month Treasury bills would have outperformed stocks? Yet that is precisely what happened in a decade where the Federal Reserve twice drove short-term interest rates down to previously unthinkable lows: The average annual total return on three-month Treasury bills was 2.943%, while those for the Russell 3000 value and growth indices were 2.838% and -3.861%, respectively.



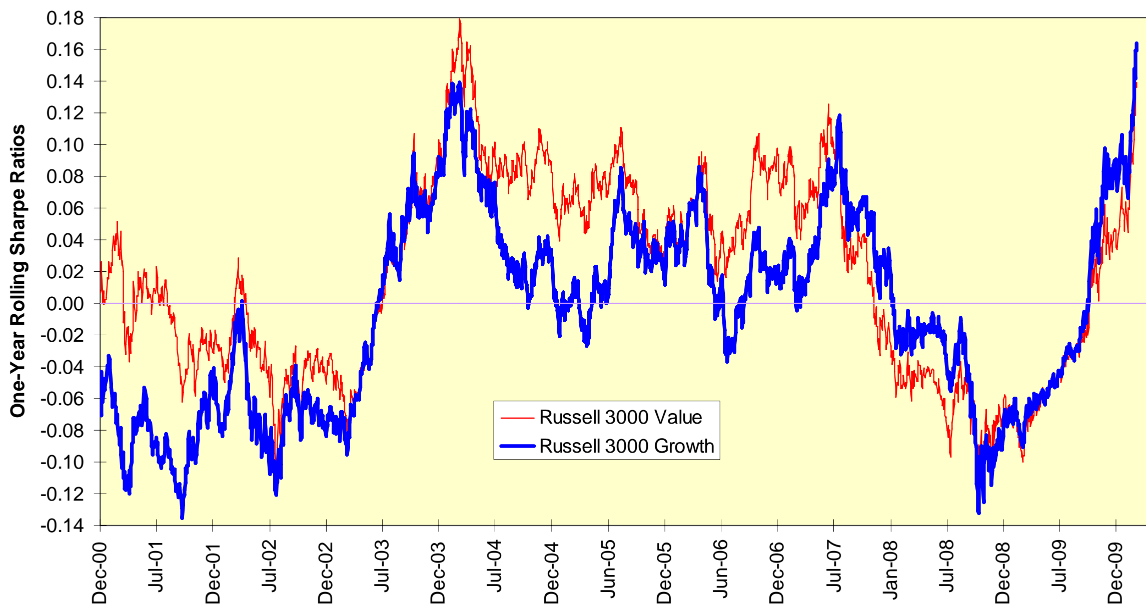
All of this sidesteps the question of what, exactly, are "growth" and "value." We could make up the answer on an arbitrary basis and join the crowd as no formal definition exists. Most of us would agree value issues have lower price/earnings and price/book ratios and maybe have higher dividend payouts. But terms such as "higher" and "lower" simply perpetuate the circular logic extravaganza.

Maybe we should just go with the late Justice Potter Stewart's definition of obscenity: "I shall not today attempt further to define the kinds of materials but I know it when I see it." So do I, your Honor, so do I.

Look Sharpe, Feel Sharpe

Just because something is cheap on a relative scale does not prevent it from becoming cheaper. Note the colossal retracement of gain in the value index between October 2007 and March 2009; it decline at an average annual rate of 67.08% as opposed to 53.50% for the growth index. The obvious reason for the discrepancy was the heavy weighting of financial issues in the value index. They annihilated performance just as much as technology issues did for the growth index back in the dotcom bust; the chief difference was the tech bust did not require massive government bailouts of firms who sold dog food over the Internet.

Which investing style is better on a risk-adjusted basis as measured by the Sharpe ratio? As we should expect for arbitrary classifications, we get "it depends" for an answer. If we take one-year rolling Sharpe ratios, we find value was the superior style during the bear market ending in 2002 and again during the bullish recovery between 2004 and 2007. Growth was superior only for brief periods during 2007-2008 and again during the 2009 bullish recovery. Rather surprisingly, while the name "growth" promises some measure of turbo-charging, it really could not outperform value on a risk-adjusted basis during either liquidity-fueled market of the last decade, 2003 or 2009.



Hardware And Footwear

If we cannot find distinctions in risk-adjusted performance, we certainly can find them when it comes to passing out the pink slips and the bling. One of the tipoffs the tech bubble was coming to an end was the loss of jobs and assets under management by value managers as the top neared. This past November, *Morningstar's* Fund Manager of the Year/Decade/Millennium finalist list was dominated by self-described value managers. This was equivalent to saying the sailors with the wind at their backs were better at their craft than the sailors with the wind in their face, but no matter: Performance sells and that is that.

No one should expect the long streak of value's dominance to persist anymore than they should expect Treasury bills to outperform stocks again over the course of a decade. The mathematics of starting point, compounding of returns and the tyranny of reversion to the mean will see to that, even in a world populated by self-proclaimed contrarians who work in cubicles.