Invest with style

Thomas Nun, CFA
Portfolio Strategist

Terry Mancini
Investment Analyst

Key takeaways

- The current dominance of growth over value has persisted for 10 years, making it historic not only in length, but also valuation spread.
- While both value and growth investment styles have their merits, value investing has historically delivered superior returns on an absolute and risk-adjusted basis.[1]
- Great-West Investments maintains an overweight position in value strategies, opposite growth, in our asset allocation strategies; we remain committed to this long-term, strategic view.
- Don't give up on value: It's impossible to predict when the cycle will turn, but we believe valuations are approaching extremes and that means reversion is a powerful corrective force in the long run.

Growth or value?

Equity investment styles are often categorized into the broad styles of either growth or value. So, what's the difference between the two and why should we embrace both, particularly given growth's recent dominance?

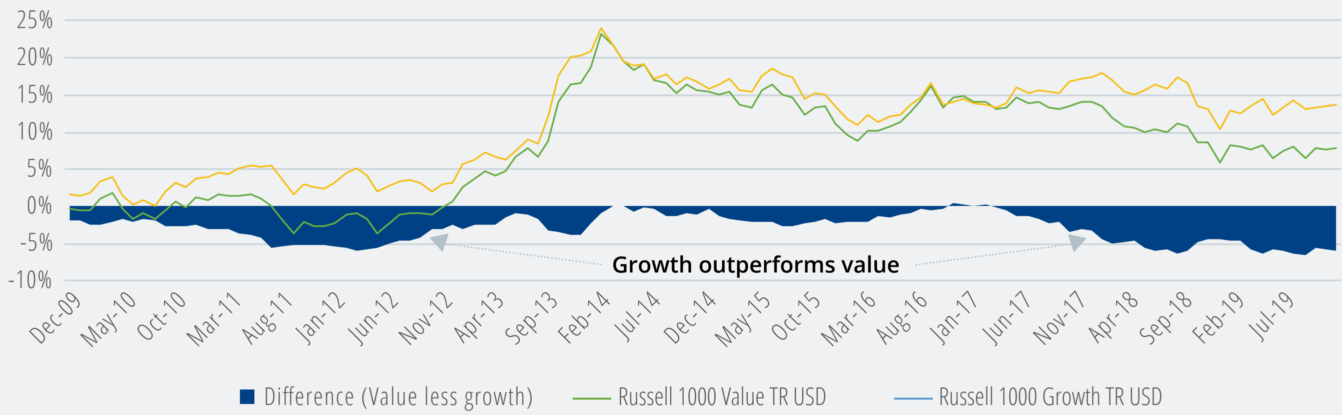
Value managers search for stocks that can be purchased at a perceived discount relative to their earnings, enterprise value or cash flow. These companies are sometimes unloved by the market due to temporary headwinds caused by product issues, industry slowdowns, management changes or perhaps new competition. In many cases, the key for value managers is recognizing a catalyst in these companies that can unlock value and produce a return for shareholders. Growth stocks on the other hand have higher valuations as investors are willing to "pay up" for the promise of greater growth in the future. Here, growth managers are tasked with finding companies that have tremendous growth potential through their superior products or revolutionary business practices.

The current cycle of growth's outperformance is historic in duration

Growth and value go in and out of favor for a variety of reasons, including economic cycles and market sentiment. As of this writing, growth has maintained its lead over value for nearly 10 years, surpassing even the "dot-com" era of the late 1990s in terms of duration, making its duration historic in length. What makes this trend unique is that it defies the historical relationship of the two styles: Since the inception of the Russell 1000 value and growth indices 40 years ago, value has maintained a modest lead over growth in the long term, both on an absolute- and risk-adjusted basis. Notably, that period includes the last 10 years of growth's near-historic dominance.

GREAT-WEST INVESTMENTS™

Growth has outperformed value in most 5-year rolling periods over the last decade

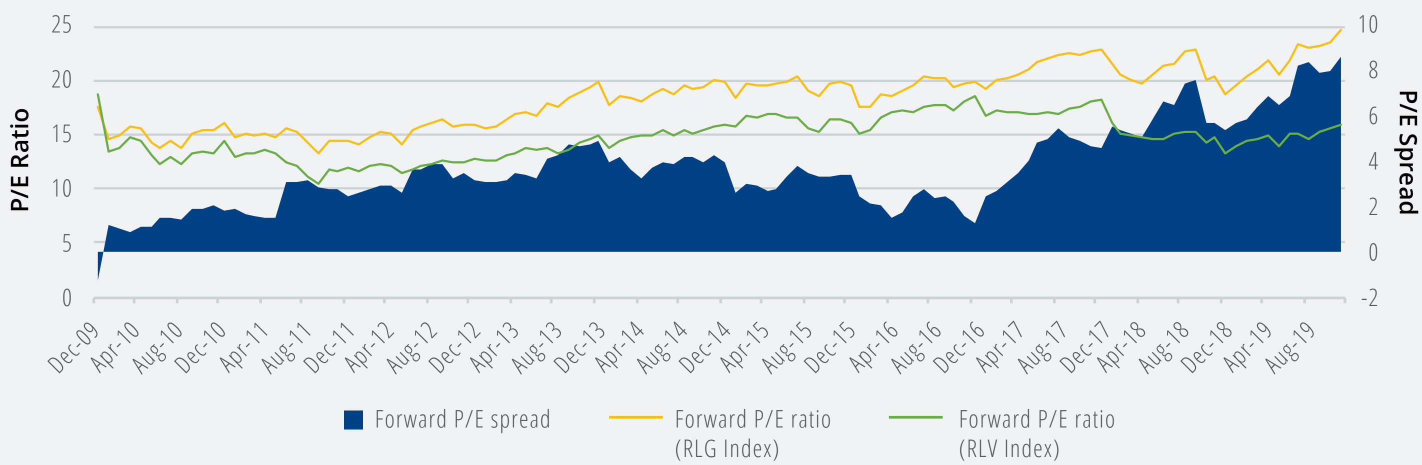


Source: Morningstar®

Price-to-earnings (P/E) multiples tell a similar story[2]

While it's obvious to suggest that value stocks would trade at lower valuations than growth stocks, the last decade has created an environment where the spread between the two is at near-historic levels. Rewinding the clock 10 years, we see value had a P/E ratio of 18.9 and growth of 17.6 in December 2009. Over the current, prolonged bull market, we've seen valuations creep higher for both growth and value stocks, but growth valuations have accelerated far faster, allowing the divergence between valuations of value and growth stocks to widen dramatically. That spread now stands at fairly extreme levels: the current forward P/E for growth stocks is 24.8, 54% higher than value stock's P/E of 16.1.

During the last 10 years the spread between value and growth has widened to near-historic levels



Source: Bloomberg

In addition to the current low rate and slow-growth environment, an often cited reason for growth's dominance is the abundance of technological advancements leading to the popularity of technology companies such as Facebook, Amazon, Apple, Netflix and Alphabet (Google.) These so-called "FAANG" stocks have experienced explosive growth as of late, fall into the higher-price multiple-growth camp, and are responsible for much of the current period's disconnect between price and valuation.

At Great-West Investments, we are naturally and intuitively drawn to the value style given its tendency to search for value amid lower-priced shares without requiring predictions regarding the sustainability of above-average forward-growth rates. That said, our philosophy also leaves plenty of room for high-quality growth and demands that we diversify client portfolios across both styles. For that reason, we're certainly not suggesting that investors should ignore either. But as the phrase goes, "Trees don't grow to the sky." Mean revision is a powerful force that has repeatedly corrected irrational exuberance in capital markets. Simply put, we believe valuations matter, as demonstrated by the long-term relationship between valuation and return. While timing a specific catalyst that causes a reversal in this growth-over-value trend might be a fool's errand, we believe that maintaining our value overweight within the context of a diversified allocation is a prudent way to invest in today's environment.

1 The Russell 1000 Value Index has outperformed the Russell 1000 Growth Index since their 12/31/1978 inception by 0.39% annualized (11.95% vs. 11.56%) while also achieving a higher Sharpe Ratio (0.54 vs. 0.47).

2 The price to earnings ratio (PE ratio) is the measure of a firm's share price relative to its annual net income per share. A high PE ratio indicates a high demand for a company's stock as investors anticipate strong earnings growth in the future

GREAT-WEST INVESTMENTS™