BENEFITS AND PENSIONS MONITOR
PENSION FUND INVESTMENT – EMPLOYEE BENEFITS MANAGEMENT

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Manager Style Report: Differentiating Growth And Value

By: Lawrence Lim

Plan sponsors don't typically decide which individual securities will be **invested** in their plans. They do, however, decide which **investment** managers they will hire for that purpose. With so many active managers to choose from, the key differentiating factor often becomes management style, 'growth' and 'value' being the most recognizable.

Value **investing** refers to the search for bargains or stocks that have been overlooked by the market and subsequently underpriced. Growth **investing**, on the other hand, is the search for stocks with above-average sustainable growth potential that justifies their above-average market price.

Generally, history has shown that one style of investing is in favour at the expense of the other, causing many plans to diversify the management of their assets through the use of different style managers in an effort to smooth out results and reduce overall volatility. Today, however, telling the difference between a growth and value stock is not as clear-cut as it once was. As a result, growth and value managers are frequently holding similar securities and maintaining similar industry weights.

In order to ensure diversification **benefits**, plans must constantly evaluate whether their managers are operating as advertised. Along with monitoring the individual manager, the plan should also look at how its entire stable of managers fits together at both the asset class and plan level. Markets have evolved and manager styles have become less distinct over the years due to this challenge of differentiating between a growth and value security.

The Past And Present

Looking back to 1999 and 2000, it was easy to tell whether a manager adopted a growth or value approach. The technology sector was the darling industry at the time and stocks, such as Nortel, were trading at incredible multiples to their current and historical earnings. The expectation of future earnings growth for those securities overcame any traditional notions of what was over-valued. It was common to see growth managers with annual returns of 60 per cent prior to the collapse.

Value managers, on the other hand, were not enjoying themselves at all during that time period. Contrary to growth managers, they did not see the tech sector as a bargain and tended toward other industries that were not in favour. And while it might be hard to remember now, the price of oil was below $20 per barrel in 2000, with little expectation of change. Well-known value managers were drastically underperforming the TSX and having to justify their approach to clients.

At the height of the growth market in Canada, we witnessed more than half of the active large cap Canadian equity funds posting annual returns of more than 45 per cent. These were staggering figures, yet they were still underperforming the index. Investment restrictions prevented them from overweighting high-flyers like Nortel, which was dominating the cap weighted index (hence the creation of the TSE 300 Capped Index).

After the tech bubble burst and investors returned to focusing more on actual valuations, there was a dramatic shift away from growth and back to value. Canadian and U.S. growth managers who were accustomed to ranking in the first quartile of their peer group samples found themselves in the fourth quartile just a year later. Value managers did the opposite and demonstrated less volatile long-term returns as markets corrected.

One of the lessons learned from those times is that performance of a style can change quickly and dramatically. What was in favour for approximately two years, suddenly spun into a downward spiral in the second of half of 2000 and marked the beginning of a shift into value investing. During that period, the difference between a growth and value security was quite clear. If your portfolio was

overloaded with growth stocks, you would have experienced incredible highs and lows in returns, while a portfolio heavily weighted in value stocks would have been much more stable.

Lack Of Breadth

The distinction between styles has since become more mixed both in Canada and the U.S. Today, you will frequently see similar holdings in both growth and value manager portfolios. In Canadian equity funds — names such as Alcan, Manulife, Petro Canada, and TD Bank — have been found in the top 10 holdings of differing style managers as recently as June 2007. One could suggest this also points to the lack of breadth in the Canadian market. Finding distinctly value or growth securities becomes increasingly challenging when your country represents just four per cent of the world's market cap and the economy is dominated by three sectors – financials, energy, and materials. As of June, the Barra style indexes for Canada have sizeable weightings in all three sectors for both value and growth. If a stock is in a growth industry and is susceptible to all the global pressures of that industry, but is trading at a discount to its peers, does that mean it's a growth stock or a value stock?

Monitoring The Portfolio

In order to evaluate a portfolio for style factors, plan sponsors have two methods of analysis they can employ – holdings-based analysis or returns-based analysis. Holdings-based analysis requires looking at the characteristics of each individual holding in the portfolio. There are no absolute standards on the measures you should use for this analysis, but some are more accepted and common than others.

Perhaps the most common valuation statistic is the price-to-book ratio. It is also common to all the major index providers in creating their style indices. A favourite among value managers seeking bargains, it can also give investors an initial view on the makeup of their portfolio. Since book value is the net worth of a company (or assets minus debt), it provides an idea of the minimum value a company should receive if it is liquidated. The price-to-book ratio gives you an indication of how the company is currently priced relative to its liquidation value. At a basic level, a value stock would be trading at low multiples and a growth stock at higher multiples.

Other popular statistics used to evaluate companies include dividend yield, price-to-earnings ratio, projected P/E ratio, price-to-sales, trailing earnings growth, and forecasted earnings growth. Different managers will place varying levels of emphasis on the statistics they deem important even within their style category.

Return-based analysis is the more simple to perform, requiring less data inputs as you need only the historical returns of the portfolio and the style indexes you want to compare to. Then, it is a matter of regressing the fund returns versus the style benchmarks and analyzing the correlation. Though the holdings-based and returns-based analysis can provide similar results over the long run, return based cannot detect potential short-term changes in style, since it's dependent on trends. Holdings-based analysis can better spot a sudden shift in style by looking at the actual securities, as well as better forecast the style going forward.

Difficulties In Benchmarking

The U.S. has the most established market for style benchmarking, where there are three notable providers – Russell, S&P, and Wilshire. All three have their own techniques to separate their respective broad market indexes into style categories with surprisingly similar results in total returns to their counterparts. However, constituents can be quite different.

Issues can be raised with each of these providers. For example, there are overlapping securities in the Russell and S&P indices, where the same security can appear in both value and growth at different weights. Breadth of coverage becomes another issue as securities from the broad market index that don't fit either style category are not included effectively shrinking the opportunity set for a style manager. Rebalancing is another important variable, as each index provider rebalances its styles indexes at least once a year. Securities that were once labeled growth can potentially be switched over to the value index and vice versa at rebalance.

To further complicate matters, the different providers of style indexes all use their own custom approach in creating their growth and value benchmarks. Demonstrating the difficulty of slicing the Canadian market into style categories, the most notable style indexes in Canada, the Barra Canada Growth and Value indices, are not used as a benchmark by any of the well-known institutional Canadian equity funds. Included in that list of funds are self-proclaimed growth and value managers.

Going Forward

Recent market activity has served to remind us that equity markets can be quite volatile and move very unexpectedly. In a prolonged bull market, it is easy to be complacent. Plans need to be ready ahead of market shocks, instead of simply reacting afterward. There is strong evidence that there are diversification benefits to having style offset managers. This has been demonstrated historically with the massive swing of growth to value in 2000. As we have seen over the past few years, markets evolve and the lines between growth and value are now blurred. Plan sponsors can't assume that offsetting style managers will have the same diversification advantages as in the past. Constant monitoring needs to be performed to ensure that the goals of diversification and reduced volatility are being met. And if your growth and value managers are both buying similar securities, there's a good chance that those goals are not being achieved.

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