A Matter of Style

There is no crystal ball in investing—but there are trends. Two types of stocks have outperformed in the long run: small (versus large) caps and value (versus growth) equities. The performance of these traditional equity investment styles has been anything but consistent (nobody said making money was easy).

Against a recent backdrop of small cap outperformance and a value versus growth stalemate, we debated the prospects for the traditional style boxes in equity investing. Our main conclusions:

- Style exposures are key drivers of portfolio returns because different investment styles can outperform (or underperform) for prolonged periods of time.
- Think outside the box. It pays to understand the content of a style box, and how it changes over time. Sector weights within investment styles can shift dramatically. This is important, because industry sectors behave differently in different economic conditions.
- Style investing may not give investors the geographical exposure they think they are getting. Look under the hood to find out where companies generate their sales, and how this has changed over time.
- U.S. small caps have been pushing against historic valuation ranges by most metrics. Yet low interest rates, below-average operating margins and rising merger and acquisition (M&A) activity suggest further potential upside.
- Growth equities trade at a slightly cheaper premium to value than usual. There is no clear signal for a (global) winner, although this plays out differently across regions. (European value currently looks like good value).

STYLISTIC ANOMALY

The outperformance of small caps and value equities is a much-debated anomaly in finance. The evidence is clear—at least in the very long run:

U.S. small caps racked up an average annual return of 12% from 1926 through 2013, 2.4 percentage points more than large caps, according to Fama French data. This may seem like small fry, but it means a 6.5-fold difference in total return when compounded over almost a century.

This phenomenon is similar to the power of reinvested dividends over very long time periods. Other factors, such as earnings and sentiment, outweigh dividends over shorter horizons, as detailed in Risk and Resilience of September 2013.

Similarly, “cheap” stocks with low price-to-book ratios (value) have delivered cumulative returns of 5,000% since 1980 in the United States, versus a near 3,000% return for “growth” stocks with high price-to-book ratios, according to Russell data.

The opinions expressed are as of March 2014 and may change as subsequent conditions vary.
Performing Review
Global Equity Styles Relative Performance, 2003–2014

Sources: MSCI and BlackRock Investment Institute, February 2014. Notes: Based on MSCI World’s Value, Growth, Large Cap and Small Cap indices.

Cycling Through Styles

So why not just load up on small cap and value equities and retire on the beach? Because performance varies greatly across time, regions and industries as investment styles drift in and out of favor.

Relying on U.S. data also can be misleading, as detailed in Risk and Resilience. Small caps actually underperformed their large-cap counterparts in Europe, Japan and Asia ex-Japan from 1990 through 2013, according to Fama French data. European small caps underperformed by 17 percentage points and Japanese small caps by 22%. Asia ex-Japan small caps trailed by a staggering 53%—underperforming for seven of the past 10 years.

This shows styles can under- or outperform for long periods (this is why diversification is key). Global small caps have bested their larger brethren by almost 60% over the past decade, but it has been a rollercoaster ride. See the left chart above.

Similarly, value has beaten growth globally over the past decade, but it has been a game of two halves. Most of the outperformance was concentrated in the early to mid-2000s as value stocks enjoyed a renaissance after the dot-com bust. Growth stocks then started to outperform in the wake of the 2008 financial crisis. See the right chart above.

Economies and markets are developing at very different speeds. This has consequences for investing in all styles. Our observations: Small caps tend to outperform during economic recoveries, growth stocks often do well in mid-cycle phases, and value and large cap equities tend to be the most resilient in recessions. See the chart on the right.

Major markets are currently in different stages of the economic cycle. Europe and Japan are early in the recovery phase. The United States and the U.K. are in late recovery. China and many other emerging markets are showing signs of a mid-cycle slowdown.

Investors may want to vary their style exposures by region. For example, small caps may have further to run in Europe, but are probably not the best bet in emerging markets. The U.S. small cap rally starts to look long in the tooth at this point in the cycle (although the bulls have pretty good ammunition; see page 6).

The Style Cycle

Economic Cycles and Investment Styles

Source: BlackRock Investment Institute, February 2014. Note: For illustrative purposes only.
UNDER THE HOOD

Getting a region’s economic cycle right is one thing. Connecting this to the appropriate style box is another. It is key to understand where companies generate their sales (and in what currency).

U.S. large caps, for example, derive just 62% of sales from North America—down from 71% a decade ago, our research shows. See the chart on the right. Developed Europe is the biggest export market, making up 15.5% of sales. U.S. small caps also have become more international but still get 84% of sales from home (down from 86% a decade ago).

Betting on the U.S. consumer? A basket of U.S. small caps will likely serve you pretty well. Buying a U.S. large cap is a far more diversified geographical decision.

European equities are much more export-oriented, with large caps generating about half of sales outside the region and small caps a third. Believing in a European recovery? (Large cap) basket buyers beware. One example: The top member of Germany’s blue-chip DAX index, Siemens, derives 86% of its sales from outside its home country.

It is important to look under the hood of benchmark indices to understand return differences between equity styles. One key differentiator is industry sectors. Defensive sectors such as healthcare, telecoms and consumer staples tend to make up a sizeable share of large cap indices. Cyclical sectors such as industrials have higher weights in small cap indices these days. Financials have a hefty weight in both. See the example of Europe below.

SIZES CHANGE OVER TIME

European Large Cap and Small Cap Sector Weights, 1997–2013

This changes over time: Staples and industrials each make up 13% of the European large cap index, up from 9% and 8%, respectively, a decade ago. Financials have shrunk to 21%, from 29%. In European small caps, industrials have gained at the expense of consumer discretionary stocks.
CHANGING STYLES

Sector differences are even more pronounced in the growth versus value divide. Technology makes up 27% of the (U.S.) Russell 1000 Growth Index, but just a sliver of its value counterpart. Conversely, financials and energy stocks dominate the value index, but are almost absent in the growth world. See the charts above. Financials were the biggest losers in the 2008 financial crisis. Many large banks are still trading below book value.

Industry weights have shifted dramatically over time here as well. Take technology. The sector’s share in the growth index ballooned as high as 57% in 2000 as the dot-com mania reached fever pitch. This was a painful period for value investors. They likely missed out on the rally, with tech making up just 6% of the value index. Yet the tables soon turned. The technology sector’s share of the growth index had plunged below 20% by late 2002 as the bubble deflated.

Rewind further and the picture changes again. (Financials were growth stocks in 1990). Lessons:

- There is nothing fixed about style indices—it is important to drill down to underlying industry sector exposures.
- Picking the right industry at the right time can make all the difference.

Another complication: There is nothing fixed about beta (the volatility of an index or sector relative to the rest of the market), either. U.S. value stocks now have a higher beta than growth equities, our analysis of Russell data shows.

This is an unusual break with the past. Financials in value indices have been more volatile since the financial crisis. And tech stocks (which dominate growth indices) have a much lower beta than they did in the past (companies such as Microsoft have matured and are more stable ships).

EYE OF THE BEHOLDER

Size is easy to measure (by market cap). Value and growth, by contrast, are very much in the eye of the beholder. The composition of indices will change depending on the criteria used. Take value. Russell Value indices focus on companies with the lowest price-to-book ratios, and the lowest expected and past growth rates. MSCI Value indices focus on low price-to-book and forward price-to-earnings ratios, but also factor in dividend yields.

Value managers delight in searching among the rubble of (temporary) earnings disappointments—and debating whether a company is still a value stock.

Growth equities, by contrast, typically trade at expensive multiples. Investors are willing to pay higher prices for future growth (think Amazon). This can be dangerous if the lofty expectations do not pan out. Many a high-flying growth stock has been relegated to the value bin. Sometimes growth stocks temporarily masquerade as value. Consider a company with a new technology that has not yet been recognized by the market. This highlights the importance of not being overly fixated on style labels.
CAUSE AND EFFECT
U.S. Sector Returns During Periods of Rising Yields, 1973–2013

PERIODS OF GROWTH

PERIODS OF INFLATION

Source: HSBC and BlackRock Investment Institute, February 2014. Notes: Average MSCI U.S. sector returns are based on 11 episodes of rising yields since 1973. Periods were labeled “growth” or “inflation” depending on which was greater: the change in real economic growth and the change in inflation.

DRIVING RETURNS
Sectors behave differently in different economic environments. Generally speaking, we are in a period of rising interest rates. Yet the cause of rising yields can make all the difference in returns. See the chart above.

U.S. energy stocks are the place to be when inflation drives up U.S. yields, according to HSBC research. Yet technology stocks jump into pole position in periods when strong GDP growth pushes yields higher, delivering annualized returns of 20% on average. Getting the economic drivers right matters. Technology has been among the worst performers (returning a negative 6% annualized) when inflation pushes yields higher. Growth managers beware.

Caution when interpreting these (limited) historical results: The difference between growth- and inflation-driven yield rises can be minimal—and history does not always repeat itself.

A SMALL PROBLEM
U.S. small caps are pushing against the top end of 35-year valuation ranges on metrics such as price-to-earnings or price-to-sales, both relative to their own history and versus large caps. High valuations mean there is ever less tolerance for small caps to miss earnings estimates. There is a limit to multiple expansion. Small cap fans have counterarguments.

The length of the current bull run in U.S. small caps is not extreme by historical standards. The current cycle is in its 60th month, compared with an average of 76 months in the 14 market cycles since the 1920s, our analysis shows. (Warning: The averages conceal a lot of variation. Cycles ranged from 22 to 224 months.)

Small caps have outperformed in periods of easy financial conditions, research from Furey Research Partners shows. A Low for Longer environment (see Squeezing Out More Juice of December 2013) could extend the small cap run.

U.S. small caps may have more room for margin improvement our analysis shows. See the chart on the left. The chart also shows a structural margin gap between the two (partly caused by more small caps making losses).

U.S. small caps historically have outperformed during periods of rising rates. The Russell 2000 small cap index has delivered average annualized returns of 16.2% in rising rate environments since 1979, versus 14.1% for the large and mid cap Russell 1000, our research shows.

Large caps in search of growth may buy out small caps. See the sidebar on the next page. Global companies held $4 trillion in cash in February, or 36.5% of the market value of global small caps, according to J.P. Morgan.
DEAL TALK
Smaller companies are takeover bait. This results in a link between small cap returns and merger and acquisition (M&A) activity. The outperformance of U.S. small over large firms has a 25% correlation with M&A volumes (which is actually quite high), our analysis of data since 1997 shows. Targets (small caps) typically get bought out at a premium, whereas acquirers (large caps) see their share price decline. Warning: This only works in an industry context. A utility is not going to buy a luxury handbag maker (most of the time). And the relationship is not perfect: Global small caps underperformed large caps by as much as 29% from 1994 through April 1999, MSCI data show.

Global equity markets and M&A activity have tended to move in sync with market peaks coinciding with M&A booms. See the chart on the right. A rebound in takeover activity to precrisis levels, however, has remained mostly a banker pipedream. This suggests the overall equity market has not peaked—yet. It is easy to see a further pickup in deals: low interest rates, easy credit, high corporate cash levels and anemic internal growth.

So how does the relative valuation of growth and value stack up today? Global growth equities are trading at around 1.5 times the earnings multiple of value equities, compared with an average of 1.7 since 1974. See the chart below. This implies that growth is a little cheaper than usual. It is a different story in Europe. The valuation spread between European growth and value is at the highest levels in a decade, according to Barclays.

Could it be time for a value renaissance? This is a tough call, since valuation is a good predictor of long-term returns—but it is not very useful as a timing device. Valuation extremes typically do signal turnarounds. See the trough in growth’s relative valuation in 1994 and its subsequent peak in 2000. Yet markets can stay over- (or under-) valued for a long time. Global growth equities had surged to their highest premium over value in decades by late 1998, but it took at least another year before they peaked at the height of the dot-com bubble. This paved the way for a prolonged period of value dominance (see the orange shading).

Some key lessons:
- The relative valuation of growth and value equities has swung wildly over the past decades, with frequent changes in leadership.
- Cycles of growth and value outperformance can last several years (testing the patience of the hardest investors). This illustrates the importance of portfolio diversification across different equity styles.
- The graveyard of growth investors is littered with skeletons that held on to growth stocks for too long. Note the precipitous falls from valuation peaks in 1975 and 2000.
- Mean reversion is (usually) the value investor’s best friend. Yet buying cheap equities and waiting for them to realize their true value can be like watching paint dry.
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