



Investment ‘styles’ – opportunities in the next phase of recovery

In this Point of View AXA’s Chief Investment Officer Mark Dutton looks at how the two main contrasting ‘styles’ of investing – growth and value – are positioned for the next phase of the recovery.

In brief

- A growth manager seeks to identify stocks that are likely to grow faster than consensus estimates.
- A value manager seeks to capitalise on controversy and hold stocks that are out of favour with the market and trading below intrinsic value.
- While growth and value often follow different cycles, this is not always the case. Both styles of investing can perform strongly or poorly at the same time.
- The next phase of the rally is likely to be underpinned by earnings, providing considerable upside for both growth and value.

What’s growth and what’s value

Growth and value are two of the most widely used approaches for investing in managed equity funds. But the two styles are frequently misunderstood and often surprise investors.

Growth investing seeks to identify stocks that are likely to grow faster than consensus estimates. An important distinction here is that a growth company and a growth stock are not necessarily one and the same. A growth stock ceases to be a growth stock when it stops reacting to good news.

Value investing on the other hand capitalises on controversy and investor anxiety by purchasing stocks that are out of favour and trading below intrinsic value. A value stock stops being a value stock when it returns to ‘fair value’.

Growth and value are not two sides of the same coin

A common misconception is that growth and value are two sides of the same coin and therefore always follow different cycles.

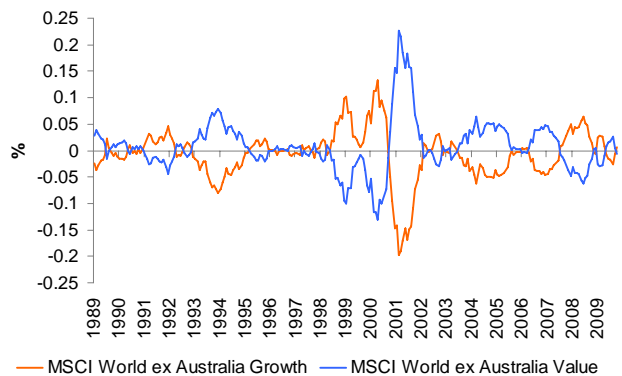
Part of this misconception comes from the construction and use of benchmarks.

For example, the overall construction of the MSCI growth and value indices seeks to ensure that 50 per cent of the market capitalisation is captured in each index.

This means that the sum of the two style indices can never outperform the broader market index – they are designed to sum to that index.

Figure 1 below shows that each style index is the reciprocal of the other and both can never outperform the market at the same time.

Figure 1: MSCI growth and value indices



Source: Mercer. Rolling 12 month excess return (% pa). Data from June 1982 through to October 2009

Beware of the trap

When growth and value are following different cycles, investors are more likely to fall into the ‘trap’ of switching funds to chase the return.

An example of this divergence was the tech bubble, where growth outperformed for a period of time because assessing investment opportunities based on valuation fundamentals was out of favour.



According to Morningstar, the huge outperformance by growth stocks during this period led to \$400 billion in net funds flows from value funds to growth funds in 1999 and 2000.

This meant that growth funds added to their positions at ever increasing prices prior to the bubble bursting.

Both styles of investing can perform strongly or poorly at the same time

While the focus largely shifted to value when the bubble burst, there were still times where growth and value did well during the last decade.

The table below shows that the median growth biased manager and the median value manager both outperformed the wider market in 2000, 2002, 2005, 2007 and 2009.

Table 1: Overseas share returns (Australian investors)

	Value*	Growth*	Market**
2000	28.2%	34.9%	24.4%
2001	-5.7%	-29.8%	-23.8%
2002	-16.1%	-22.3%	-22.9%
2003	1.4%	-6.1%	-3.5%
2004	11.3%	4.8%	7.3%
2005	15.7%	14.8%	13.0%
2006	22.9%	14.2%	16.9%
2007	1.1%	5.1%	-0.2%
2008	-21.6%	-22.6%	-17.7%
2009	-9.4%	-13.4%	-14.5%

Source: Mercer. *Median value biased manager and median growth biased manager. Returns for the last 10 years to 31 October 2009. Highlighted numbers refer to years where both growth and value performed well compared to the wider market.

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What this means for investors

2008 showed that both styles of investing can simultaneously perform poorly compared with the total market. The Global Financial Crisis (GFC) meant that investors weren't looking for more 'growth' or more 'value' but rather, less risk.

The first stage of the 2009 rally favoured value as it largely comprised a broad market revaluation of oversold stocks.

The next phase of the market rally is likely to be driven by specific company earnings.

Initial signs for 2010 look positive, as the magnitude of global earning revisions are among the highest in 20 years.

The value style of investing is likely to continue to do well as anxiety levels subside further and investors pay more attention to fundamentals.

If history is a guide, past periods of poor value style returns have been followed by an average 4.75 years in which value outperforms the broader market.

The stage is also set for growth given the wide dispersion of investment opportunities that are dependent on earnings growth.

For both styles of investing, research will play an increasingly important role. Not only will stocks that exceed expectation do well, but those that don't deliver on earnings will be punished.

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