Value versus Growth: Which investment approach to choose?

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Everybody who has read academic literature on the performance of shares will know about the fact that value shares (and small cap shares) outperform so-called growth shares in the long run.

Value shares are shares with an attractive valuation in terms of P/E (price-earnings ratio) and P/B (price-to-book value ratio), while the distinctive feature of growth shares is their above-average profitability and earnings expectations.

Sources: Datastream, MSCI-Indices (Value: MSCI World Developed Markets Value-Index; Growth: MSCI World Developed Markets Growth-Shares)

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Taking into account the past 40 years of historical data, the statement that the performance (i.e. price gains plus dividends) of value shares is superior to that of growth shares is correct. That being said, value shares have underperformed growth shares by more than 60% over the past ten years. Both the extent and the duration of the underperformance are surprising. Not even during the TMT bubble was the underperformance of the value segment this drastic.

In the following we will try to ascertain the reasons for this development. In the long run, earnings growth and the valuation are the driving factors for share price performance.

We shall start by looking at the EPS figures of the value and the growth universe.

In doing so, we find that over the long term the earnings of value shares have not underperformed those of growth shares at all. However, earnings today are back at the level of 2006, and are indeed 25% short of their 2007 highs. The earnings of growth shares, on the other hand, have increased by 4.2% per year over the past ten years and are currently at a high.

The opposing development of value and growth earnings over the past twelve months is interesting. – A development that we have not seen often in the past.

EPS V = earnings development Value Stocks
EPS G = earnings development Growth Stocks
Sources: Datastream, MSCI

The earnings of value shares undoubtedly display a more cyclical set of data than those of growth shares. The higher risk may be one explanation for the fact that value shares command lower valuations than growth shares.

A comparison of the earnings of value and growth shares over the past years gives a good indication as to the reason of growth shares outperforming value shares over that period.

In order to explain the entire extent of underperformance produced by the value segment, we shall now have a look at valuation data. In doing so, we will be examining the relationship of PTB between value and growth segment. By definition, the ratio between the two measures has to be below 1, i.e. value shares are cheaper than growth shares. On average, value shares are 39% cheaper, i.e. the ratio is about 0.61.

The chart depicted below clearly shows the following findings:

- Value shares went out of fashion during the TMT bubble at the end of the 1990s and therefore became very cheap relative to growth shares
- In the first half of the 2000s, however, they experienced a strong comeback (on the back of the commodity boom)
- By 2007, value shares had become very expensive in comparison to growth shares
- This development was followed by a correction, which is ongoing to date

Sources: Datastream, MSCI , own calculations

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Today, valuations are back at their long-term average.

The valuation and the overall development illustrate why value shares have underperformed so drastically in recent years.

The question is now, "what does the future hold in store?"

Currently there are no signs that would suggest a change in the earnings trends of value and growth shares. Commodities in general and the oil price in particular will be a decisive factor. A stabilising oil price could stop the negative earnings trend in the value segment.

The valuation should not play a significant role anymore given that the overvaluation of value shares vis-à-vis growth shares has been removed.

A balanced portfolio takes account of both, Value and Growth shares.

At the moment we cannot see any significant indicators that would suggest value outperforming growth shares. However, a stabilising oil price and the neutral valuation could cause the performance of value relative to growth shares to at least stabilise, too. This means that we would advise to review any sizeable overweight of growth shares in the portfolio and to establish a balanced structuring with regard to the allocation in value and growth shares.

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Harald Egger, Chief Analyst and Crypto Asset Specialist. He has worked at Erste Asset Management since 2001. Previously he worked for four years as a fund manager and analyst for AXA Investment Management in London. He headed the equity segment within Erste Asset Management and was CIO until April 2013. He has been employed in the finance industry since 1992. Harald Egger has a Master in Statistics from University of Vienna and a Master degree in Digital Currencies from University Nikosia.