Value Your Wealth - Part One Introduction

In this article and a series of others to follow, we explore the distinction between growth and value investment styles. Those looking in their rearview mirror will likely laugh at our analysis and focus on what worked yesterday. Those aware of the inevitable turns in the road ahead will understand the unique worth that a value-focused investment style offers.

We believe the market is on the precipice of a monumental shift, and one that will blindside most investors. Through this series of articles, we aim to provide research and investment ideas that will allow you to protect your wealth when the investment cycles shift and thrive when most investors suffer.

Discipline, Process, and an Appreciation for Cycles

Spring has sprung, flowers are blooming, and pollen is swirling through the air. It?s time to put away our winter boots, scarves, and bulky jackets and replace them with swimming trunks, baseballs gloves and the promise of afternoon naps on the beach.

Investing also has its seasons. Economic and investment cycles alternate between periods where risk-taking and speculating is preferred and periods where conservatism and discrimination are essential. Unlike the seasons, there is no calendar that tells us when these investing cycles begin and end. Nevertheless, an appreciation for history along with an understanding of economic trends, valuations, demographics, and monetary and fiscal policy provides helpful clues.

Awareness of potential changes in economic and market cycles, however vague the timing is, allow us to strategize on how to reposition our portfolios when the change in season appears imminent. Because of vastly different investing environments and associated outcomes, success in building wealth over long time frames requires discipline and a durable investment process. It is important to ride the market higher in the good times, but we can?t stress enough the value of avoiding the inevitable large market drawdowns that erase wealth and the precious time you have to compound it.

Value vs. Growth

The market?s surge higher since the financial crisis and the governmental and corporate policies used to sustain economic and market growth have been nothing short of extraordinary. In many articles, we discussed topics such as the unparalleled use of monetary policy to prop markets higher, massive fiscal spending designed to keep economic growth positive, how corporations have shunned future growth to buy-back stock, and the substantial shift towards passive investment styles.

As a result of these behaviors and actions, we have witnessed an anomaly in what has historically spelled success for investors. Stronger companies with predictable income generation and solid balance sheets have grossly underperformed companies with unreliable earnings and over-burdened balance sheets. **The prospect of majestic future growth has trumped dependable growth. Companies with little to no income and massive debts have been the winners.**

Over the past decade, investors have favored passive instruments that track a market or a large swath of the market. By doing so, they have easily outperformed active investors that are doing their homework and applying time-tested fundamental analysis to their investment selection process. This passive behavior is circular in nature and has magnified the growth/value imbalance. The investment world has been turned on its head.

The underperformance of value stocks relative to growth stocks is not unique, but the current duration and magnitude of underperformance are unprecedented. Before embarking on a more detailed discussion, a clear definition of what is meant by growth and value is important.

Growth- Growth stocks represent companies that have demonstrated better-than-average gains in sales and/or earnings in recent years and are expected to continue delivering high levels of profit growth. They are generally higher priced than the broad market in terms of their price-to-earnings and price-to-sales, and their stock prices tend to be more volatile. To help fuel earnings, growth stocks often do not pay out a dividend.

Growth stocks generally perform better when interest rates are falling and corporate earnings are robust. On the other hand, they are also most at risk of losses when the economy is cooling.

Value- A value stock tends to include companies that have fallen out of favor but still have good fundamentals such as dividends, earnings, and sales. Value stocks are lower priced than the broader market, are often priced below similar companies in their industry, and are perceived to carry less risk than the market.

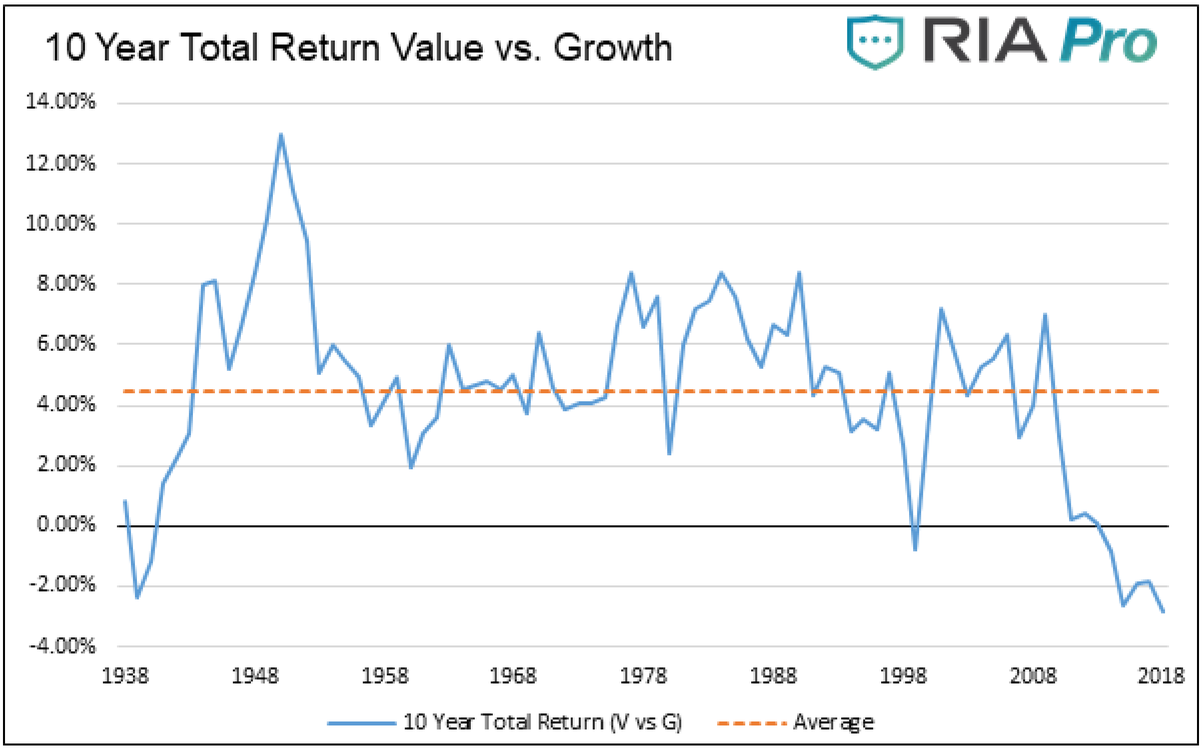
Value stocks generally hold their value better in an economic slowdown, tend to do well early in an economic recovery, and frequently lag in a prolonged bull market. In general they pay above market dividends.

Historical Context ? Growth vs. Value

It is important to understand which investment styles have been successful during the post-financial crisis era. Given that we are statistically and logically very likely nearing the end of the cycle, it is even more crucial to grasp what decades of investment experience through all sorts of economic and market climates, not just the last ten years, tells us *should* be successful in the future.

The graph below charts ten year annualized total returns (dividends included) for value stocks versus growth stocks. The most recent data point representing 2018, covering the years 2009 through 2018, stands at negative 2.86%. This indicates value stocks have underperformed growth stocks by 2.86% on average in each of the last ten years.

The data for this analysis comes from Kenneth French and Dartmouth University.



There are two important takeaways from the graph above:

- Over the last 90 years, value stocks have outperformed growth stocks by an average of 4.44% per year (orange dotted line).
- There have only been eight ten-year periods over the last 90 years (total of 90 ten-year periods) when value stocks underperformed growth stocks. Two of these occurred during the Great Depression and one spanned the 1990s leading into the Tech bust of 2001. The other five are recent, representing the years 2014 through 2018.

To say the post-financial crisis era has been an anomaly is an understatement. The current five-year string of a negative trailing 10-year annualized return differential is the longest on record, and the most recent ten-year return ending last year is the lowest on record at NEGATIVE 2.86%.

When the cycle turns, we have little doubt the value-growth relationship will revert. As the graph above shows, seldom does such reversion stop at the average. To better understand why this is so important, consider what happens if the investment cycle turns and the relationship of value versus growth returns to the average over the next two years. **In such a case value would outperform growth by nearly 30% in just two years. Anything beyond the average would increase the outperformance even more.**

Summary

This article and the others to follow are not intended to implore you to immediately buy value and sell growth. They will, however, provide you with a road map that allows you to plan, strategize and use discipline in moving to a more conservative, value-based strategy if you so choose.

As mentioned, we will explore this topic in much more depth in coming articles. Already in the works are the following analyses:

- A stock screen that discerns between value and growth stocks.

- A tool to help find funds and ETF?s that provide value versus those that use Value in their name but provide little value.
- Sector analysis to steer you toward specific industries that tend to have more value stocks than growth stocks.

Value and growth are just two of the many factors to explore. In the future, we will also introduce and discuss others such as momentum and size.

We want to be astute stewards of wealth and safeguard our portfolios so that when the investing cycle comes to an end, we are prepared to take advantage of what the next season has in store. This will help ensure those naps on the beach are not dreams but reality.