Surz/Senior Consultant Style Analysis

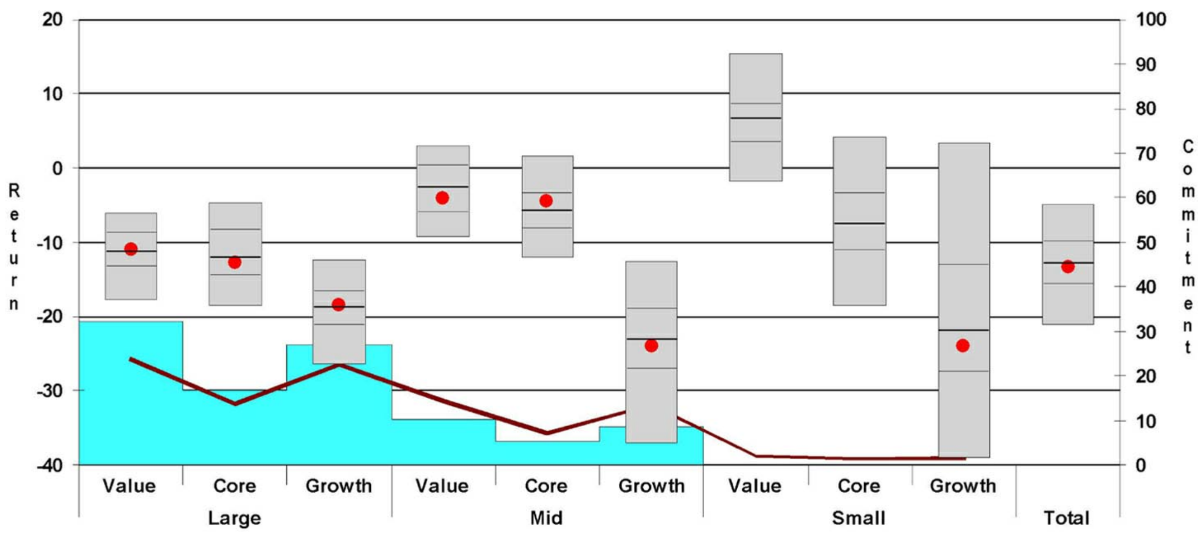
Enough! It's Time For Greed To Overcome Fear (Or, Confusing Style With Skill Can Be Costly)

The market went down again in the second quarter of 2002, this time by about 13%, bringing the cumulative loss for the new millennium to over 30%. Growth stocks have been decimated, losing 65% of their value since January 1, 2000. How much more can we take? In the tug-of-war between fear and greed, isn't it time for greed to kick in? In the following, we try to put these recent losses into perspective by first looking at the current quarter, then the current cycle and lastly, the recent history of cycles, especially as they relate to investment styles. We conclude that there has been enough of a correction, so that a return to more normal times is imminent. Enough is enough.

The current quarter again punished growth stocks, particularly smaller growth companies. Small growth stocks lost more than 20%, and large growth companies fared only moderately better with a 19% loss. Technology stocks, especially smaller tech companies, continued to get pummeled, losing another 25% of their value.

Another trend that continued into this quarter is the dominance of small company value stocks. Small value, led by health care companies in this style, was the only positive performing style, earning 6.7%. Overall, it was better to be in small companies than in large, which has been the case for most of the new millennium. Some have proclaimed this a "stock picker's market," primarily because the majority of managers have beaten the S&P 500. This suggests that managers have gotten smarter and more nimble so they can outmaneuver the mighty S&P. Unfortunately, the reality is simply that the S&P has a style that has been out of favor, namely larger companies. Figure 1 summarizes the current quarter market environment by style and puts the S&P into perspective.

Figure 1.
Style Performance for S&P 500
(Quarter Ending 6/30/2002)



	Large Cap Value	Large Cap Core	Large Cap Growth	Mid Cap Value	Mid Cap Core	Mid Cap Growth	Small Cap Value	Small Cap Core	Small Cap Growth	Total
S&P500	-10.92	-12.86	-18.49	-4.11	-4.56	-24.05			-23.96	-13.40
Fund Commitment	32.19	16.64	26.91	10.18	5.40	8.68	0.00	0.00	0.01	
Total Mkt Return	-11.16	-11.97	-18.63	-2.54	-5.73	-23.10	6.70	-7.54	-21.76	-12.70
Total Mkt Commitment	23.72	13.75	22.58	14.36	7.10	13.50	2.06	1.36	1.58	

The blue shaded area in the graph shows the S&P make-up by style. Contrast this to the red line showing the market's style composition, noting the greater concentration of the S&P in large companies. The gray floating bars in the graph show the range of portfolio opportunities available in each style of management. Note that the S&P's performance within style, as indicated by the red dot, is near the average for each style. The far right bar shows the S&P underperforming somewhat in the quarter, losing 13.4% versus the market's 12.7% loss, due entirely to its overweight in large companies. Also note the good relative performance of the value and core styles, especially for mid- and small-cap companies. In other words, smaller companies or those with a non-growth orientation fared well in the quarter, continuing a trend that has been in place since 2000. There are more winners against the S&P500 now because the style of being different from the S&P is in favor, not because it's a stock picker's market. We need to be careful to not repeat the chronic, and costly mistake of confusing style with skill.

The cost of confusing style with skill can be observed in the most recent economic cycle. As a rule of thumb, peak-to-trough market cycles are said to occur about every five years. Investment policy statements frequently have 5-year review cycles for this reason. Let's take a look at the current 5-year cycle (Figure 2), and see what has happened to growth and value investors.

Let's start with the S&P500. $10,000 invested five years ago in the S&P, at the beginning of the third quarter of 1997, would have grown to a peak value of $18,000 in August of 2000 and then declined to its current $12,000 value, for a 5-year unannualized return of 20%. Now ready for a surprise? That 20% cumulative return is equivalent to earning 3.7% per year – barely above inflation and less than Treasury bills. As Alice once said: "It's taken all the running we can do to stay in the same place."

That's pretty sad. Now, let's interject some good news. Value stocks have chugged along at a pretty constant 10% per year, so our $10,000 in value stocks has grown to $16,000. But look at how appealing growth stocks once were relative to their lumbering value alternative. $10,000 in growth stocks, invested on July 1, 1997, would have soared to $24,000 in 2.5 years – exactly halfway through our 5-year cycle. Remember the rationale behind trees growing to the sky? Greed caused many to abandon staid value stocks for glorious growth stocks, and some still cling to the growth economy mindset today. Consider what happened to those who switched in 2000. Growth stocks proceeded to lose 67%, while the abandoned value market appreciated 16%, for a total loss of 83%. Many who made this switch know whereof we speak.

So what did we learn? One of the lessons was **don't confuse style with skill**. Value managers were fired and replaced with growth stock managers. Neither got smarter or dumber. Calling style turns is a separate and distinct decision from the choice between active or passive management. Active management should only be chosen if you believe you know managers who have skill. The behavior of the switches from value to growth generally used active managers, suggesting belief in skill. That is, investors behaved like they thought that they were switching to better managers, not to a style that they expected to outperform. Style shifts could have been implemented much more efficiently with passive investments. Investors who confuse style with skill make a very costly mistake. As indicated above, a similar mistake is being made now with the S&P 500. This is confirmed by Figure 3, which

Figure 2.
Growth of a Dollar: Style Growth

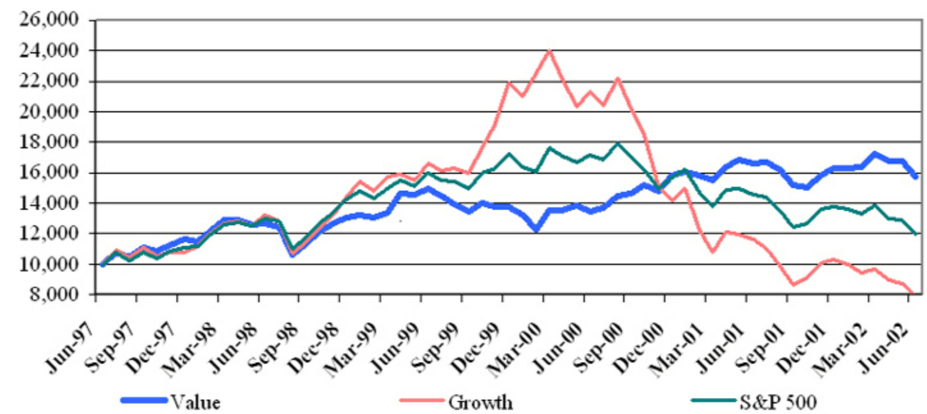
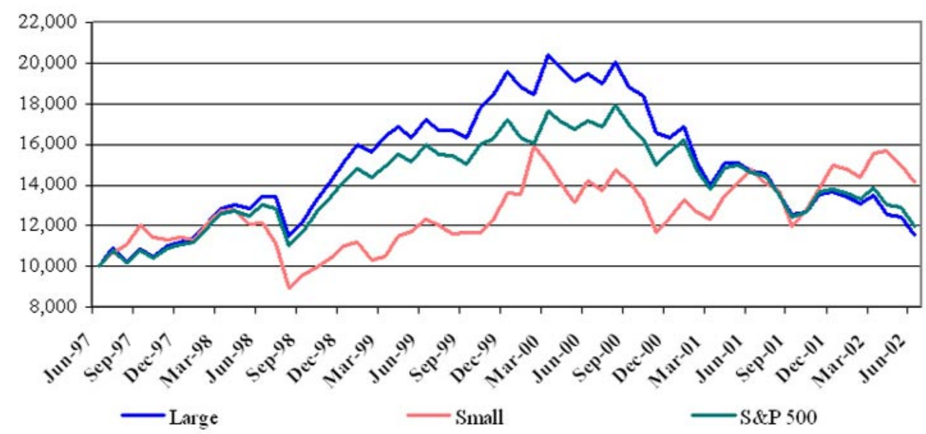


Figure 3.
Growth of a Dollar: Size Growth



shows that the current cycle has switched to smaller companies being in favor, making it easy to beat the large cap S&P 500.

But what does this all mean for the future? Is the worst over, or can we expect more of the same? To try to answer these questions we take a closer look at how the 2.5 years of the new millennium compare to other such 30-month periods. 2.5 years is half of an up-down cycle. How much more down might be left? Figure 4 shows rolling cumulative 30-month annualized returns for growth, value and the S&P.

Here's what's happened so far. 30-month returns have gone through up and down cycles, trending between 0% and 26%, evidencing a regression toward the mean. Then in 1996, value stocks penetrated the upper bound and remained there for a couple of years, subsequently correcting. As value was retreating, growth stocks blew through the upper bound, and then began their correction toward the end of 1999. The problem is that the growth stock correction appears to have gone too far too fast. Rolling 30-month returns have never been lower, and they're getting lower and lower. Both the length of this correction and its magnitude is unprecedented. Looks like enough to me.

In addition to this history of returns, we can look to price/earnings ratios (P/Es). P/Es have returned to their 1997 levels of low 30s, which is still high by historical standards. Some have argued that a higher multiple is justified by the higher quality of earnings created by the technology revolution. Recent accounting and corporate governance fiascos have set this argument right on its ear, and may prolong the suffering as investors remain leery of corporate management. But we could still return to normal multiples with slow, cautious, growth in prices, coupled with faster growth in earnings. There needn't be a rush to plough P/Es below 20 or 25. That is, the hemorrhaging in growth stocks has to end sometime, and Figure 4 above suggests that it's likely to be soon, as greed overcomes fear, even in the face of new fears created by the greed of corporate management. After all, earnings will improve as public outcry forces management to curtail their pillaging of stakeholders.

One last observation. We've constructed a similar picture of 30-month rolling returns, delineated by company size. It comes as no surprise that the S&P is easy to beat when small companies do better, as they have in the recent past. "Evaluate Skill, Not Style" is not a new admonition. (See "Evaluate Skill, Not Style", *Senior Consultant*, June/July 2001.)

Unprecedented things happen all the time, but they're only unprecedented once. Enron was unprecedented, but the others that follow, like Worldcom, are not. September 11 was unprecedented. Indeed, it is the confluence of these bombshells that has exacerbated the collapse of the bubble, leading to an unprecedented crash in growth stocks. It's not so much the depth of the correction as it is the shortness of the period over which it has occurred. But we all hunger for normal times. The analysis presented here suggests that the worst may be over. We've had enough. ■

This analysis is provided by PPCA, Inc. Visit them at www.PPCA-Inc.com.

Figure 4.
30-Month Moving Windows, Computed Monthly

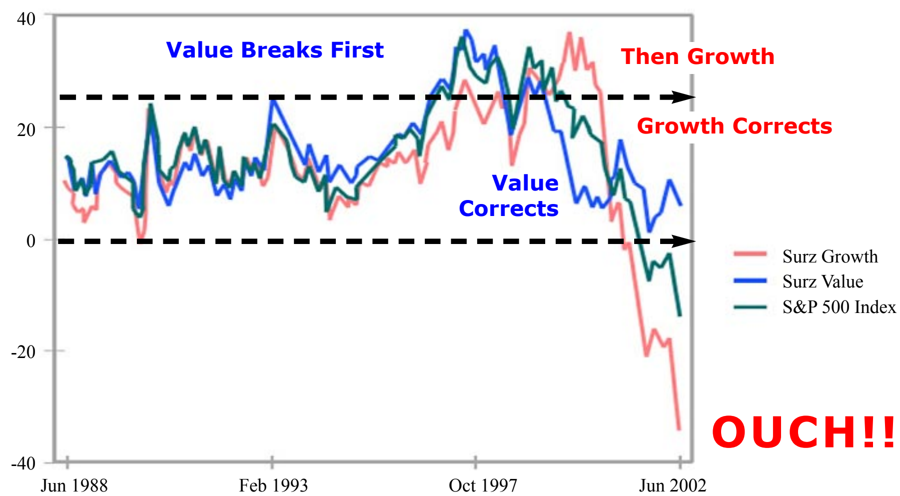


Figure 5.
30-Month Moving Windows, Computed Monthly