Value Stocks: Poised to Outperform?

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Value versus growth? Which is better, and when? It's a great debate in the investing world. There's no one right answer, and is akin to matters of religion and politics.

So, should investors stick with growth stocks' recent momentum, or start tilting to value laggards?

Bottom Line

Although over the long haul value investing has outperformed growth investing, value stocks have fallen behind more recently. Historically, leadership has been cyclical, suggesting that at some point value may start to outperform growth. However, exactly when that transition may occur is hard to discern. We believe investors should take advantage of recent weakness and add superior value stocks to their portfolios now.

Value stocks are well represented in the energy, financial, basic materials, and utility sectors. However, value stocks can be found in all sectors. Investors employing a value tilt should maintain portfolios diversified across all the market's sectors.

What's the Difference Between Value and Growth?

Nobody quite even agrees on their definitions. Generally value stocks are those that are cheaper on various metrics. For example, value stocks typically offer more assets, earnings, cash flow, sales, and or dividends per dollar of your investment.

The rub is that these companies may have more muted growth prospects, or face greater risks. Whenever you see a value stock, ask yourself why it is cheaper. As economists are wont to say, you are unlikely to find a ten dollar bill on the sidewalk.

Growth stocks are the opposite, sporting higher prices but believed to have superior prospects. Dividends may be low or non-existent because managers and investors believe the best use of earnings and capital is to reinvest in the business.

Value Has Outperformed Over Long Periods of Time

Investors don't always agree on which category of stocks have been better performers. Starting and finishing dates are critical.

Still, over the long haul many are convinced of value's superiority. Fidelity's study of growth versus value over a 31 year period ended 2010 indicated that large capitalization value stocks outperformed their growth counterparts by about 1.8% annually. On $10,000 invested at the start of the period, that translates into an $118,000 difference.

Value oriented midsize and smaller companies also trumped their growth counterparts by a greater margin. A $10,000 investment in midsize value outfits generated $234,000 more versus midsize growth companies, while small cap value bested small cap growth by $414,000.

Realizing that many investors did not have a 31 year time horizon, the study looked at rolling five year periods during that 31 years. It found that at least two thirds of the time, value beat growth, and the degree of superiority on average was significantly greater than growth's when it outperformed. Similar results were seen over rolling three year periods but the probability of value's triumph increased with the period's length.

Bottom line, over the long haul value has an edge over growth.

Recently Value Has Lagged

Year to date the Russell Growth Index has outperformed, up 4.83%, versus the Russell Value Index, down 3.73%. Over the last five and ten years the Russell Growth has also outperformed. For example, it's up 8.1% on average annually for the ten years ending September 30 of this year, besting Value's 5.7%.

Reasons for recent growth outperformance vary. Some say since the economy is tepid, investors gravitate towards growth, due to its scarcity value. Others maintain that this is a period when quality matters. Growth stocks are said to be of higher quality.

Why Value May Be Poised To Catch Up

Value may be ready to return to favor. One of the largest sectors within the value universe is financials. Financials is the only sector that has not yet returned to its pre-subprime crisis highs. Valuations are well below what normally prevails in this group; in many cases stock prices are at or below book value.

Many of the problems bedeviling banks are receding. Loan portfolio quality is improving, while litigation costs are abating.

The chief issue confronting financials are low interest rates and a tepid economy. Low interest rates squeeze financials' margins between the cost of deposits and the rate on their loans. If, as nearly all pundits believe, interest rates rise as the economy improves, financials' bottom lines will improve.

Energy stocks are another big value group. They have dragged down value stocks as the price of their key commodity has collapsed by two thirds since its peak.

The cure for low commodity prices is simply that, low prices. Low prices send signals to the industry to reduce or eliminate capital expenditures to develop new sources. Soon enough current supplies will dwindle, causing crude oil prices to stabilize.

Eventually, interest rates and energy prices will rise, increasing the profitability of financials and energy stocks. This may well be the catalysts for value stocks offering superior returns.

Potential Value Opportunities

Exxon (XOM) is the largest holding in the Russell Value Index. Value can't begin to outperform absent energy outperforming, and it's tough to see energy rebounding absent Exxon doing well.

Still, even if energy continues to struggle, this company is well situated. Not only can it boast of broadly integrated operations, what with its legendary upstream operations, coupled with its pipelines and downstream refining, but it's well diversified across the planet, plus has one of the best balance sheets. Yield is 3.4%, nearly 1.1% more than the ten year US Treasury.

Bank of America (BAC) is a well situated financial value play. Permission to return more money to shareholders in the form of dividends and stock buybacks seems imminent.

BAC boasts of a unique franchise, coupling one of the largest deposit holding institutions with brand name investment house Merrill Lynch. This combination offers some tremendous cross-selling opportunities, as investors look for cash management and credit facilities, and well-heeled savers desire to move up to investment products.

Value play **Caterpillar (CAT)** is a construction and mining equipment behemoth with a 100 year history. While shareholder return is flat over the last five years, over the last 15 it has more than doubled the S&P 500's return.

Although it's hard to identify a catalyst for a resurgence in commodity prices, which would spur its customers to spend more, CAT is extremely well situated when that happens. Its manufacturing scale, large dealer network, and near 20% market share, more than double its biggest rival, will assure that it participates in the next construction and mining boom. You are well compensated while waiting with a generous 4% dividend yield.

In sum, value stocks have lagged for at least a decade now. A reversion to a period of out-performance relative to growth stocks seems overdue. We believe investors should prepare now for this potential change in trend.