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Growth Stocks Moved to New Recovery Highs Last Week as Value Stocks Struggled

- Even before this weekend's news of a potential flu pandemic raised concerns about economic growth and profits, stock markets around the world last week ran into some stronger headwinds. As we noted in our "Report Card Changes" last week, the 6-week rally had reduced investors' bearish sentiment somewhat, and equity valuations were not as supportive as the extremely inexpensive ratings we had seen in March. The week started with a bad stumble, but the S&P 500 and Dow Industrials cut their losses to less than -1% by week's end.
- The Nasdaq, with its growth-oriented equities, continued to lead the market — as it has since the November lows — and closed up more than +1% for the week. Growth's advantage was also evident in the relative performance of the S&P 500/Citigroup Growth index, which resisted Monday's selloff to close +0.4% for the week. The corresponding S&P 500/Citigroup Value index, weighed down by financial stocks, lost -1.3% over the 5-day span.
- Our longer-term projections call for growth stocks to outperform value stocks by a small amount — about +0.5% per year — over the next 10 years. Outperformance of this magnitude will not be a surprise if the economic growth trend is slower than the past 15-25 years as we suspect.
- Our belief that growth stocks will also be less volatile than their value counterparts is perhaps more controversial. In the past, value stocks have tended to be less volatile than average, in large part because a higher portion of their total return was delivered in the form of seemingly reliable dividends. By contrast, growth company returns are comprised almost entirely of appreciation, which is by no means guaranteed. Besides, the growth index experienced a huge boom/bust cycle from 1998 through 2003, which elevated the volatility one might compute if markets were backward-looking.
- What investors are learning in 2008-09 is that dividends are by no means guaranteed, either. We are concerned that the current economic environment — which is the worst recession in 50+ years — will continue to destroy businesses and in particular, the existing equity value of businesses. Many potential victims of this difficult environment are found in "value" indexes — and the recent rally has boosted their share prices significantly.
- One key question for investors in difficult times is how long the companies they own (or are lending to) are able to make timely payments of interest and principal. We evaluated the balance sheet strength of companies in the 6 major indexes comprising the Standard & Poor's 1500 index: the 1) growth; and 2) value "investment style" portfolios in each of the a) S&P 500; b) S&P 400 Midcap; and c) S&P 600 Smallcap indexes.
- We used a well-known financial test of balance sheet strength called the "Altman Z-Score," developed in 1968 by Edward I. Altman, a professor at New York University. The Altman Z-Score test is not applicable to financial companies, but that is really no shortcoming, as it is clear that many companies in the financial sector are already severely stressed. Large cap growth stands out as having the lowest exposure to weaker balance sheets.

Fig. 1

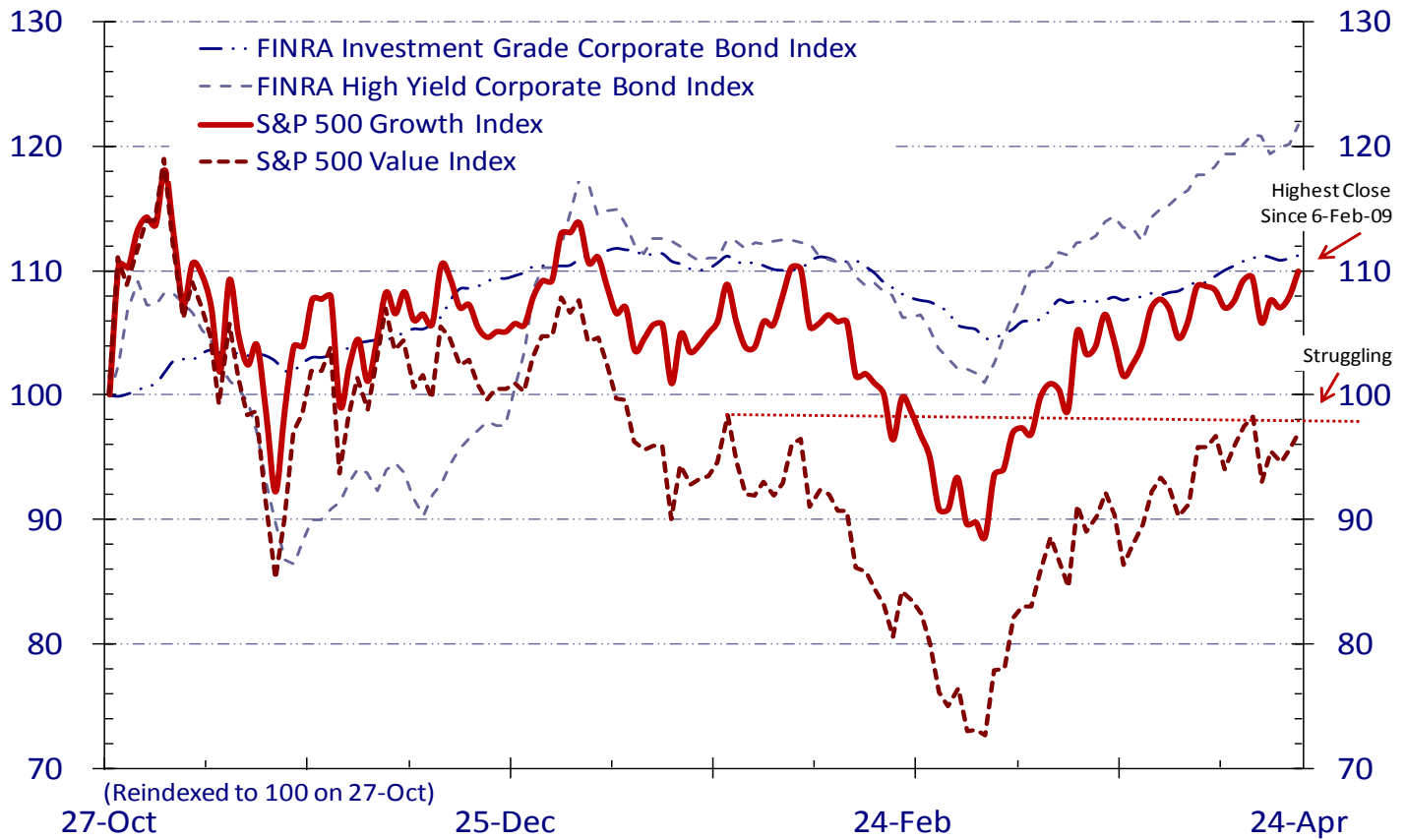
How Much of Your Index Investment is "In Distress" ... or Worse?

(Index Weighting of Stocks Rated "C+" or "C" or "F" as a Percent of All Stocks With an Altman Z-Score Grade)

Index	Growth Index ¹	Value Index ²	Overall Index ³
a) S&P 500	8.2%	38.2%	20.6%
b) S&P 400 Midcap	16.8	30.3	22.6
c) S&P 600 Smallcap	14.0	24.0	18.4

Note: Using the Altman Z-Score methodology, most index stocks are graded A, B+, B, C+, C, or F. Table shows the index weighting of poorly-rated stocks as a percentage of all rated stocks. Standard & Poor's/Citigroup Growth & Value methodology is based on 7 different growth and value factors. Past performance is not an indication of future results. An index is not managed and is unavailable for direct investment. Source: Bloomberg, Standard & Poor's.

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Note: Total return indexes: all dividends and income received are reinvested into the index. Fees, commissions and expenses are not included in figures and would have a negative impact on investment results. Past performance is not an indication of future results. An index is not managed and is unavailable for direct investment. Source: Bloomberg/FINRA, Standard & Poor's.

One of the most important concepts of value investing — popularized by Benjamin Graham — is the “margin of safety.” In the brutal bear market/severe recession/credit crunch environment we currently face, there is no shortage of asset classes that one would consider “attractive value.” Even companies whose shares were normally considered too expensive because of their attractive growth characteristics now possess a good margin of safety.

What is scarce in the world today is quality growth. Growth companies serve markets that expand at least as fast as nominal gross domestic product, which we have already shown is a function of population, participation and productivity. Many of them provide products and services that are considered non-discretionary (or “less discretionary”); thus demand is expected to remain somewhat steady through both ups and downs. Good quality companies can finance their own growth without the help of outside sources, so their capitalization is either mostly equity — or, in some cases — entirely equity. To the extent they have significant debt on the balance sheet, cash flow covers interest expense with room to spare, so investors are less concerned about timely payments of interest and/or principal. *Tom McManus*

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