Making Sense of the Current Growth vs. Value Dynamic

How Trends Compare to the 1990s and Why They Could Persist

Many investors seem concerned that the current era of growth style dominance will come to the same untimely end as its 1990s predecessor. However, we think there are distinctions in the factors that have driven the current outperformance of growth vs. value, which could result in this cycle playing out differently than the prior one. Here's why.

Key Highlights

- Current P/E levels relative to the 90s combined with a low interest rate environment, in our opinion, indicates that earnings growth has been a more significant driver of the recent outperformance of the Russell 1000 Growth Index (R1G) vs. Russell 1000 Value Index (R1V).
- Our research shows that the top contributors to the R1G's performance saw far more economic value accrue to their businesses relative to their R1V counterparts, and we believe this demonstrates the underlying fundamental strength of the R1G companies.
- We believe the full promise of the internet boom is now being realized as the infrastructure required to support the momentous changes envisioned in the 90s are largely in place.

Since the market bottom of the Great Financial Crisis in March 2009, the Russell 1000 Growth Index (R1G) has outperformed the Russell 1000 Value Index (R1V) by over 300% cumulatively. This level of relative outperformance is reminiscent of the 1990s, along with the angst and frustration it seems to manifest for investors who allocate between the two styles. In fact, the cumulative outperformance of the R1G vs. the R1V during the eleven years from 2008-2019 has been roughly the same as it was in the period from 1988-1999.

Many seem fearful that this current era of growth style dominance will end with the same thud as its 1990s predecessor. According to the Wall Street Journal, growth stocks are on pace to outperform value stocks by the widest margin since the dot-com era, and many investors wonder how long this can last.[1] We make no claims about the future and acknowledge this paper could be poorly timed. Yet, despite the appearance of style déjà vu, we think the factors that have driven the current outperformance of growth vs. value are different than the previous incarnation.

Past vs. Present: Valuation vs. Earnings Growth

During the 1990s, the relative outperformance of growth vs. value was most pronounced towards the end of the decade when the excitement over the coming internet age reached a fever pitch. In just the two calendar years of 1998-1999, the R1G outperformed its value counterpart by a cumulative 60%. As shown in Figure 1, this outperformance was valuation driven—the relative P/E of the R1G, at its peak, reached 3.5x the P/E ratio of the R1V, a level far above the longer-term trend.

Analyzing 2008-2019, the relative P/E of both the R1G vs. R1V has certainly trended higher but remains well below the levels seen in late 1999/early 2000. It is also important to note that interest rates today are much lower compared to twenty years ago— if anything, this fact generally justifies higher growth equity valuations. Given this data, we infer that compared to the late 1990s, earnings growth has been a more significant driver of the recent outperformance of the R1G over the R1V.

1 Otani, A. (2020, May 19). Growth Stocks Outperforming Value by Widest Margin in Decades. Wall Street Journal. https://www.wsj.com/articles/growth-stocks-outperforming-value-by-widest-margin-in-decades-11589904864

Trailing P/E: Russell 1000 Growth Relative to Russell 1000 Value

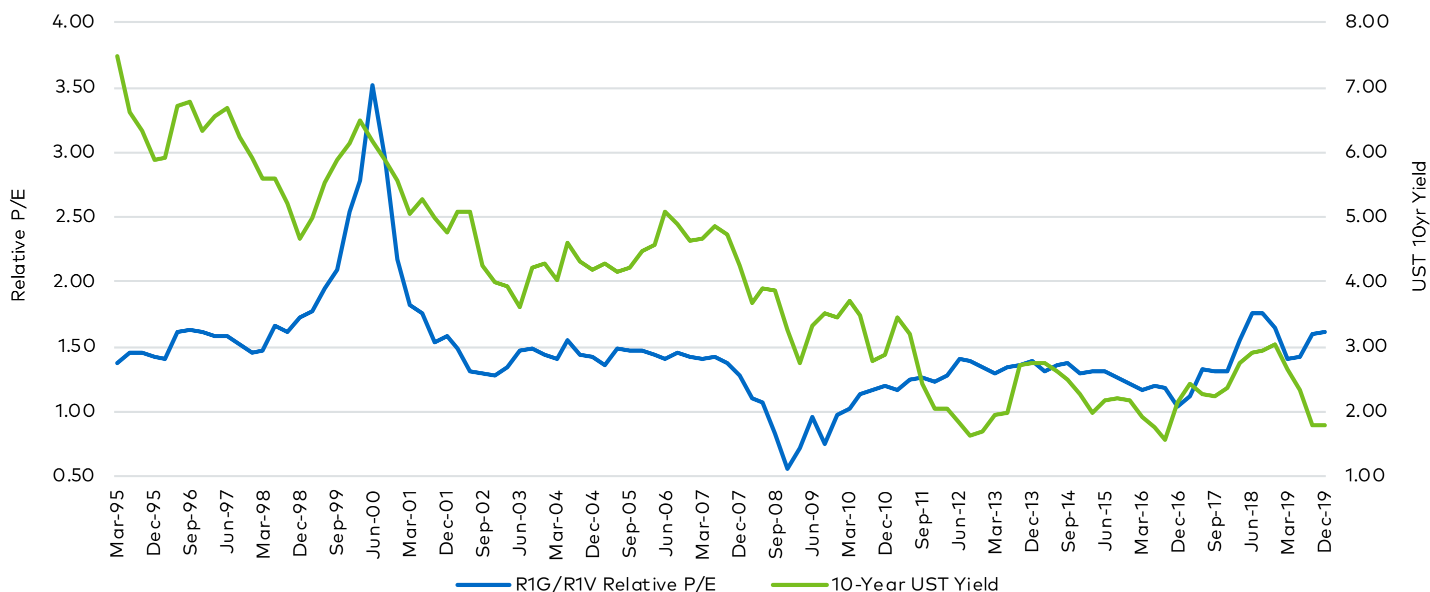

Figure 1: Source: Factset; Fred Database.

The Economics of Today's Growth vs. Value Dynamic

We can also examine the fundamentals behind the growth vs. value dynamic. Consider the accrued economic value (based on revenues) generated by the ten most significant contributors to each index's performance. This can help to properly frame the value created by the companies most responsible for the performance of each benchmark.

The Price/Book Ratio is one of the key metrics that FTSE Russell uses to define their growth and value style indices. However, we wonder how helpful Price/Book Ratio is for understanding companies in the digital age. These businesses tend be more reliant on intangible assets (which naturally lends itself to higher P/B ratios) compared to many traditional companies that are more reliant on tangible assets. With this type of methodology, digital, asset-light businesses will usually be classified in the growth indices even though, in our opinion, some of the world's largest digital businesses currently trade at very reasonable prices relative to their earnings power (as opposed to their book value).

The charts in Figures 2-5 show the absolute change and growth in revenues and net income for the top ten largest contributors to each of the R1G and R1V over the past five and ten years.

Just looking at revenues, between 2009-2019, the ten largest contributors to the R1G's performance generated $500bn or over 2.5X more in revenues than the ten largest contributors to the R1V's performance. Between 2014-2019, the R1G's top ten contributors generated $400bn more in revenues compared to the ten largest contributors to the R1V. If overall revenue and net income generation and the growth of these metrics are an indicator of underlying business strength, then the companies driving the R1G's performance collectively appear to be much stronger than those driving the R1V's performance. In this context, the comparative outperformance of the R1G seems hardly surprising. The top contributors to the R1G's performance saw far more economic value accrue to their businesses relative to their R1V counterparts. In our opinion, it would be irrational if the market did not assign a greater value, in the form of larger market caps, to these best-performing growth businesses.

Change in Revenues 2009-2019: Ten Largest Contributors for Each Index

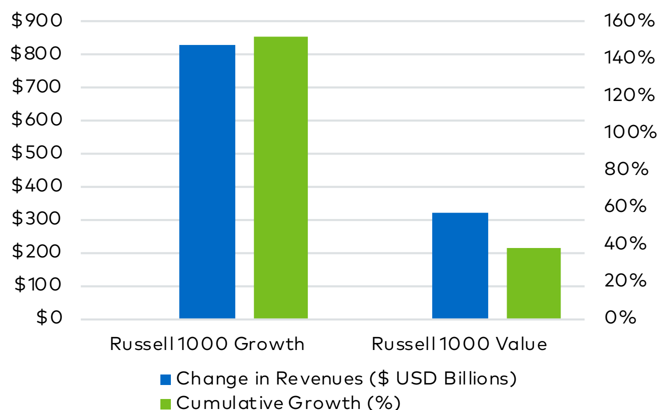

Figure 2: Source: Bloomberg. Ten largest contributors for R1G returns 2009-2019 in order of contribution: AAPL, MSFT, AMZN, GOOG (A and C shares), FB, V, HD, MA, BA, XOM.
Ten largest contributors for R1V returns 2009-2019 in order of contribution: JPM, JNJ, BRK.B, PFE, PG, CSCO, INTC, T, CVX, WFC.

Change in Revenues 2014-2019: Ten Largest Contributors for Each Index

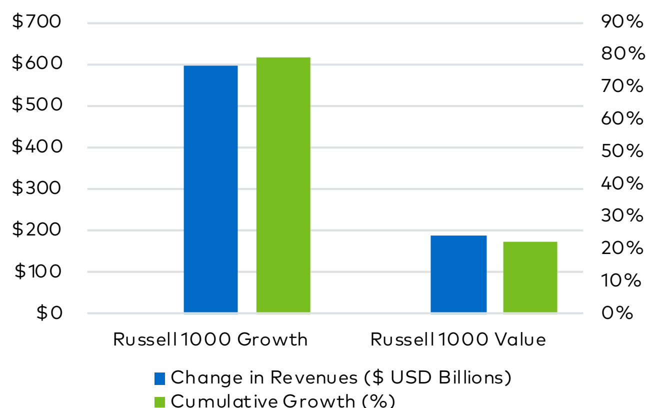

Figure 4: Source: Bloomberg. Ten largest contributors for R1G returns 2014-2019 in order of contribution: AAPL, MSFT, AMZN, GOOG (A and C shares), FB, V, MA, UNH, HD, BA.
Ten largest contributors for R1V returns 2014-2019 in order of contribution: JPM, BAC, CSCO, BRK.B, JNJ, INTC, PG, T, MRK, PFE.

Change in Net Income 2009-2019: Ten Largest Contributors for Each Index

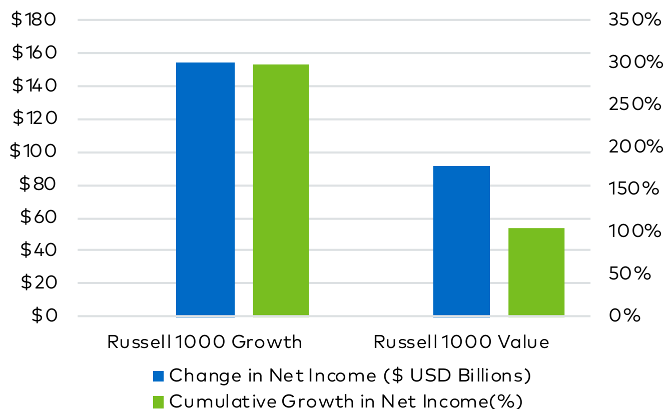

Figure 3: Source: Bloomberg. Ten largest contributors for R1G returns 2009-2019 in order of contribution: AAPL, MSFT, AMZN, GOOG (A and C shares), FB, V, HD, MA, BA, XOM.
Ten largest contributors for R1V returns 2009-2019 in order of contribution: JPM, JNJ, BRK.B, PFE, PG, CSCO, INTC, T, CVX, WFC.

Change in Net Income 2014-2019: Ten Largest Contributors for Each Index

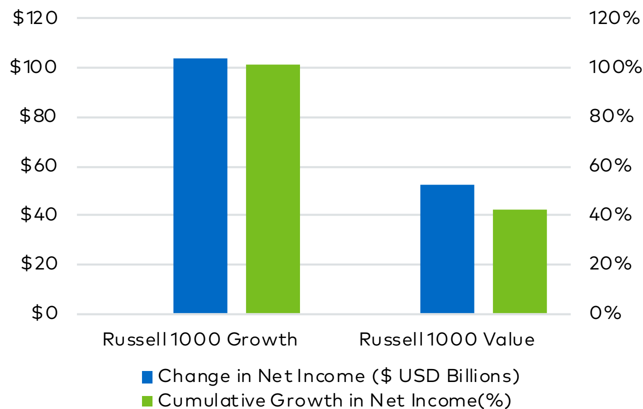

Figure 5: Source: Bloomberg. Ten largest contributors for R1G returns 2014-2019 in order of contribution: AAPL, MSFT, AMZN, GOOG (A and C shares), FB, V, MA, UNH, HD, BA.
Ten largest contributors for R1V returns 2014-2019 in order of contribution: JPM, BAC, CSCO, BRK.B, JNJ, INTC, PG, T, MRK, PFE.

We were interested to see how the above data compared to the 1990s. While we do not have data on the largest contributors to each Index for this time period, we do know the largest index weights which we feel can be used as a close proxy. We examined the five-year period ending 12-31-1999 and believe this is sufficient to make a fair comparison. As can be seen in Figures 6 and 7, while the largest-weighted companies in the R1G outgrew the largest-weighted companies in the R1V, it was to a much lesser degree compared to the 2014-2019 period. In fact, the largest holdings in the R1V generated a greater absolute increase in aggregated net income compared to the largest holdings in the R1G. We believe this further supports our view that the 1990s growth vs. value cycle was more valuation driven compared to today.

Change in Revenues 1994-1999: Ten Largest Weights for Each Index

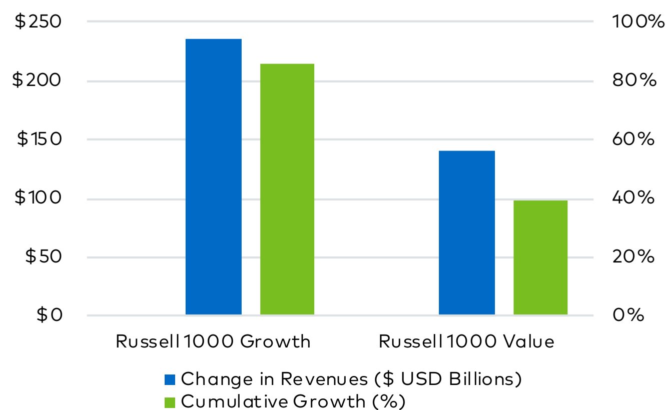

Figure 6: Source: Bloomberg. Ten largest weights for R1G as of 12-31-1999 in descending order: GE, MSFT, CSCO, INTC, LU, WMT, AOL, IBM, HD, MRK. Ten largest weights for R1V as of 12-31-1999 in descending order: XOM, C, T, SBC, AIG, Bell Atlantic, BellSouth, BAC, MS, GTE.

Change in Net Income 1994-1999: Ten Largest Weights for Each Index

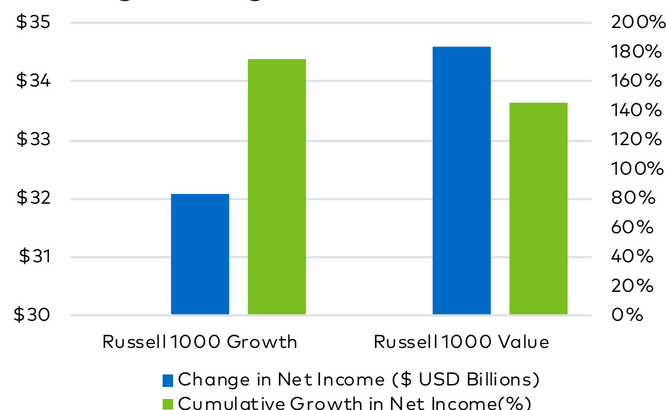

Figure 7: Source: Bloomberg. Ten largest weights for R1G as of 12-31-1999 in descending order: GE, MSFT, CSCO, INTC, LU, WMT, AOL, IBM, HD, MRK. Ten largest weights for R1V as of 12-31-1999 in descending order: XOM, C, T, SBC, AIG, Bell Atlantic, BellSouth, BAC, MS, GTE.

The main takeaway from this analysis is that the current growth vs. value cycle appears, to us, to be more fundamentally driven than the 1990s. The 1990s growth vs. value cycle may have begun as a fundamentally driven cycle. However, by the end of that decade, it had morphed into a valuation-driven mania that, even then, seemed unsustainable. If we conclude that today's cycle is more fundamentally driven, the implication is that it may prove to be more sustainable than its 1990s predecessor. Only time will tell, but the companies who make up the most significant contributors to the R1G, led by the massive tech platforms, are seeing their business models driven forward by enormous structural trends around the digitization of the global economy, a shift that is perhaps still in the early innings.

The Full Promise of Digitization

Somewhat ironically, today's digital transformation was significantly accelerated by the internet and mobility trends that had blossomed during the 1990s. In a sense, that era's excitement about the momentous changes these technologies would create was more than justified—the stock market was simply too far ahead of many of the actual business models. These models required a level of infrastructure (computing power and storage, mobility networks, data speeds, etc.) which was, arguably, inadequate at the time. Today, with much of that needed infrastructure in place, the full promise of the internet boom is now being realized.

One result of this development—a digital paradigm shift catalyzed by the underlying infrastructure needed to support it—has been the creation of some incredibly successful digital ecosystems.

Many of these platforms are now the largest companies in the U.S. growth indices, and, in our view, they are some of the more powerful business models we have seen in the 30+ year history of our firm. When viewed through this lens, the outperformance of growth vs. value for the past ten years is not only unsurprising but may continue, as long as its fundamental underpinnings remain in place.

We recognize why today's growth cycle might create some uneasiness, especially when it feels eerily similar to the eleven-year growth cycle of the past. Yet, the fundamentals tell us that today's growth cycle is largely being supported by earnings growth, the stronger underlying economics of the businesses, and the full realization of digitization's promise, which we believe has many more years ahead.

Concerned about Index Concentration? There is a Bright Side

The concentration at the top of the Russell 1000 Growth Index has reached its highest levels in over 30 years, with the top five companies by market cap comprising nearly 37% of the Index as of June 2020. This level is well above the previous record of 29% seen in May 2001. We recognize this degree of concentration is likely to prompt questions and concerns from clients and investors.

The challenge? If these businesses continue to outperform, not owning them can make it difficult to beat the Index. But it also presents a challenge for active managers who do favor these businesses. For example, Microsoft, Apple, and Amazon alone account for some 30% of the Index. Thus, a manager who believed this trio of companies to be among their best ideas would likely need to allocate at least one-third of their portfolio to them to achieve a meaningful active weight. Even for highly concentrated managers, such a decision would likely be heavily scrutinized.

And, while this concentration at the top is the highest in history, we would caution investors that it is not an inevitable consequence that these businesses will underperform going forward. In fact, these five companies are generating attractive growth and collectively are trading at lower P/E multiples than their counterparts in 2001 (see table).

The bright side is that 165 companies within the R1G outperformed the Index in 2019. In other words, there were ample opportunities to generate alpha independent of these top five holdings.

We believe that durable and competitively advantaged companies can and should continue to persist over time and the opportunities to generate alpha remain attractive.

	EV/EBITDA	Trailing 5-yr EBITDA Growth
TOP 5 R1G Holdings 2020	17.4	27%
TOP 5 R1G Holdings 2001	30.6	26%

Source: Bloomberg.

Top five weights in Russell 1000 Growth as of June 2020 (AAPL, MSFT, AMZN, GOOGL, FB). Top five weights in Russell 1000 Growth as of May 2001 (MSFT, INTC, PFE, GE, TWX). EV/EBITDA based on trailing 12 months data as of June 2020 and May 2001, respectively. Five-year EBITDA growth based on CAGR of EBITDA for six annual fiscal periods prior to June 2020 and May 2001, respectively. Data points based on the median number for each subgroup to reduce outlier effects.

Authors

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Mr. Atkins joined Polen Capital in 2012. Prior to joining Polen Capital, Mr. Atkins spent 12 years as a portfolio manager at Northern Trust Investments, including eight years as a mutual fund co-manager. Before joining Northern Trust, Mr. Atkins spent two years as a portfolio manager at Carl Domino Associates, LP. Mr. Atkins received his B.S. in Business Administration from Georgetown University and a General Course degree from the London School of Economics. Mr. Atkins is a CFA® charterholder and a member of the CFA Institute and the CFA Society of South Florida.

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Mr. Holt joined Polen Capital in 2018. He was born and raised in South Florida and graduated as salutatorian from Westminster Academy in Fort Lauderdale. He received his B.A. in Economics from Princeton University with Highest Honors, and he was the recipient of the Burton G. Malkiel '64 Senior Thesis Prize for the most outstanding senior thesis in the field of finance. Prior to joining Polen Capital as an employee, Mr. Holt interned with the company in the summer of 2017.

Going Beyond with Polen Capital

Polen Capital is a team of experienced investment industry professionals who share an unwavering commitment to our clients, community and each other. We have been dedicated to serving investors by providing concentrated portfolios of the highest-quality companies for more than three decades. At Polen Capital, we have built a culture of results, and in this, an inherent belief in going beyond what's expected for the people and communities we serve.

We believe that an important part of growing our clients' assets also includes preserving them. To pursue this, we adhere to a time-tested process of researching and analyzing the highest-quality companies around the globe—seeking only the best to build highly concentrated portfolios. Then, we invest for the long haul and with a business owner's mindset—giving these companies time to grow.

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