Topical Study #70: What's In Style?

OAK ASSOCIATES, *ltd.*

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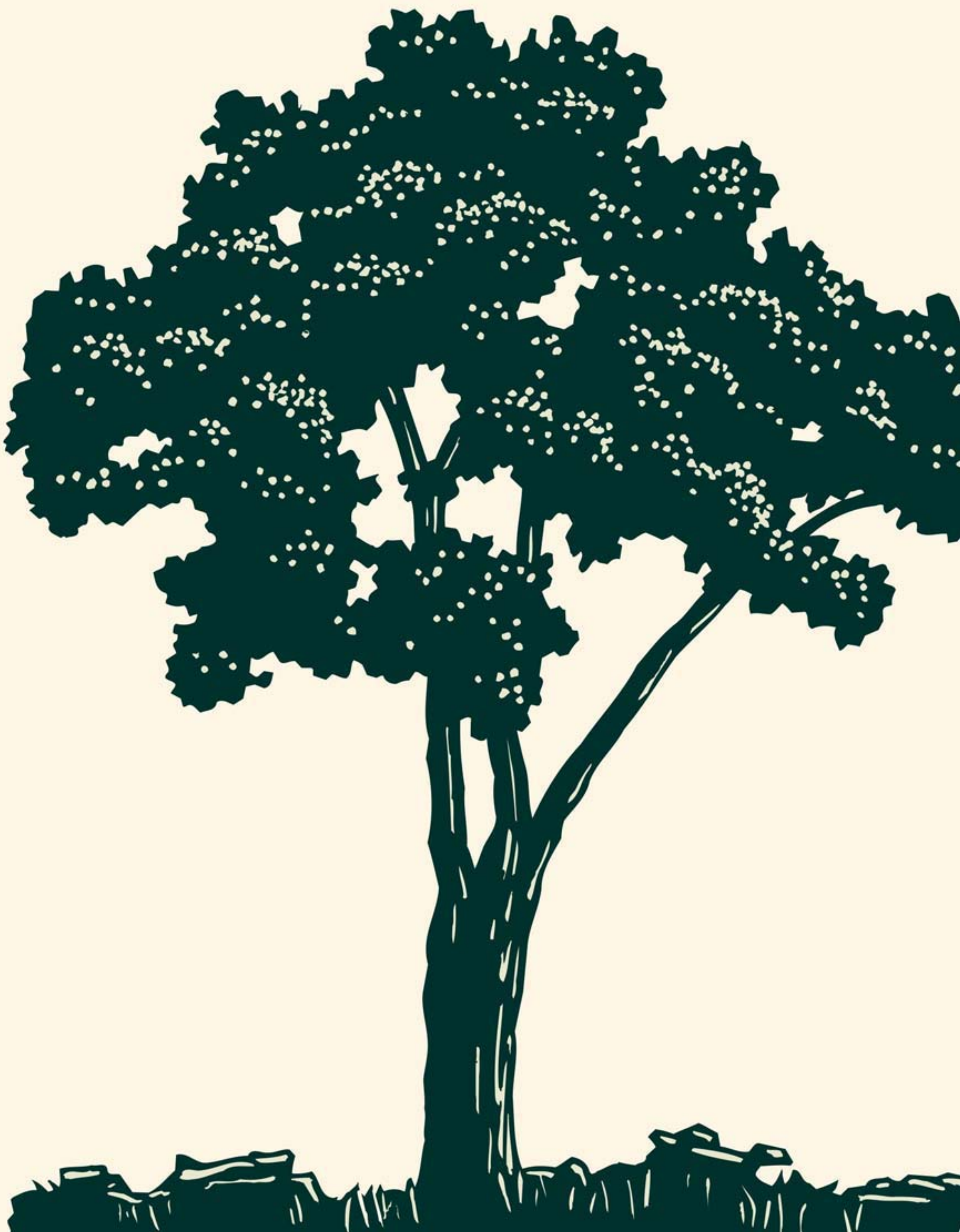


Please visit our websites at
www.yardeni.com &
www.oakassociates.com

I. Main Street Strategist

Now that I am on the "buy side" of the Street, I have a different perspective on the institutional investment process. Generally speaking, institutional investors tend to offer their clients investment products that have well-defined styles. Many of these products are differentiated by their market capitalization, which the buy side typically divides into three categories: Large-Cap, Mid-Cap, and Small-Cap. Many fund managers also like to distinguish between Growth stocks and Value stocks. Combining these parameters produces six style boxes, i.e. Growth or Value portfolios limited to one of the three market cap sizes.[1]

I have been with Oak Associates *ltd.* now since September of last year. Our style is Large-Cap Growth. This style has been out of favor since 2000, with the exception of 2003 and the fourth quarter of last year. Naturally, I am biased: I happen to believe that this style is likely to make a significant comeback soon.

I wouldn't have left a perfectly good career as an investment strategist on the "sell side" of Wall Street if I had thought that the Large-Cap Growth style would remain challenged over the rest of the decade. On Wall Street, I spent much of my time focusing on the outlook for the S&P 500 Large-Cap Index, as well as identifying which of the 10 sectors of this index should be overweighted or underweighted. Now that I am on "Main Street" in Akron, Ohio, I continue to do so. I still favor the sectors that are most likely to benefit from the Global Synchronized Boom, especially selected Technology, Financials, and MEI (i.e. Materials, Energy, and Industrials).

Now, working at Oak, I believe I have a better and more hands-on understanding of how the buy side operates. In my opinion, Wall Street's strategists probably spend too much time sharing their forecasts and insights with the wrong customers. They spend most of their time explaining why they are bullish or bearish to institutional investors who are institutionally disposed to being permanently bullish because they are always fully invested. The strategists predict whether Growth will outperform Value or whether Large Caps will beat Small Caps and explain why to investors who are fully invested in well-defined style boxes. All this information is probably much more relevant to the ultimate consumers—the folks who hire the portfolio managers to manage their money. They are the ones who need to decide how to allocate their portfolios among the different styles, using managers who are "boxed" into those styles.

[1] There are many other style boxes including sectors and countries. There are portfolios that invest internationally and in emerging markets. There are index funds. So-called "alternative investment" styles include hedge funds, private equity funds, real estate, and real assets (like timberland).

II. The Allocators

Most institutional investors are always fully invested in their styles because their clients expect them to be fully invested all the time, not to time the market. Their clients also expect that there will be no "style drift." So, for example, a money manager who has been hired to provide exposure to Large-Cap Growth can't suddenly raise lots of cash or load up with Small-Cap stocks. Consequently, the Large-Cap Growth manager will at times outperform and other times underperform other styles. Performance is usually gauged not in terms of absolute return, but rather relative to a benchmark index for a particular style. For Large-Cap Growth, the index often used is the Russell 1000 Large-Cap Index. Figure A provides brief definitions of the most widely used benchmarks.

Figure A: Major Stock Market Performance Benchmarks

Index	Description
S&P 500	A market capitalization weighted index of 500 stocks representing a sample of leading companies in leading industries and with a market cap of $4 billion or more.
S&P 400	This composite includes stocks with a market cap of $1 billion to $4 billion.
S&P 600	This composite includes stocks with market cap under $1 billion.
S&P Growth	A capitalization-weighted index of all the stocks in the S&P 500 that have high price-to-book ratios. It is designed so that approximately 50% of the S&P 500's market capitalization is in the Growth Index.
S&P Value	A capitalization-weighted index of all the stocks in the S&P 500 that have low price-to-book ratios. It is designed so that approximately 50% of the S&P 500's market capitalization is in the Value Index.
Russell 1000	This index is constructed to provide a comprehensive and unbiased barometer for the large-cap stocks.
Russell 2000	This index is constructed to provide a comprehensive and unbiased small-cap barometer.
Russell Growth	This index contains securities that generally have higher price-to-book and higher forecasted growth values than those in the Value index.
Russell Value	Contains securities that generally have lower price-to-book and lower forecasted growth values than those in the Growth index.

It is up to the client—or the client's asset allocation manager—to determine the style composition of the total portfolio. Of course, among the most important decisions is how much of the portfolio should be placed in different asset classes including stocks, bonds, real estate, real assets (like timberland), cash, and other investments. The next step is to choose the style composition of the equity portion of the portfolio. Over time, if a certain style outperforms others, asset allocators will most likely rebalance the style mix by reducing the exposure to that style and placing the extra funds in other styles. Again, I am biased, but I do believe that now is the time to overweight the Large-Cap Growth style, especially since it has been out of favor for so long.

III. The Case For Large Caps

On my website, www.yardeni.com, I recently started to post an "Investment Style Guide," which compares the performance of some of the most popular styles of investing. I intend to update it on a weekly basis. In this *Topical Study*, I reproduce the latest charts and provide an introduction and conclusions that support my opinion about the right style now. Let's begin with a discussion about Large Caps versus Small Caps:

- Over the business cycle, the worst environment for companies is just before and during recessions. At the tail end of economic expansions, the costs of doing business typically rise faster than revenues. Productivity gains are harder to achieve when capacity utilization is high.

- Recessions are often triggered by credit crunches. This scenario is especially tough for smaller businesses, which are often at greater risk of going out of business than larger companies that have more financial resources and more ways to cut their costs. Therefore, during major bear markets, Small Caps should drop faster than Large Caps.

- During economic recoveries, Small Caps should rebound faster because they should experience the greatest "relief rallies." Investors are relieved that the Small-Cap survivors actually survived. Moreover, smaller firms have tremendous earnings leverage at this point, because credit conditions have already eased significantly and business activity is rebounding.

- As the expansion matures, Small Caps should start to underperform partly because they are no longer cheap, and they are still riskier than larger, more mature companies. Also, larger companies may start to benefit more from their exposure to a rebound in the global economy, which often lags the U.S. upturn. The foreign-exchange value of the dollar is often weaker during economic expansion. This will tend to boost the profits of larger, multinationals more than the profits of smaller companies that might be more limited to the domestic market.

This stylized business cycle model suggests that now is the time for Large Caps to outperform Small Caps. How does this theory compare to today's reality? Here are my observations from the latest version of my Investment Style Guide:

1) During the economic recovery of 2003 through 2004, the 12-month forward consensus expected earnings of the S&P 500 Large Caps rose 35%, while comparable earnings for the S&P 400 Mid Caps and S&P 600 Small Caps rose 39% and 44%, respectively. Since the start of this year, the forward earnings of Mid Caps and Small Caps have stalled, while S&P 500 earnings continue to rise into record territory (Figure 1). All this supports the notion that smaller companies have more earnings leverage in an economic recovery and that this advantage diminishes as the economic expansion matures.

2) Large-Cap valuation multiples significantly exceeded those for the other two cap categories from 1999 through 2001. All three converged at much lower levels during 2002. During late 2003 and the first half of 2003, when investors were especially nervous about the outlook for the economy, the multiples of Small Caps and Mid Caps were lower than that for Large Caps. During the second half of 2003 and the first half of 2004, the valuation multiples of all three market caps were almost the same. They all lost about three percentage points during the first three quarters of last year. Over the rest of last year, all three multiples reversed some of their declines, but they diverged with Small-Cap and Mid-Cap valuations rising more than Large-Cap valuations.

3) Analysts' weekly earnings estimates for 2005 have been relatively flat so far this year for all three market caps. At the same time, analysts have been raising their estimates for 2006, especially for Mid Caps and Small Caps (Figure 3).

4) The S&P 500, 400, and 600 indexes are up 5%, 11%, and 17%, respectively, over the latest 52 weeks through the week of February 18 (Figures 4 and 5). Mid Caps and Small Caps have been outperforming Large Caps since early 2000 (Figure 6). This has been mostly true since the beginning of last year among the 10 S&P sectors, and especially within the Consumer Discretionary, Consumer Staples, Health Care, Industrials, and Materials sectors (Figure 7).

5) In the investment community, an alternative benchmark to the S&P 500 is the Russell 1000 Large-Cap Index. The alternative to the S&P 600 Small-Cap Index is the Russell 2000 Small-Cap Index. On a yearly percent change basis, the Russell Indexes are almost identical to their S&P counterparts. Both Russell Indexes tracked each other very closely during the first half of the 1990s. They increasingly diverged during the second half of that decade as Large Caps soared, while Small Caps languished. From 2000 through 2002, they converged as Large Caps gave back all the gains from 1998, while Small Caps remained relatively flat. Both rallied during 2003 and 2004 with Small Cap outperforming as the Russell 2000 converged with the Russell 1000 (Figure 8). In my opinion, both should rise this year and next year, but I expect that Large-Caps will now outperform in line with the stylized business cycle scenario discussed above.

IV. The Case For Growth

The case for Growth now is similar to the case for Value during 1999 and 2000. Back then, Value significantly underperformed for several years. The most popular and most successful style was Large-Cap Growth. There was a significant reversal of fortune for this style starting in 2000.

In theory, Growth stocks should consistently outperform Value stocks since earnings grow faster among the former than the latter. The problem with such an obvious conclusion is that it doesn't work under the following circumstances:

- If growth stocks are extremely overvalued, the valuation multiple could fall, offsetting the rapid increase in earnings. In other words, growth stocks may be selling at valuation premiums that make it very difficult for them to outperform value stocks over time.

- If growth stock earnings increase at a slower-than-expected pace, the valuation multiple might also fall. Of course, if earnings actually fall as a result of weak demand during a recession or too much supply because of excess capacity and intense competition, then both earnings and valuation would depress the prices of growth stocks.

- Fast-growing companies grow into big, slow growing companies. They mature. They also attract competitors seeking to displace them with better products and innovations. In other words, great success can sometimes set the stage for significant failure.

Before we proceed any further, you really must have a look at Figure B, which shows the top 50 S&P 500 growth and value stocks sorted by market capitalization. There are many Large-Cap Growth managers who might be surprised to learn that Exxon Mobil, IBM, Altria Group, Coca-Cola, Du Pont, Colgate Palmolive, and Illinois Tool Works are Growth stocks. Indeed, they are among the biggest components of the S&P 500 Growth Index against which the performance of Growth managers is benchmarked. Similarly, I suspect that many Value managers might be unaware that Texas Instruments, MBNA, EMC, FedEx, and Applied Materials are Value Stocks. Appendix I shows the same table sorted by last year's performance of the top 50 Growth and Value stocks.

Now let's see what the charts have to say on the subject of Growth versus Value:

1) Currently, earnings momentum favors Value. Forward earnings of both styles rose significantly during 2003 and 2004. In recent months, Growth has lost earnings momentum as both 2005 and 2006 consensus estimates have been reduced. Meanwhile Value estimates for this and next year continue to rise, which is why forward earnings continues to rise rapidly (Figures 9 and 10).

2) Analysts currently expect Growth and Value earnings to increase 12.0% and 8.2%, respectively in 2005 and about the same in 2006 (Figures 9 and 10).

Figure B: Top 50 S&P 500 Growth & Value Stocks Sorted by Market Cap

S&P 500 Growth Stocks	Market Cap (billion dollars)	S&P 500 Value Stocks	Market Cap (billion dollars)
Exxon Mobil	384	Citigroup	254
General Electric	381	Pfizer	201
Microsoft	279	Bank Of America	188
Wal-Mart	224	American International Group	182
Johnson & Johnson	197	JP Morgan Chase	132
International Business Machines	155	ChevronTexaco	126
Intel	153	Wells Fargo	103
Procter & Gamble	147	Verizon Communications	100
Altria Group	134	Time Warner	84
Cisco Systems	115	Wachovia	80
Coca-Cola	104	SBC Communications	80
Dell	104	ConocoPhillips	75
Pepsico	93	Tyco International	74
Home Depot	92	Comcast	72
Amgen	81	Morgan Stanley	63
Abbott Laboratories	73	Viacom	63
Merck	72	Hewlett-Packard	62
American Express	69	Walt Disney	59
3M Company	68	Merrill Lynch	58
Oracle	68	Fannie Mae	57
Medtronic	65	US Bancorp	56
UnitedHealth Group	60	Carnival Corporation	47
Eli Lilly	59	Bellsouth	47
Qualcomm	59	Texas Instruments	45
Du Pont	54	Freddie Mac	43
Wyeth	54	McDonalds	41
Dow Chemical	52	Motorola	38
United Technologies	51	Allstate	37
Gillette	51	Washington Mutual	36
Yahoo	50	Sprint	35
Bristol-Myers Squibb	48	MBNA	33
Lowes	47	Honeywell	33
Target	46	EMC Corporation	31
Schlumberger	45	Metlife	31
Walgreen	44	Fedex	30
Boeing	43	Exelon	30
Anheuser-Busch	38	Applied Materials	29
Apple Computer	36	Alcoa	27
First Data	33	Occidental Petroleum	27
Nextel Communications	33	St. Paul Travelers	27
Caterpillar	32	Duke Energy	26
Kimberly-Clark	32	Suntrust Banks	26
Colgate Palmolive	30	Fifth Third Bancorp	26
Schering-Plough	28	Lehman Brothers	26
Emerson Electric	28	Cardinal Health	26
Boston Scientific	28	Southern Company	24
Illinois Tool Works	27	Dominion Resources	24
Lockheed Martin	27	National City	24
Automatic Data Processing	25	Ford Motor	24
Guidant	24	Cendant	24

As of February 18, 2005
Source: Bloomberg and Standard & Poor's Corporation.

3) Interestingly, while industry analysts always expect that the long-term earnings growth (LTEG) of Growth will exceed that of Value, they occasionally do predict that the short-term earnings growth (STEG) of Value might exceed Growth's STEG. In February, LTEG for Growth was down to a record low 12.9% versus 10.7% for Value. The spread between the two is the narrowest on record. At 12.0%, Growth's STEG exceeds Value's 8.4% in February, and both are slightly below their respective LTEGs (Figure 11). In other words, from a contrary perspective, Growth stock analysts aren't very exuberant about the outlook for their companies compared to 2000, when LTEG for Growth rose to a record 23.1% and STEG for Growth rose to 22.0% (Figure 11).

4) In February, the forward P/Es of Growth and Value were 19.3 and 14.0, respectively. Growth's multiple has been fluctuating between 18 and 21 since late 2002. This is about the same as the valuation of Growth in 1996, before irrational exuberance pushed the P/E to a record high of 40.9 during July 2000. The P/E fell sharply during late 2000 through the summer of 2002 from that record high (Figure 12). Growth is certainly cheaper, though admittedly it isn't as dirt cheap as it was in 1995, when the PEG ratio—i.e., P/E divided by LTEG—was close to 1.0. Today it is 1.5 (Figure 13).

5) The market capitalization shares of the S&P 500 have been almost evenly divided between Growth and Value since the mid-1990s. On the other hand, the earnings shares have been lopsided with Growth fluctuating around 40% and Value around 60% (Figures 14 and 15).

6) Both Growth and Value stock analysts made plenty of upward revisions to their earnings estimates last year. Now there aren't very many upward or downward revisions. In February, the Net Earnings Revisions Index was 2.9% for Growth and -0.5% for Value (Figures 16 and 17).

7) Value has significantly outperformed Growth since the beginning of 2000. Figure C shows the five-year track record of these styles using the Russell Indexes (Figures 18, 19, 20, and 21).[2] In my opinion, Growth should beat Value over the remainder of this decade.

Again, look for weekly updates of our Investment Style Guide on www.yardeni.com including performance reviews of style benchmarks based on market capitalization and Growth versus Value (Figures 22 and 23).

[2] On a yearly percent change basis, there isn't much difference between Russell 1000 Growth and S&P 500 Growth. The same can be said about Russell 1000 Value and S&P 500 Value.

Figure C: Five-Year Style Performance (percent change)

Styles	Russell 1000 Large-Cap	Russell 2000 Small-Cap	Russell 3000 All-Cap
Total	-15.9	24.8	-13.5
Growth	-42.4	-21.7	-41.1
Value	16.1	93.2	20.4

* * *

Appendix I: Top 50 S&P 500 Growth & Value Stocks Sorted By 2004 Performance

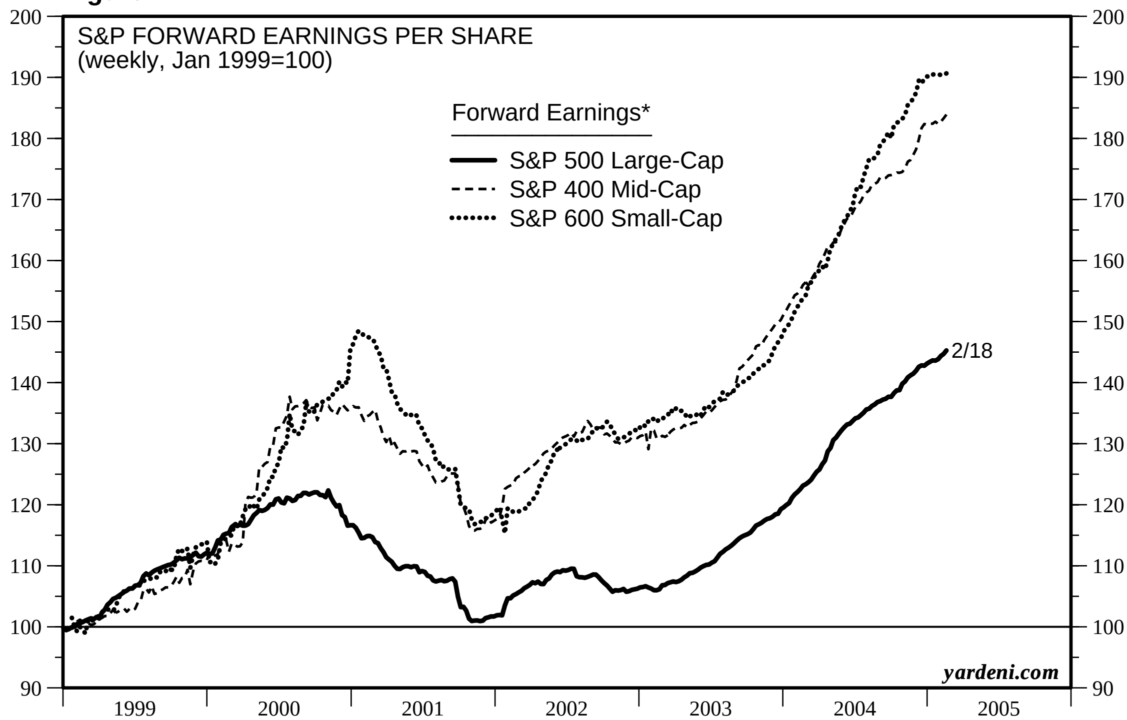
S&P 500 Growth Stocks	% Price Change	S&P 500 Value Stocks	% Price Change
Apple Computer	201	Sprint	51
Yahoo	67	Fedex	46
Qualcomm	57	Carnival Corporation	45
UnitedHealth Group	51	Occidental Petroleum	38
Target	35	Tyco International	35
Exxon Mobil	25	Exelon	33
Dell	24	ConocoPhillips	32
Boeing	23	McDonalds	29
Johnson & Johnson	23	Freddie Mac	26
Schlumberger	22	Duke Energy	24
Gillette	22	Motorola	23
Home Depot	20	ChevronTexaco	22
Schering-Plough	20	Metlife	20
Guidant	20	Allstate	20
Dow Chemical	19	Walt Disney	19
General Electric	18	Bank Of America	17
Caterpillar	17	Verizon Communications	15
American Express	17	EMC Corporation	15
Altria Group	12	MBNA	13
Pepsico	12	Lehman Brothers	13
Automatic Data Processing	12	Wachovia	13
Kimberly-Clark	11	Southern Company	11
Illinois Tool Works	10	National City	11
Procter & Gamble	10	Time Warner	8
United Technologies	9	JP Morgan Chase	6
Emerson Electric	8	Dominion Resources	6
Lockheed Martin	8	Honeywell	6
Nextel Communications	7	Wells Fargo	6
Du Pont	7	Washington Mutual	5
International Business Machines	6	US Bancorp	5
Walgreen	5	Cendant	5
Lowes	4	Comcast	5
Amgen	4	Suntrust Banks	3
Oracle	4	Merrill Lynch	2
First Data	4	Citigroup	-1
Colgate Palmolive	2	American International Group	-1
Medtronic	2	SBC Communications	-1
Wyeth	0	Bellsouth	-2
Abbott Laboratories	0	Morgan Stanley	-4
Wal-Mart	0	Cardinal Health	-5
Microsoft	-2	Fannie Mae	-5
Boston Scientific	-3	St. Paul Travelers	-7
3M Company	-3	Ford Motor	-9
Anheuser-Busch	-4	Hewlett-Packard	-9
Bristol-Myers Squibb	-10	Texas Instruments	-16
Coca-Cola	-18	Alcoa	-17
Eli Lilly	-19	Viacom	-18
Cisco Systems	-20	Fifth Third Bancorp	-20
Intel	-27	Applied Materials	-24
Merck	-30	Pfizer	-24

Source: Bloomberg and Standard & Poor's Corporation.

- Market Cap: S&P Earnings & Valuation -

Forward earnings is moving higher for the S&P 500, though at a slower pace. Forward earnings for the S&P 400 and S&P 600 seem to have stalled out recently.

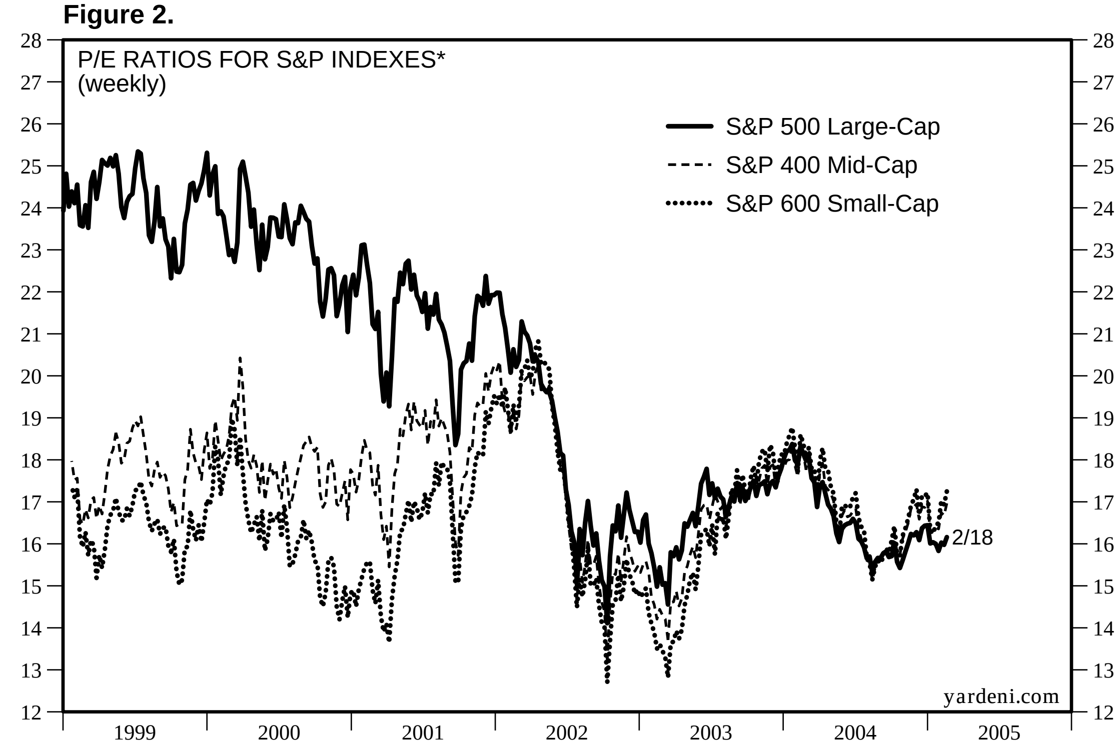
Figure 1.



* 52-week forward consensus expected operating earnings per share. Time-weighted average of the current year's and next year's consensus forecast.
Source: Thomson Financial.

P/E ratios for all three market-cap groups remain very tight.

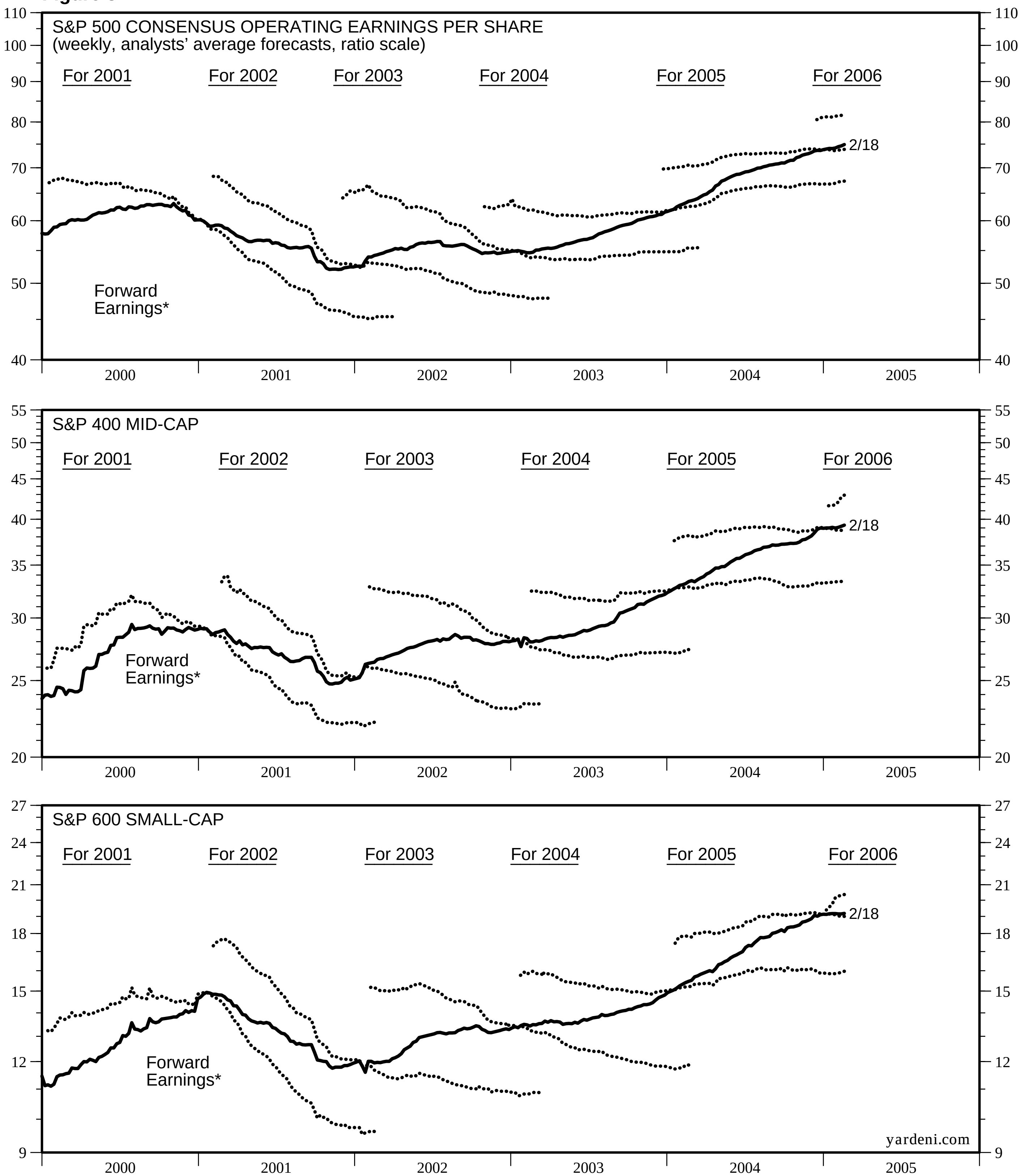
Figure 2.



* Price divided by 52-week forward consensus expected operating earnings per share.
Source: Thomson Financial.

- S&P Earnings Squiggles -

Figure 3.

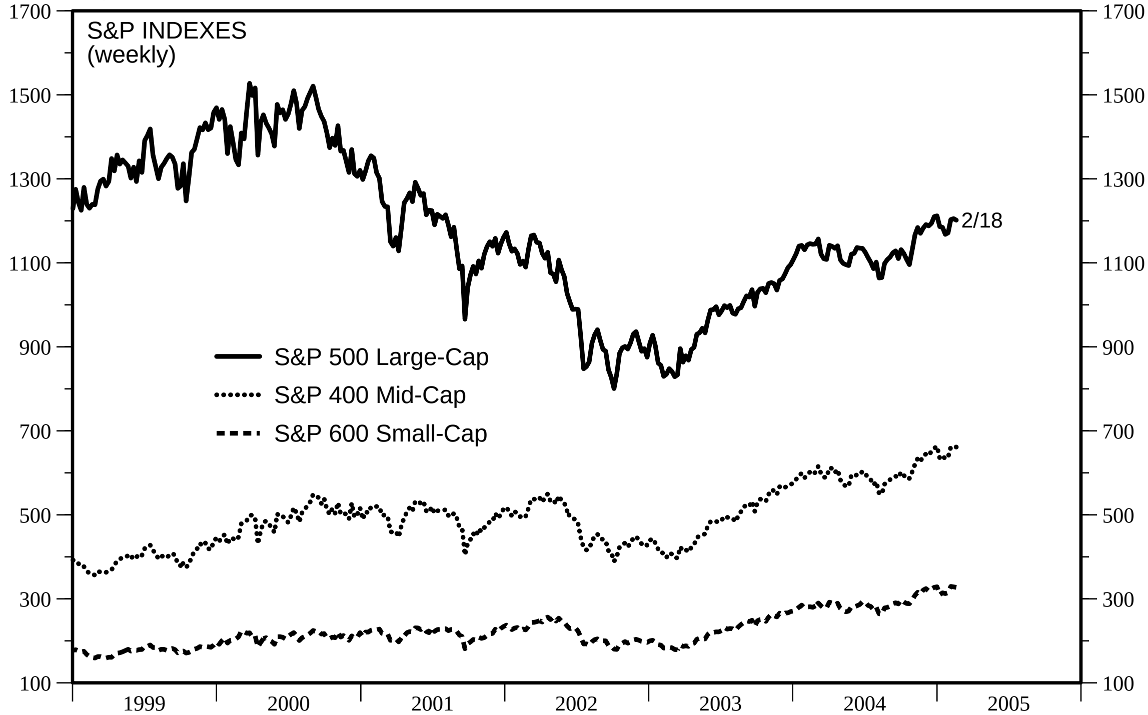


* 52-week forward consensus expected S&P 500 operating earnings per share. Time-weighted average of current and next year's consensus forecasts.
Source: Thomson Financial.

- Market Cap: S&P 500, 400, 600 -

S&P Large-Cap, Mid-Cap, and Small-Cap are all on uptrends.

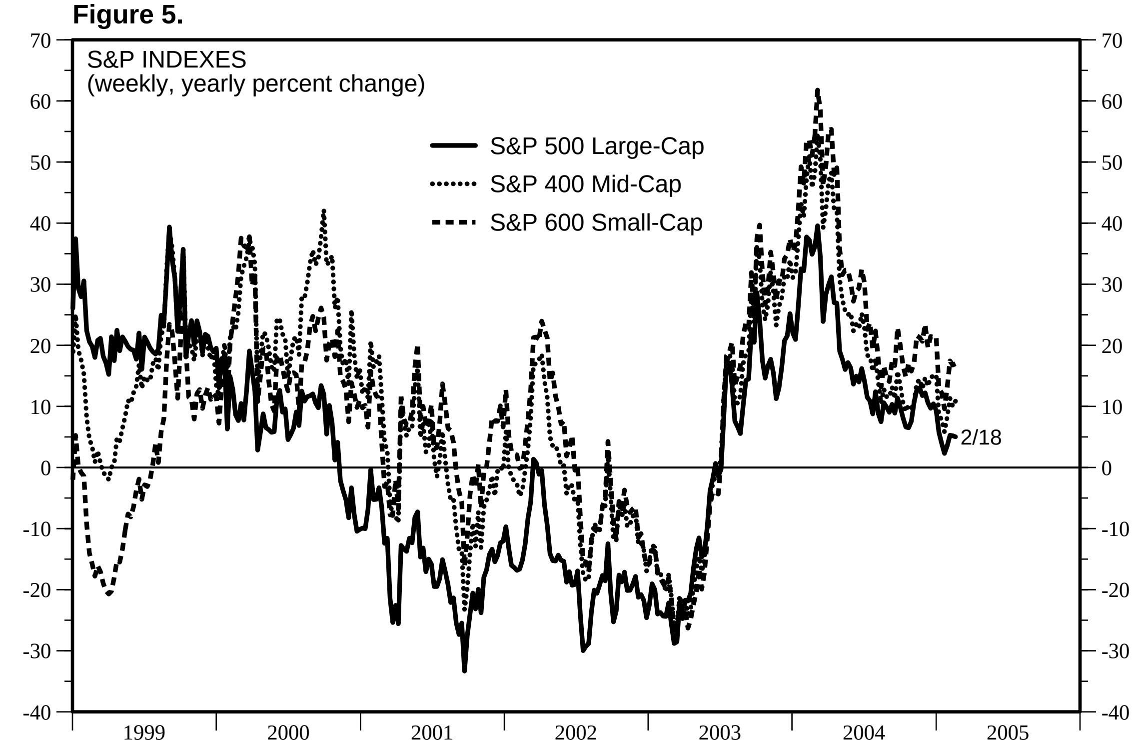
Figure 4.



Source: Haver Analytics.

S&P 500 underperformed S&P 400 and 600 last year. It should outperform this year.

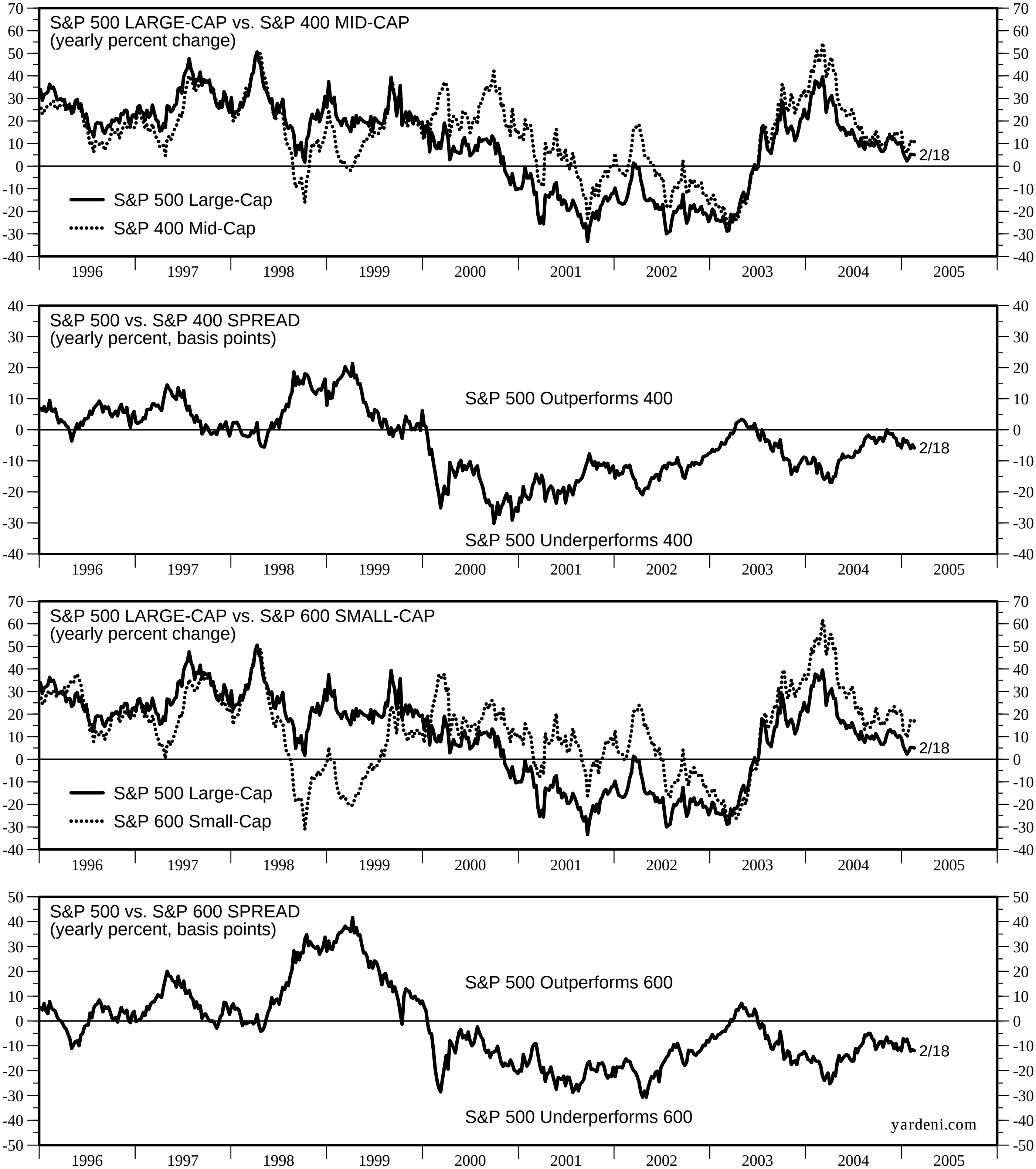
Figure 5.



Source: Haver Analytics.

- Market Cap: S&P 500, 400, 600 -

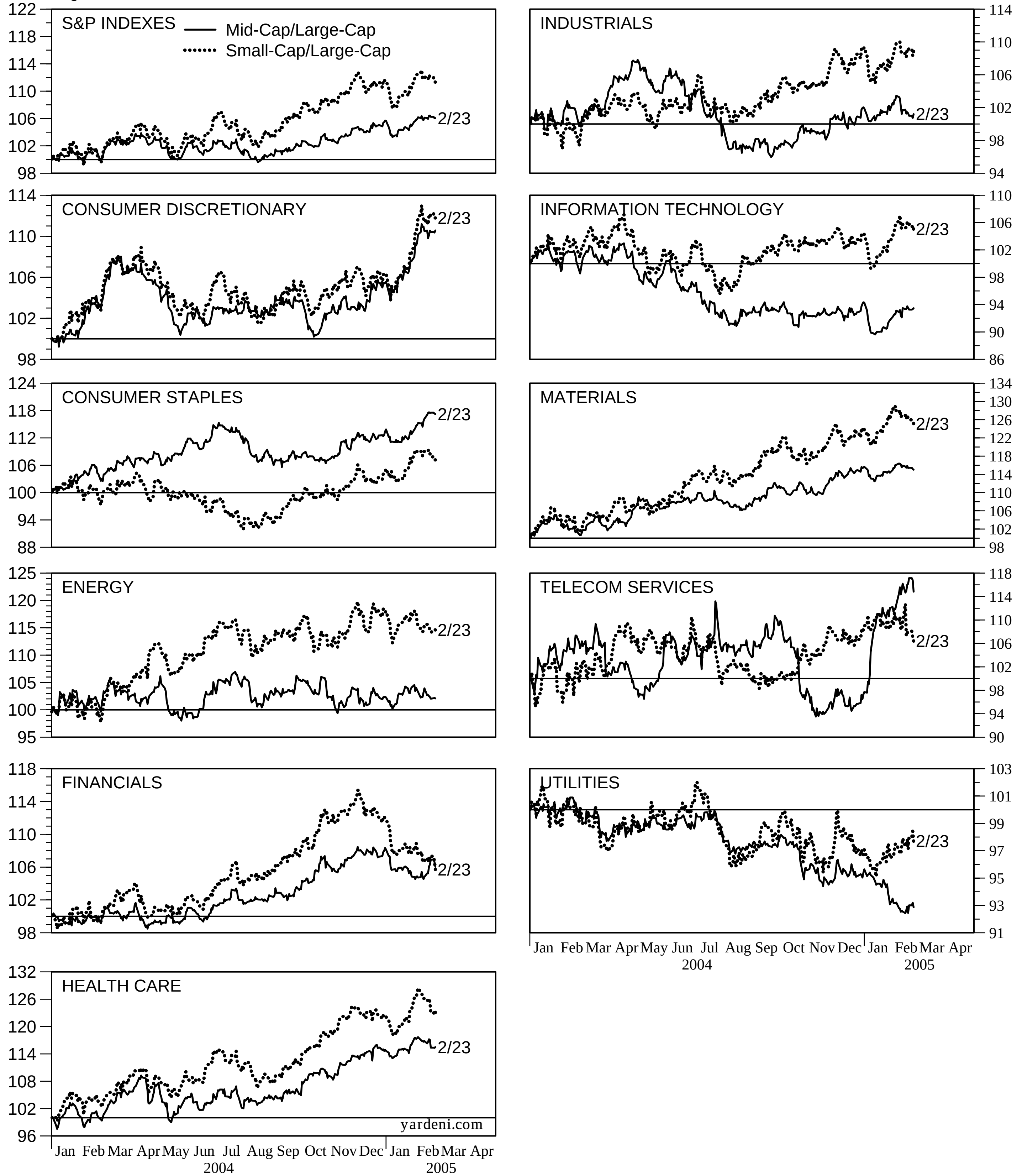
Figure 6.



Source: Standard & Poor's Corporation and Haver Analytics.

- Market Cap: S&P Sectors -

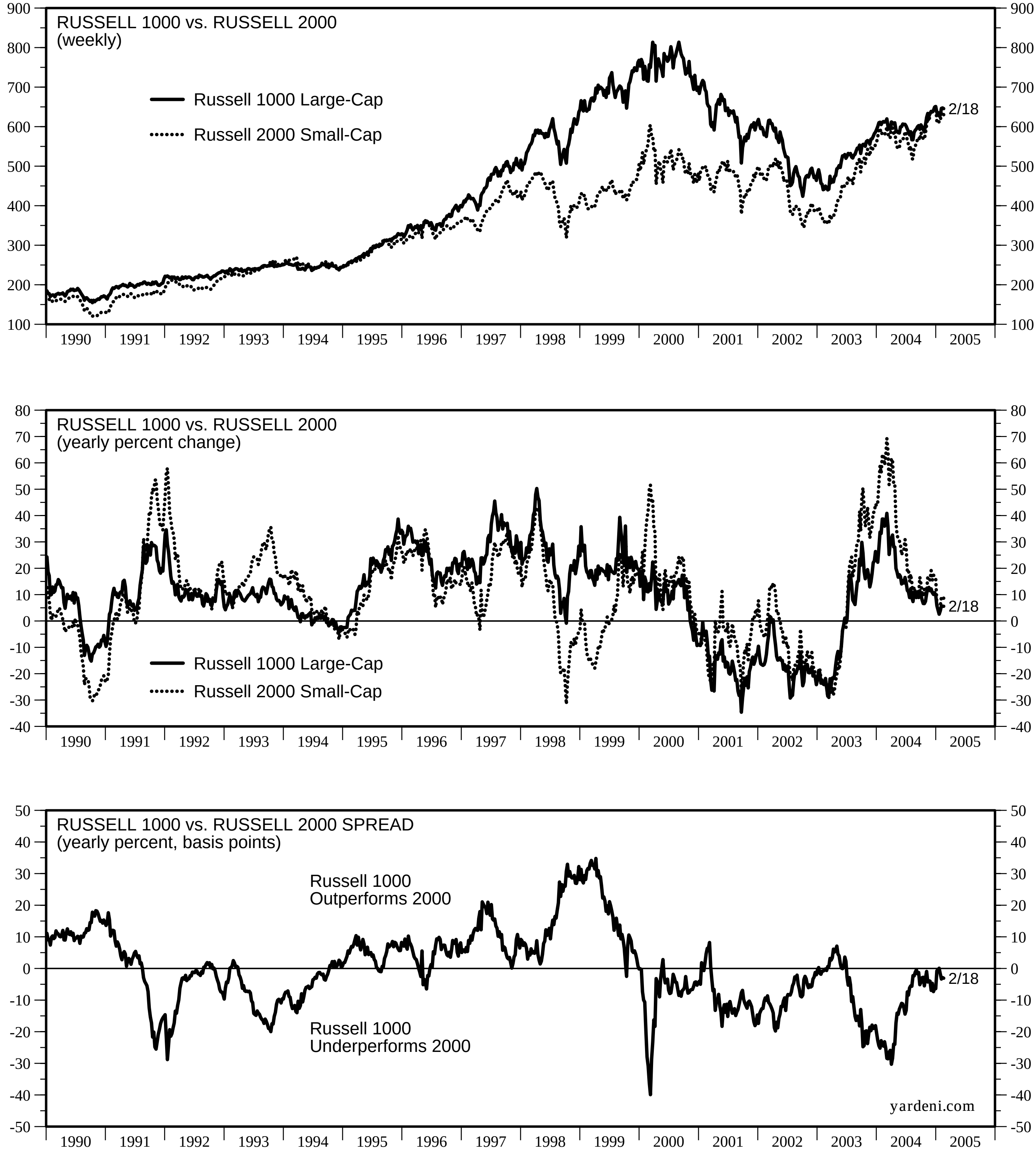
Figure 7.



Source: Standard & Poor's Corporation.

- Market Cap: Russell 1000 vs. 2000 -

Figure 8.

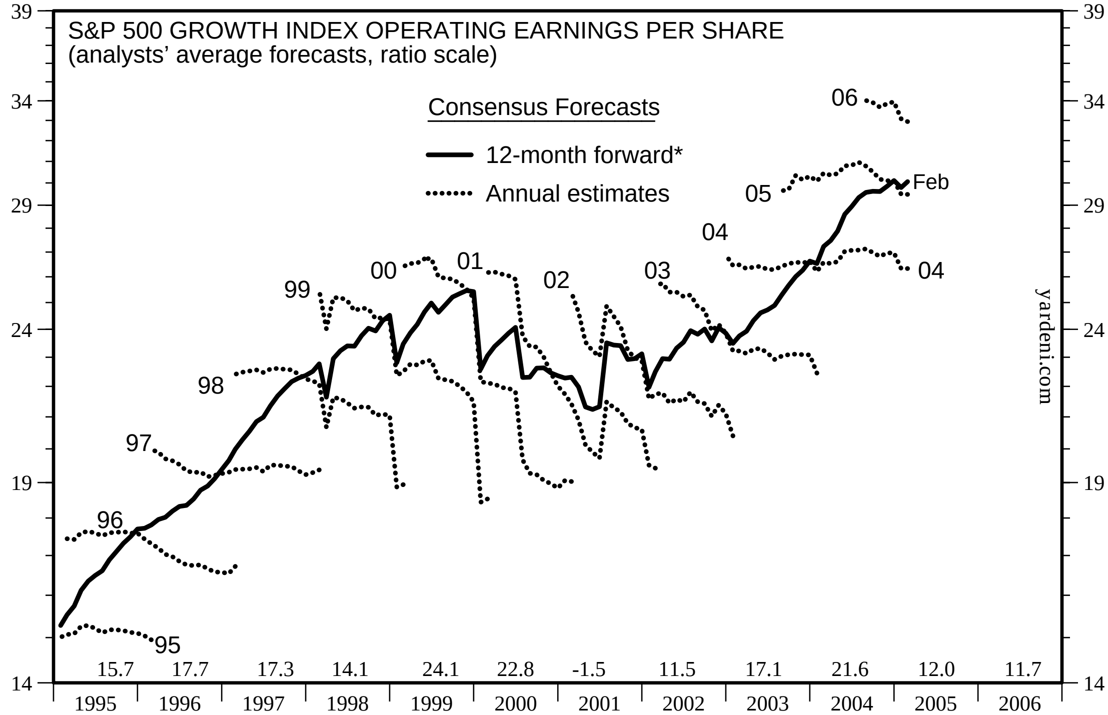


Source: Frank Russell Company and Haver Analytics.

- Growth vs. Value: Earnings Squiggles -

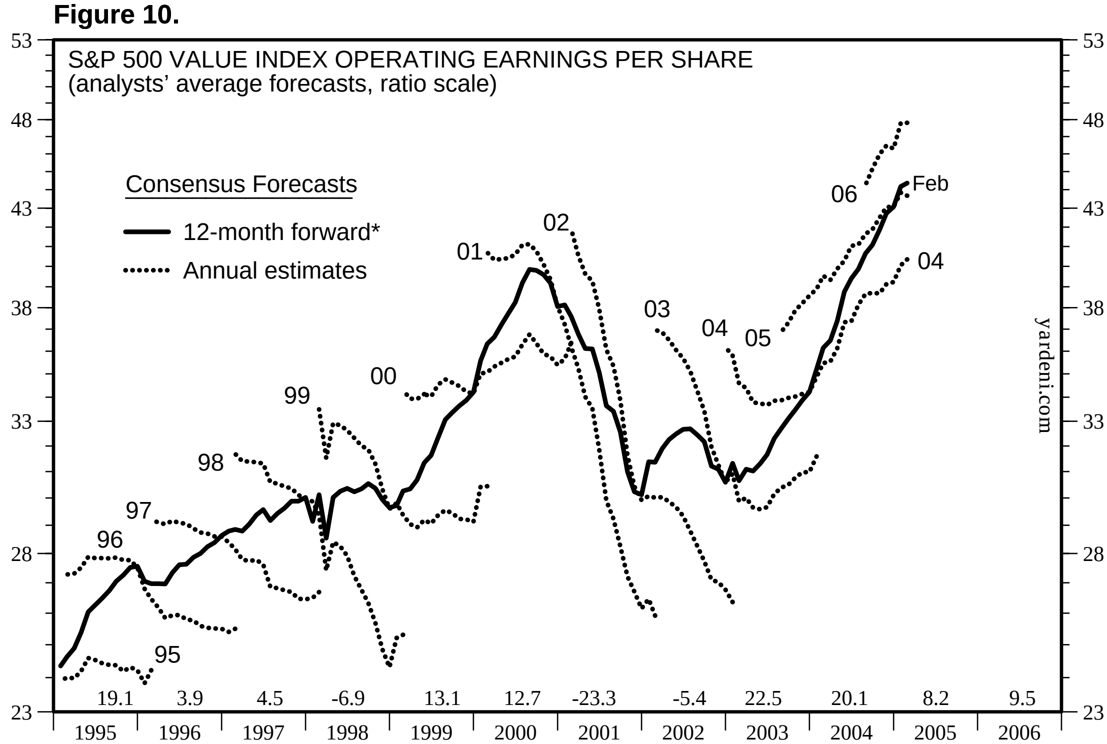
Forward earnings momentum is slowing for Growth, but remains on steep uptrend for Value.

Figure 9.



* Time-weighted average of current and next years' consensus earnings estimates. Numbers above time line are annual growth rates.
Source: Thomson Financial.

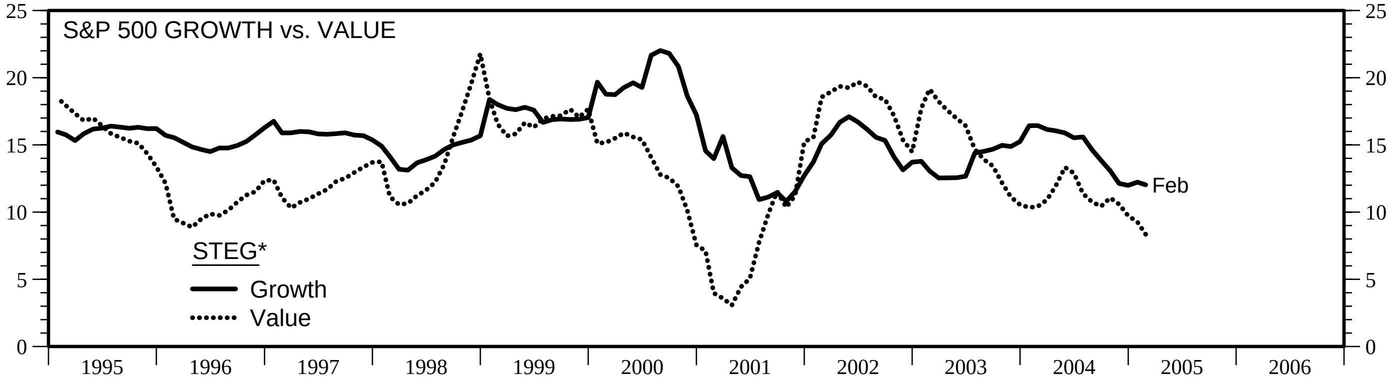
Figure 10.

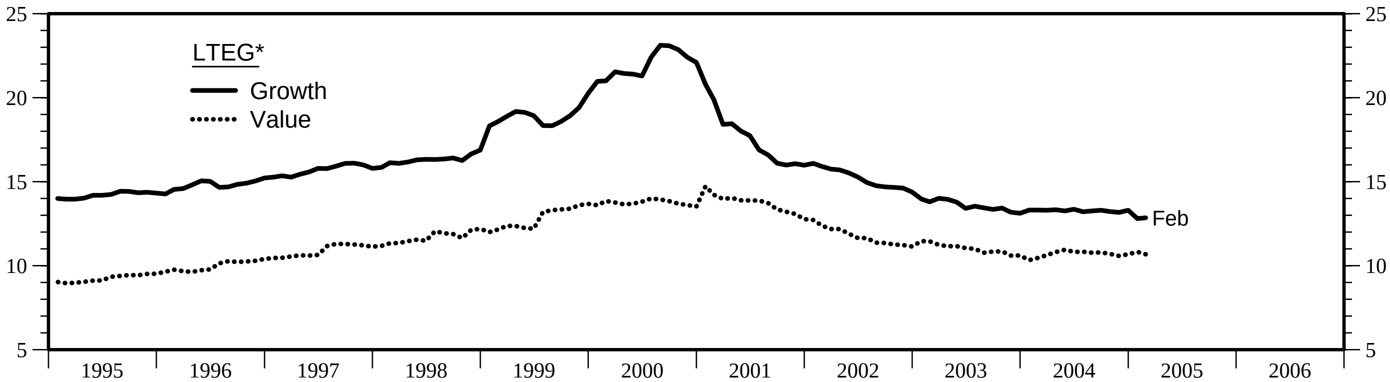


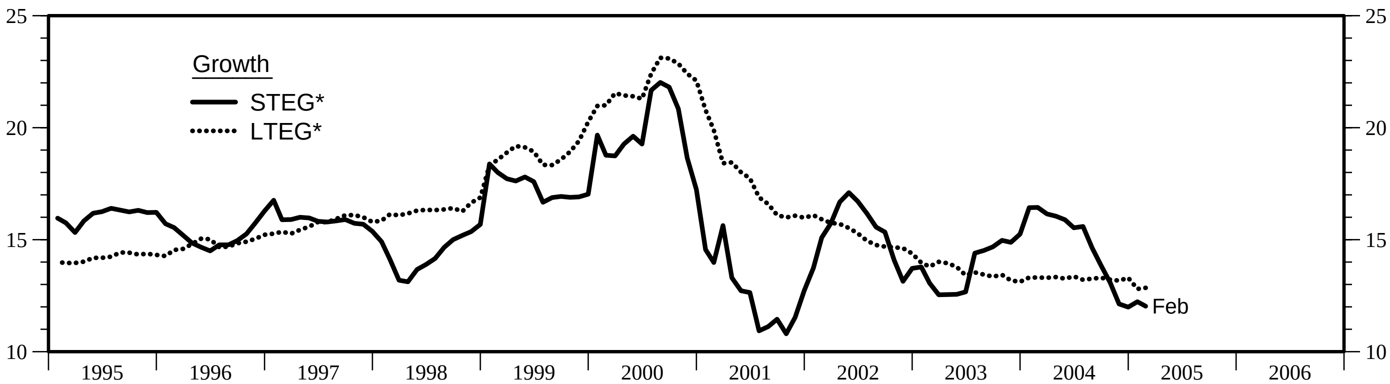
* Time-weighted average of current and next years' consensus earnings estimates. Numbers above time line are annual growth rates.
Source: Thomson Financial.

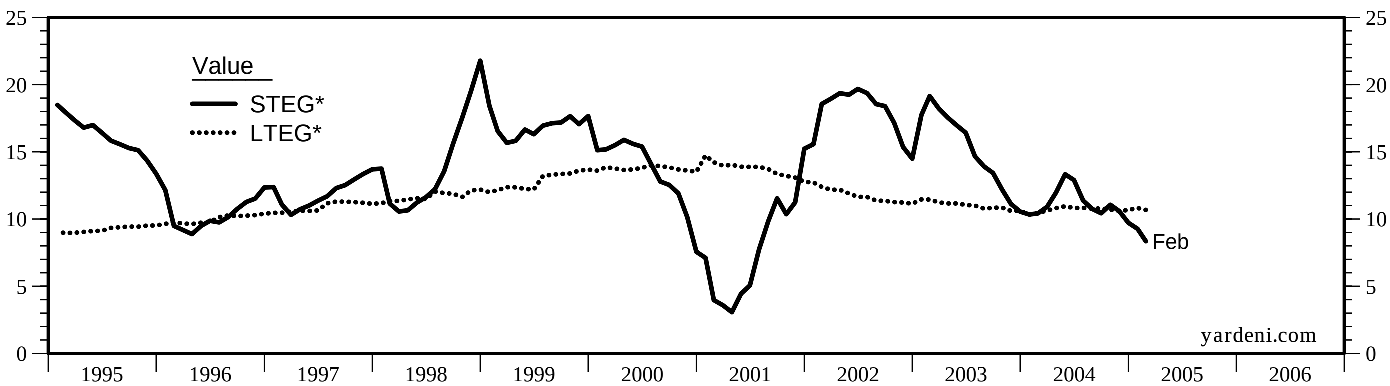
- Growth vs. Value: Earnings Growth -

Figure 11.









* STEG: 12-month forward consensus expected earnings growth.
LTEG: 5-year forward consensus expected earnings growth.
Source: Thomson Financial.

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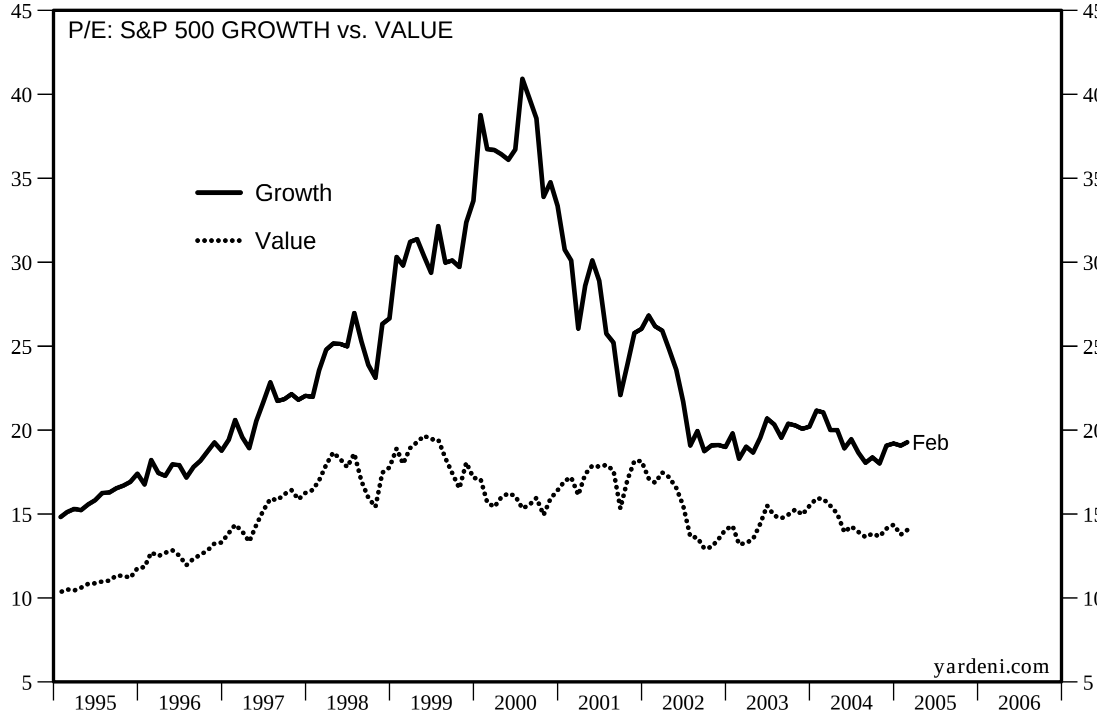
- Growth vs. Value: Valuation -

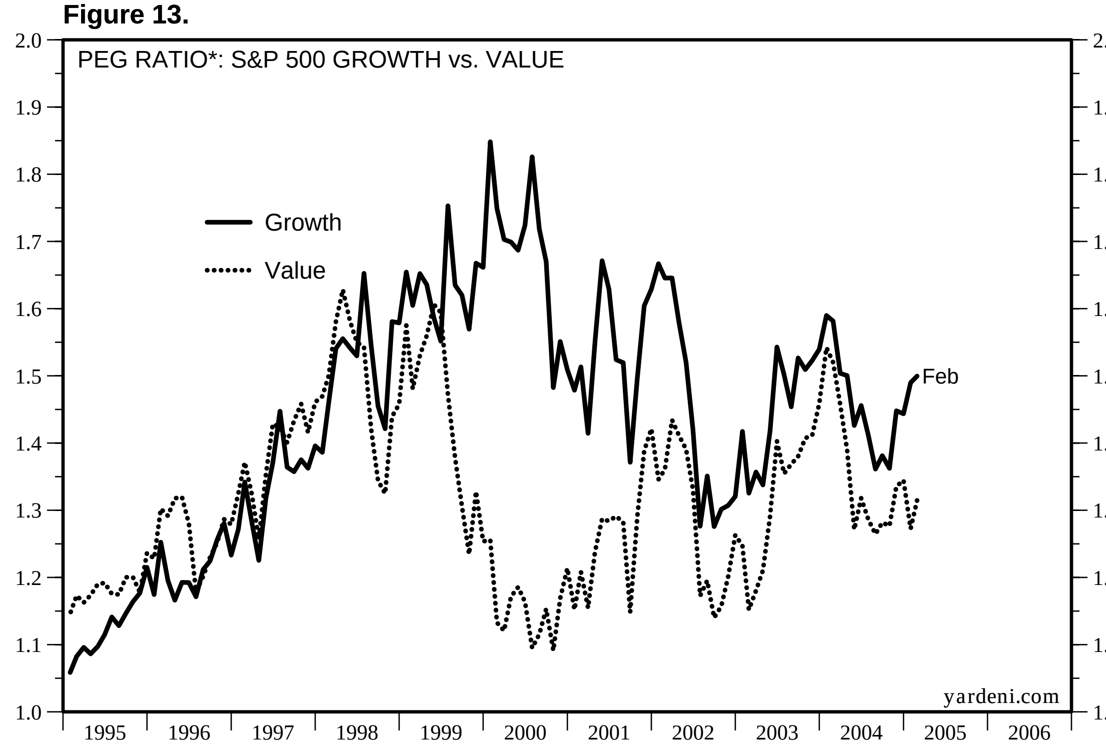
Figure 12.



* Using consensus 12-month forward earnings forecasts.
Source: Thomson Financial.

Growth valuation multiple now looks reasonable relative to Value, though Growth's PEG remains high.

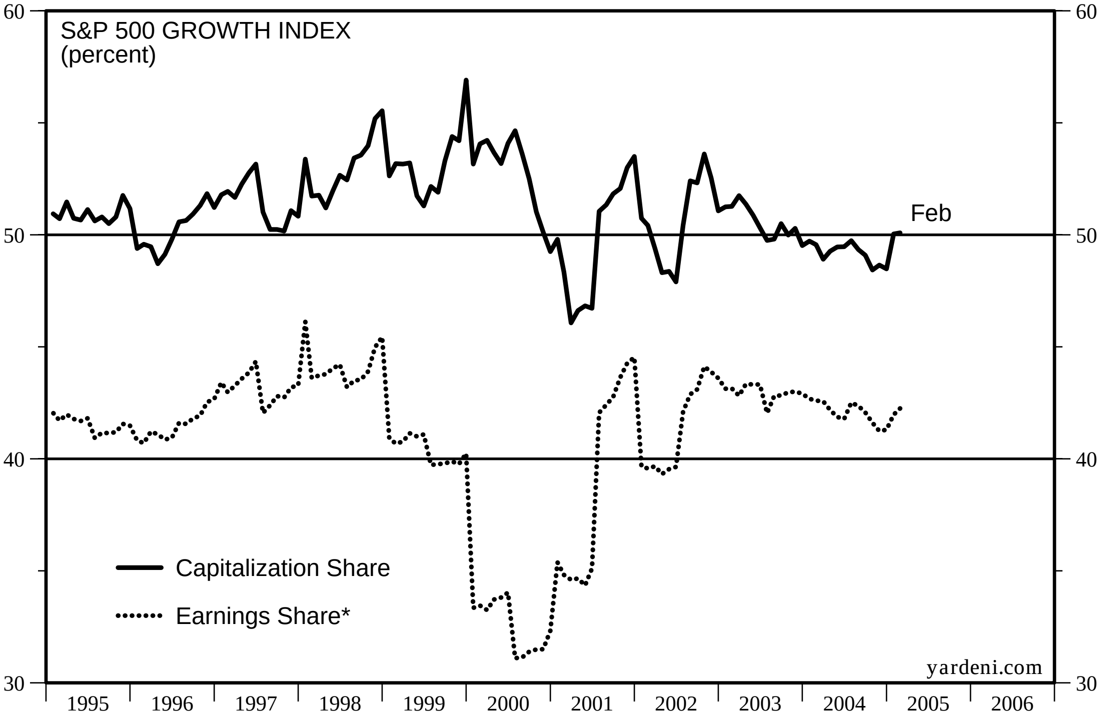
Figure 13.



* Using 5-year forward consensus expected earnings growth.
Source: Thomson Financial.

- Growth vs. Value: Market Cap Shares -

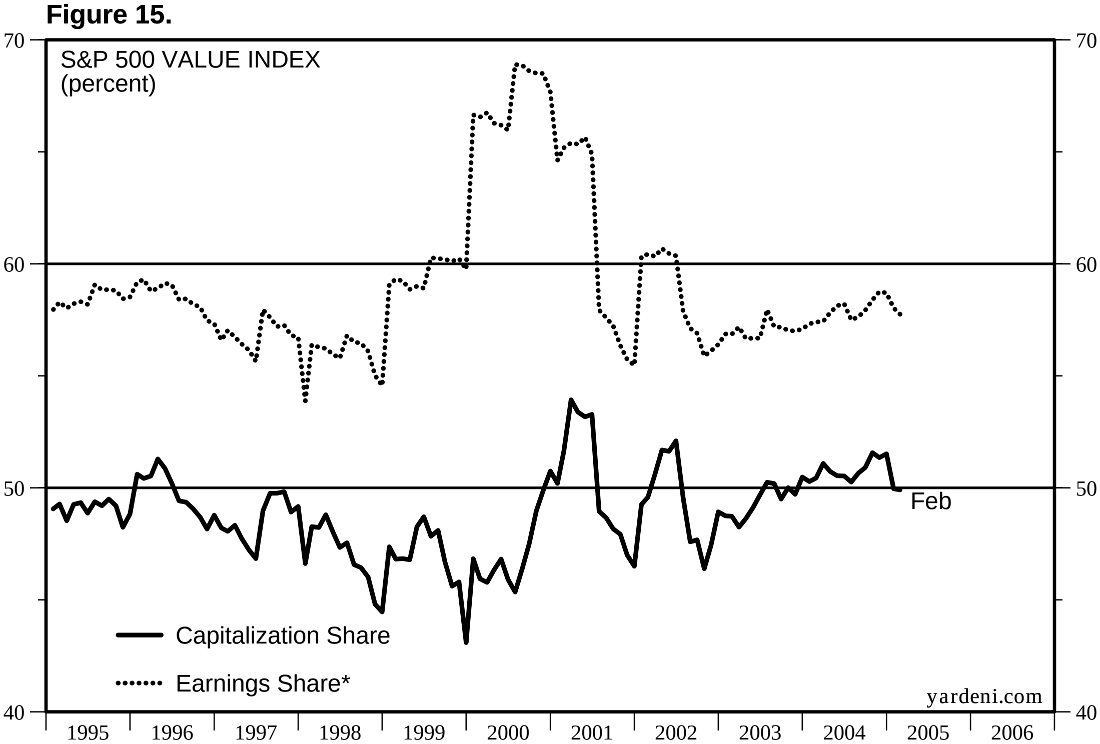
Figure 14.



S&P 500 market cap about evenly split between Growth and Value.

* Using consensus 12-month forward earnings forecasts.
Source: Thomson Financial.

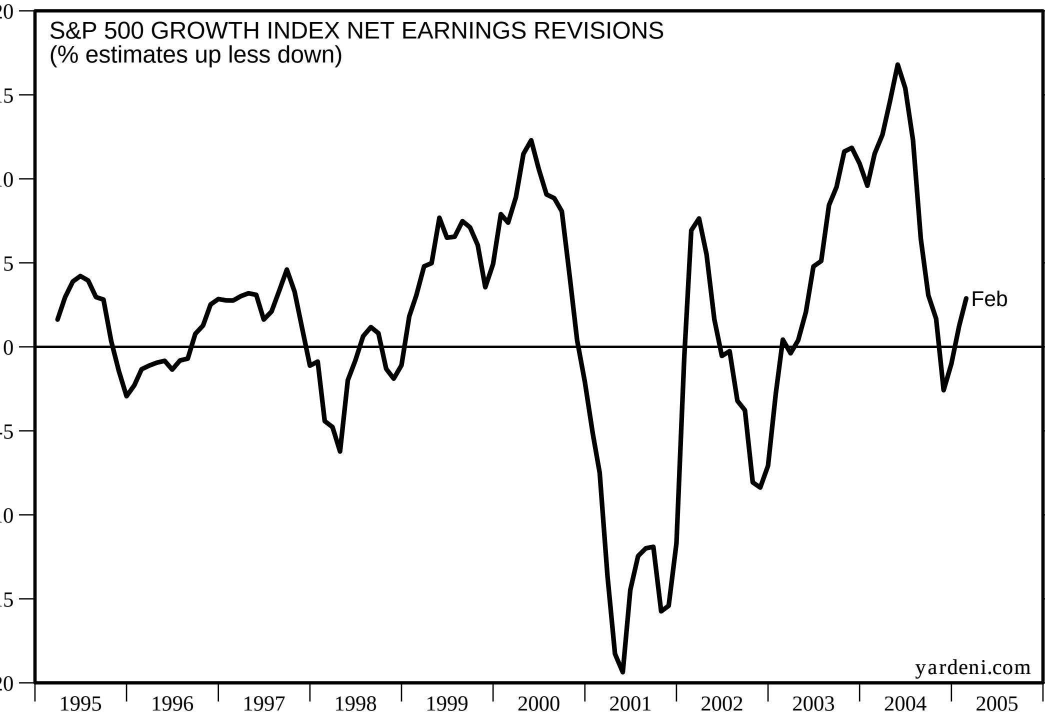
Figure 15.



* Using consensus 12-month forward earnings forecasts.
Source: Thomson Financial.

- Growth vs. Value: Net Earnings Revisions -

Figure 16.



* Three-month moving average of 12-month forward consensus operating earnings per share using mid-month consensus forecast.
Source: Thomson Financial.

Fewer upward revisions among both Growth and Value stock analysts.

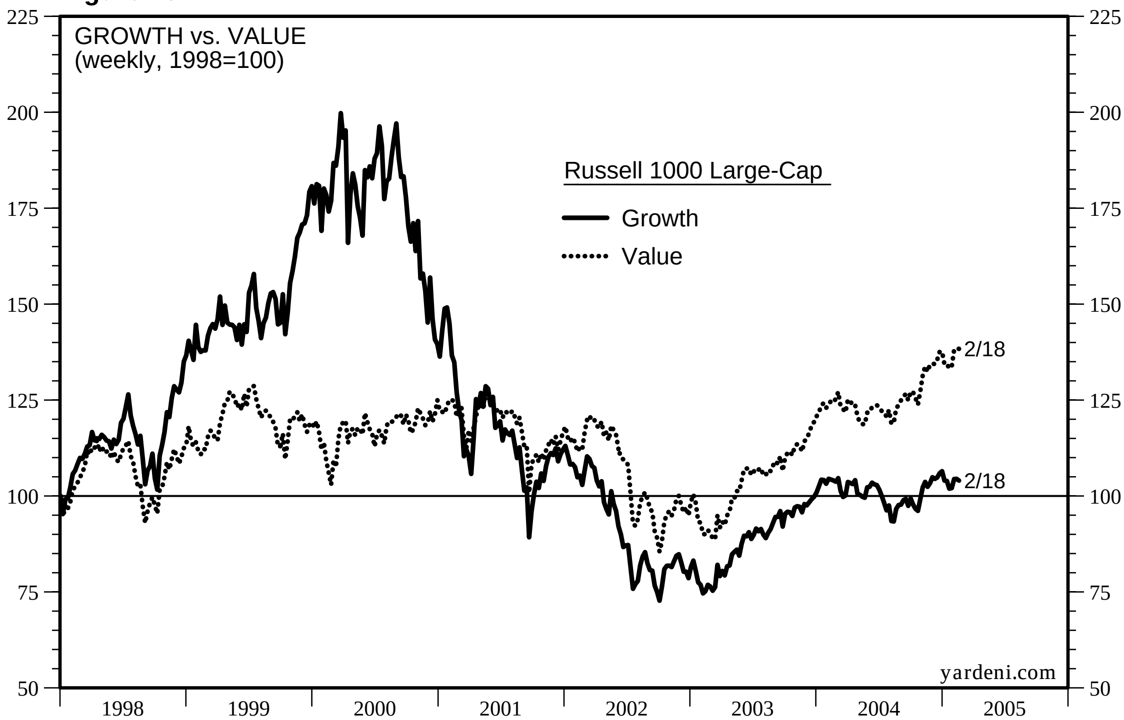
Figure 17.

* Three-month moving average of 12-month forward consensus operating earnings per share using mid-month consensus forecast.
Source: Thomson Financial.

- Russell Large, Small, Growth, Value -

Figure 18.

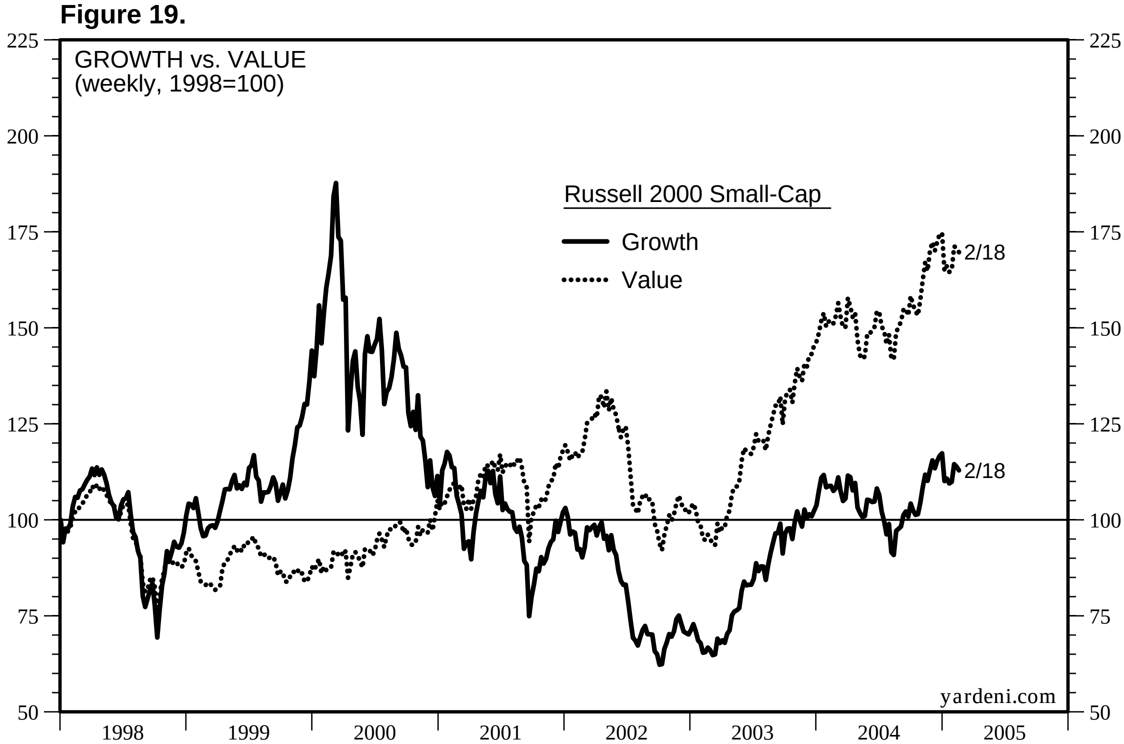
Large-Cap Value at record high. Large-Cap Growth is recovering but remains well below 2000 peak and below comparable Value index.



Source: Haver Analytics.

Figure 19.

Small-Cap Value has outperformed Small-Cap Growth since late 2000.

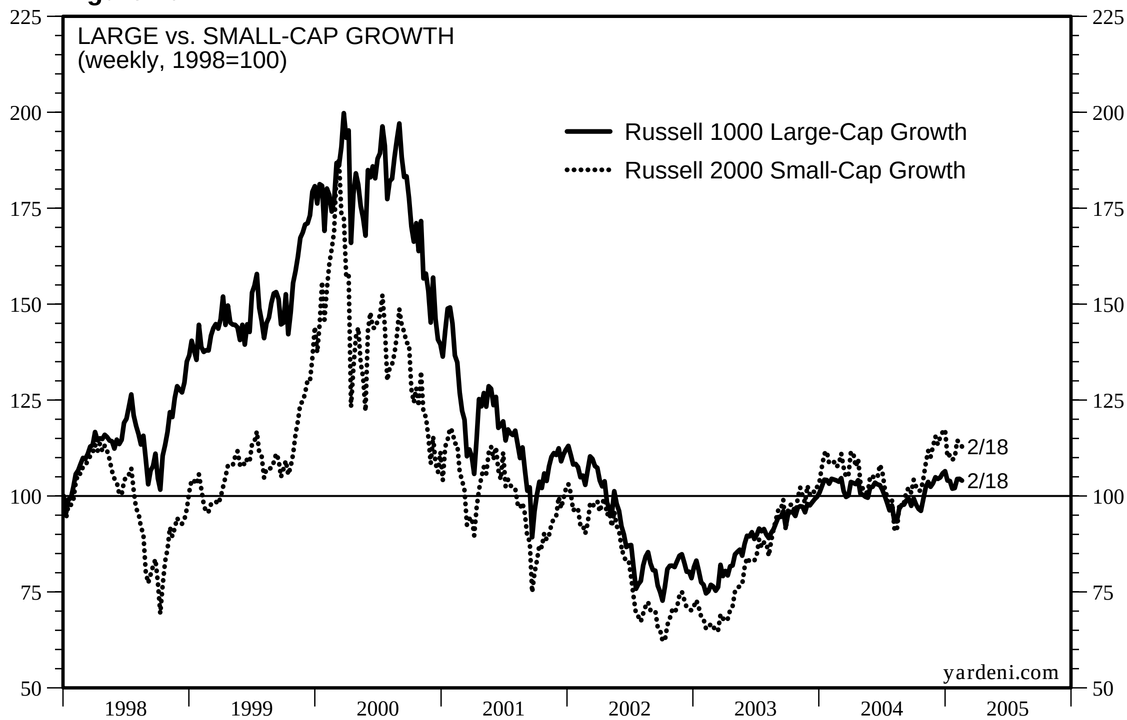


Source: Haver Analytics.

- Russell Large, Small, Growth, Value -

Small-Cap Growth and Large-Cap Growth in similar patterns recently. Both are near the tops of their one-year ranges.

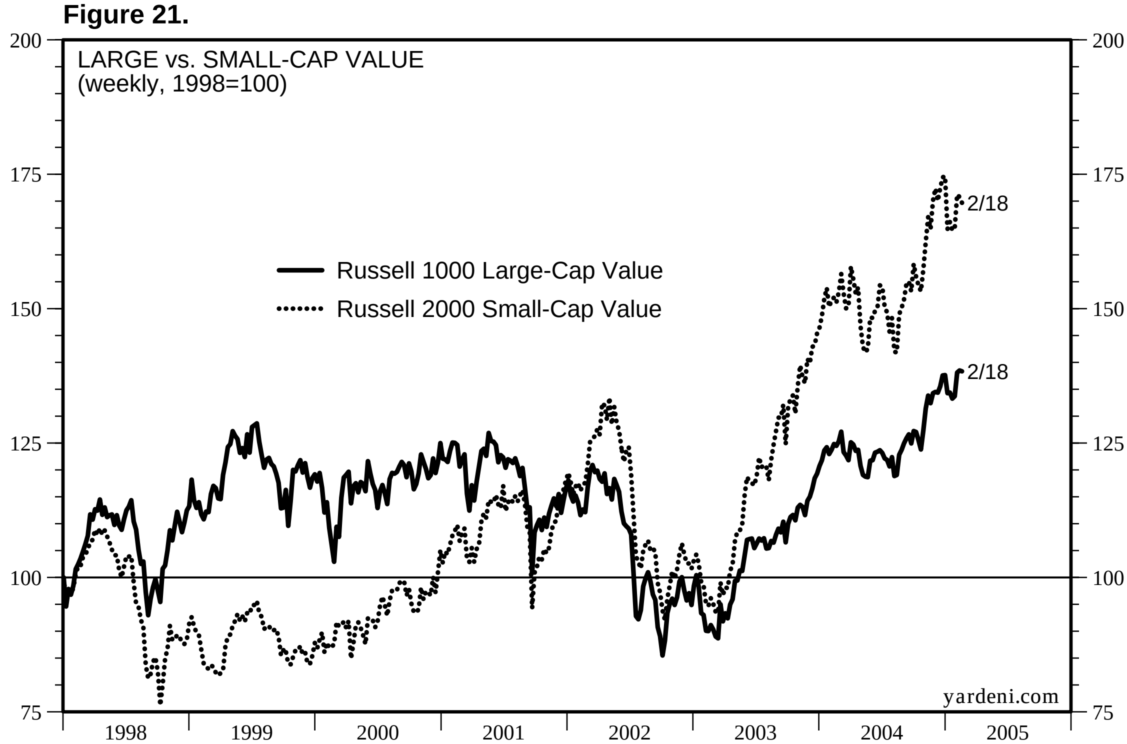
Figure 20.



Source: Haver Analytics.

Small-Cap Value has outperformed Large-Cap Value since early 2003. Both are at record highs.

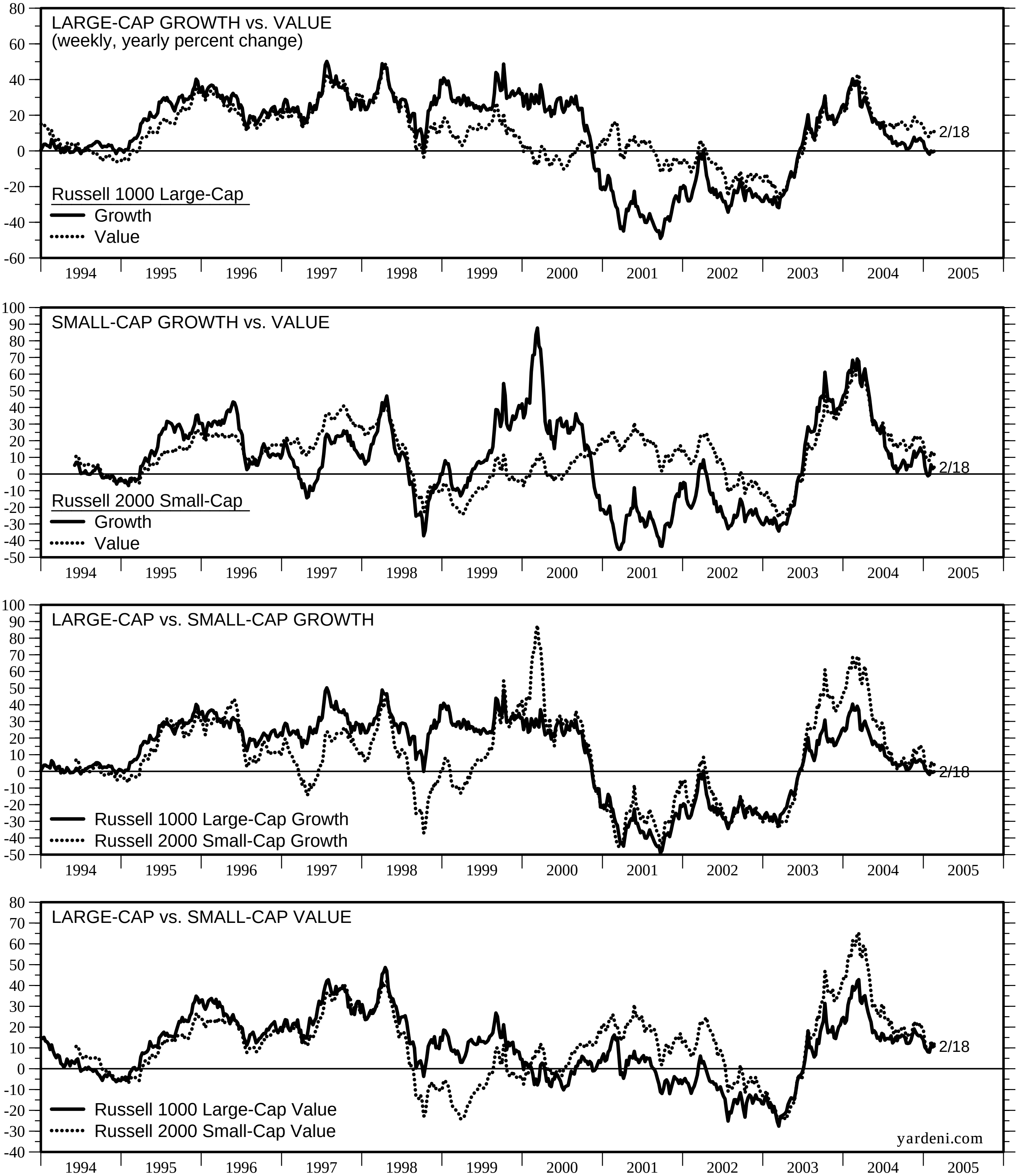
Figure 21.



Source: Haver Analytics.

- Russell Large, Small, Growth, Value -

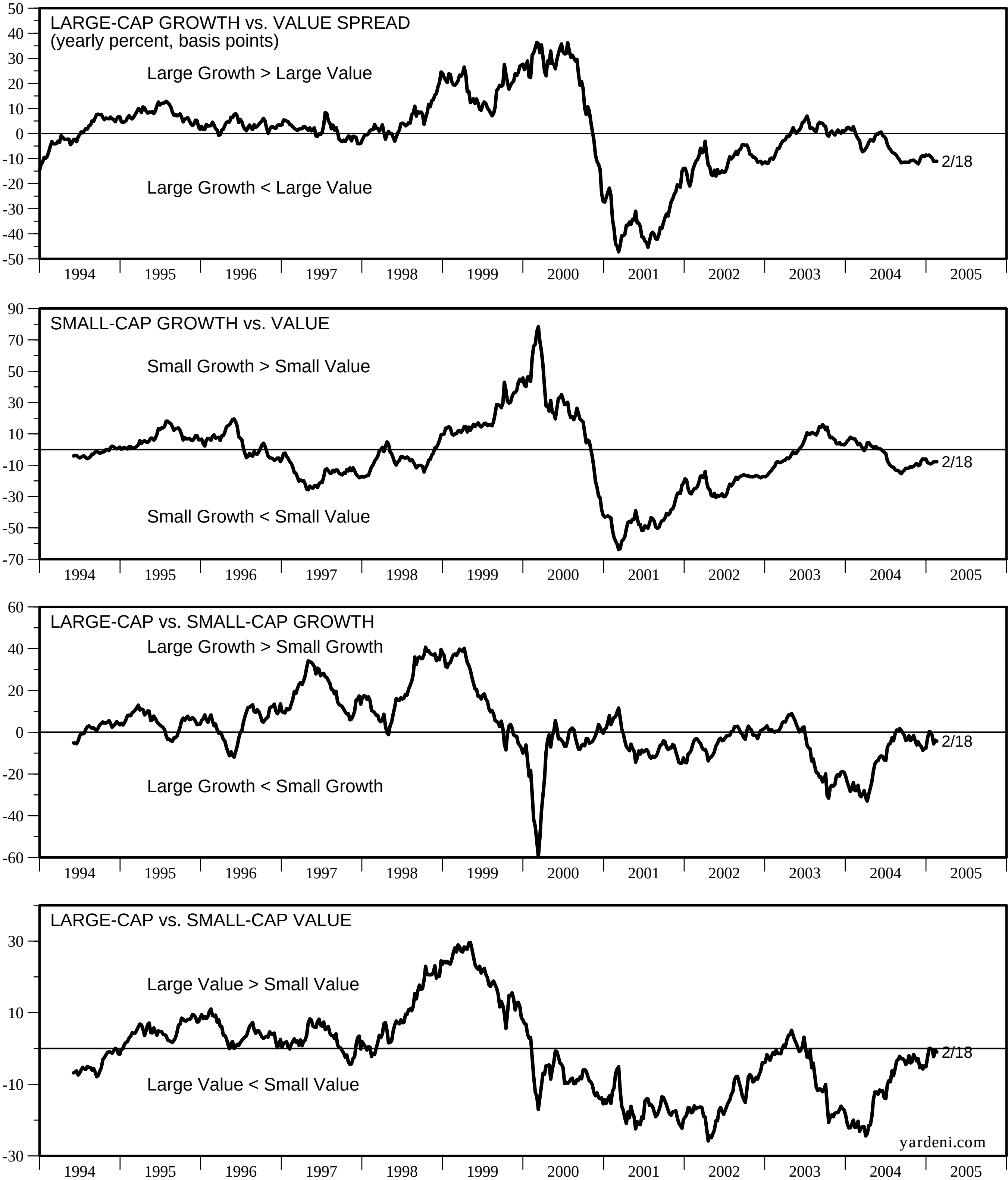
Figure 22.



Source: Frank Russell Company and Haver Analytics.

- Russell Large, Small, Growth, Value -

Figure 23.



Source: Frank Russell Company and Haver Analytics.

Additional Information Available on Request.