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The Value Premium

Newsletter: 2009-Vol.IV

Many investors are enticed by well-publicized 'growth' stocks as a way of accumulating wealth in their investment portfolios. Unfortunately, these stocks do not always lead to long-term positive outcome for these investors. Well documented research by professors Eugene Fama (U of Chicago) and Kenneth French (Dartmouth) point to a 'value premium in the performance of stock returns. The most recent research into the returns of growth versus value stocks points to a confirmation of this value premium.[1]

Let's first define growth stocks. Growth stocks typically represent companies growing their earnings (i.e. profits) faster than the industry average or the market as a whole. Growth stocks can also represent companies who are not earning profits yet, but are *expected* to provide their shareholders with strong profits in the future. During the tech bubble of the late '90s there were plenty of companies that never earned a dime, but were considered growth stocks based on the high, and often irrational, expectations of investors. Growth stocks also have high price/earnings ratios.

Value stocks are often very good companies that are earnings profits, but they have a lower price/earnings ratio than their industry average or the overall market. For these companies it is just a matter of lower expectations among investors that have kept its stock price lower than others in its industry or the overall market. There are some value stocks that do represent companies that are in severe financial distress. Hence, while value stocks may not necessarily be more volatile than growth stocks, they do tend to represent more risk.

Let's now turn to the data that supports the value premium. The following table represents returns from 1980-2008 and are taken from the average of two different Dow Jones indexes:

	Growth	Value	Value Premium
Large Cap Stocks	8.9%	11.4%	2.5%
Mid Cap Stocks	9.7%	12.5%	2.8%
Small Cap Stocks	8.4%	12.9%	4.5%

Let's put these numbers into perspective by using real dollars. The following table shows assumes that $10,000 was invested in 1980 and was left to grow until the

[1] Craig L Israelsen, Financial Planning, *The Value Premium*, June 1, 2009

end of 2008. The table shows how *much more money* an investor would have in each size category if the funds had been invested in value stocks instead of growth stocks:

	Value Premium
Large Cap Stocks	$113,000
Mid Cap Stocks	$161,000
Small Cap Stocks	$235,800

Hence, the value of the small cap value portfolio would total more than $339,000 while the small cap growth portfolio would have only been $103,200; a difference of $235,800.

During shorter time periods, such as a five-year period, there are no guarantees that value will outperform growth. But, if we look at 5-year rolling periods from 1980-2008, approximately 75% of the time value outperformed growth.

Does this mean that investors should exclude growth stocks from their portfolios? The answer to this is 'no', but as long as investors recognize the risks of investing in value stocks, particularly small cap value stocks, they may want to tilt their portfolio to value stocks for higher expected returns.

For additional information on putting together a proper investment plan for your future please contact Ken Weingarten at (609) 620-1770.