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A Tale of Two Markets

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Article Background

These essays were originally published in October 2001.

I have written in past newsletter articles about the value style of investing and the growth style of investing. In a nutshell, value investors look for companies with high quality of existing business and good prospects but where for some reason, the stock is simply not popular at the moment. The low stock price is an opportunity for a *bargain*. Extreme value investors look for companies where they can, buy company assets for say 50c on the dollar. Growth style investors, on the other hand, put more emphasis on future rapid growth in sales and profits. They hope that high growth will be maintained for many years. They don't mind paying a very high price for a stock today on the grounds that future growth will make it worthwhile.

Value investing works (it is the style of history's greatest investors, and most wealthy individuals). One reason it works is because a company's stock price is determined as much by the market *expectations* as the actual fortunes of the company. For example, if a reasonably good company whose stock price is out of favor (a value stock) turns out to do better than the market expects, then the stock price tends to do very well. (And if it doesn't, the investor often loses less because the stock price was on the low side to begin with)

Pure growth investing is very dangerous because the stock price is usually not well underpinned by current business. The optimism that carries the stock upwards is simply an emotion based on expectations for future success, and when the hoped-for profits fail to materialize, sometimes by only a tiny bit, the emotion turns to pessimism. With the optimism no longer holding the stock up, the price is hammered. Growth investing is doubly dangerous because the stock price can rise for a long time and to great heights based only on this optimism, which makes the stock appealing to neophytes.

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Back to the story. As you may be aware, the major stock market indexes (TSE 300, S+P 500, Dow 30 and so on) are down significantly from their highs of March 2000. The S+P 500, an index of 500 US stocks is down almost 40% (at early October 2001). Yikes! The NASDAQ index is down by 75%. Major ouch!

Why is this happening? Because of the way indexes are calculated, the collapse of the high-priced growth stocks (Nortel and JDS each down by more than *90%, to 1/10 their highs*) is driving the indexes lower.

What about value stocks? The Frank Russell Company, an investment analytics and management firm in Tacoma Washington, calculates indexes for both growth and value stocks. Grabbing an old newspaper from my storage box shows what

the world looked like in February 2000:

Average annual rates of return
(Russell Canadian Index)

	February 2000		
	1Yr	3Yr	5Yr
Growth Stocks	89%	28%	25%
Value Stocks	7%	3%	12%

Source: Globe & Mail 3/16/00

Value stocks seemed to be the mutts of the kennel at the time, even if the longer term performance was still excellent by anyone's (rational) standards. The 3 year value stock numbers show a low 3% per year return because of the bear market in 1998. Anyway, see how the world has changed to 2001:

Average annual rates of return
(Russell Canadian Index)

	August 2001		
	1Yr	3Yr	5Yr
Growth Stocks	-65%	-1%	+1%
Value Stocks	+9%	+17%	+13%

Source: Financial Post 9/17/01

This little table demonstrates that the value stocks have come through the current bear market handsomely. The 3-year returns are high at 17% because the 1998 bear market has

moved out of the 3-year numbers into the 4th year. Not only that, the 5-year returns, which still include the 1998 bear market, remain excellent by anyone's standards. So while the broad market indexes are being driven down by the mathematics of the collapsing high-priced growth stocks, the value stocks are doing just fine.

That, folks, is the 'Tale of Two Markets' (with apologies to Charles Dickens).

In closing, my clients know that I don't make forecasts, but I wouldn't be surprised if the major stock market indexes didn't go anywhere for awhile. The indexes still have many stocks in them at too high prices. As these stocks settle down to reasonable valuations, they will tend to hold the indexes back. But that doesn't mean that smart investors can't do well – you just need investment managers whose portfolios don't look like the indexes.

And that is why my client portfolios all have value stocks in them.

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