Classification Confusion: Understanding Equity Style

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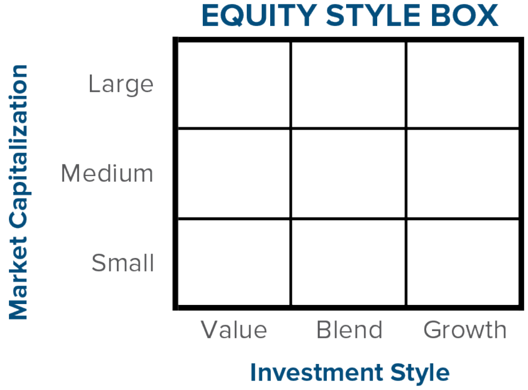
An important, but often, overlooked aspect of defined contribution (DC) investment lineups is the style of an equity fund. Defined contribution retirement plan investment menus typically offer an array of nine equity "style boxes" that allow participants to express their investment views and build diversified portfolios. There is no concrete textbook definition of "value" or "growth," and even market-cap categorization can be a point of confusion given the emergence of various indices. However, Morningstar categorizes stocks based on a mathematical formula and ranking system to determine whether a fund is value, growth, or core. While fund managers do not universally agree with the methodology, it does serve as a way to measure different fund managers.

MORNINGSTAR'S EQUITY STYLE BOX



While definitions vary, style considerations are important in the construction of retirement plan investment lineups. The investment options available to participants should provide them with the tools to build a diversified lineup or gain exposure to a certain asset class that they favor. Essentially, investment options ought to do what they say they will do.

VALUE VS. GROWTH

Value stocks are shares of companies that trade at a discount to their intrinsic value. As a result, they tend to have higher dividend yields and lower price multiples, such as price-to-earnings (P/E) and price-to-book (P/B). One approach to "value investing" includes identifying stocks that are discounted relative to other companies in the given industry. The discount for a stock may exist due to a short-term issue such as a weak earnings report or a negative headline related to a temporary issue like legal action or a public-relations concern. In general, value stocks tend to be mature companies with stable dividends and earnings. While it may seem that value stocks are less risky than their growth counterparts, this is not often the case. A value stock is discounted because the market is skeptical of the company's longer-term prospects; for example, perhaps the cause of the stock's depressed value becomes permanent or is worse than originally thought.

Growth stocks are shares of a company that exhibit high rates of earnings growth, sales growth, and book value growth. Often, growth stocks do not pay dividends or they have a low payout ratio. As a result, growth stocks typically have price multiples (i.e., P/E and/or price-to-cash flow (P/CF)) that are much higher than their value counterparts. These companies look to reinvest profits into research and development or other efforts that will further stimulate their growth. Investors in growth companies are looking to grow their wealth through capital appreciation. Conversely, value investors may not receive the same capital appreciation as growth companies, but they can accrue dividends. Growth stocks are most prominent in the technology, biotechnology, and consumer discretionary industries. Many companies in the growth space have unique products or services that drive their growth. The risk with growth companies is that they often have only one product or a narrow product offering on which investors are relying to have strong demand in the future. Weakness in earnings or industry disruption can hurt the stock price.

In addition to value and growth, some funds are considered to be core (also known as “blend”). A core fund exhibits both value and growth traits and cannot be definitively defined as one or the other. For example, a mid-cap growth fund will not typically hold all mid-cap growth stocks. However, that fund is likely to purchase only stocks in the mid-cap growth universe. Over time, they may appreciate and grow into large-cap stocks. For this reason, mutual funds are categorized based on the average characteristics of their holdings.

UNDERSTANDING STYLE DRIFT

Asset managers do not always view style in the way Morningstar defines value or growth. Typically, a fund’s strategy and stock purchase parameters will lead it to stocks that fall within the style universe in which they aim to be. For example, a mid-cap growth fund will not hold all mid-cap growth stocks. However, that fund will typically only purchase stocks in the mid-cap growth universe. Over time, they may appreciate and grow into large-cap stocks. For this reason, mutual funds are categorized based on the average characteristics of their holdings.

Style drift refers to an investment strategy being inconsistent with its style, and thus moving around the style box over time. Ideally, a strategy will not exhibit much style drift. While the performance of value stocks and growth stocks is similar in the long run, in the short-term, they often exhibit differing return patterns. Participants looking for specific style exposure from an investment option will want that option to be true to its stated style. If it does not, the performance of the fund may not meet the participant’s expectations. For example, consider a participant who purchases a small-cap value fund hoping to capitalize from a rally in that asset class. If that asset manager drifts too much towards core or growth, and the small-cap value rally materializes, the participant will miss out. For this reason, plan sponsors and retirement plan advisors are sensitive to style.

WHAT RETIREMENT PLAN INVESTORS NEED TO KNOW

Many investors are questioning the current run that growth stocks have experienced relative to their value counterparts. There have been periods in the past year where value has outperformed (such as Q4 2018), but these were short-lived and always eclipsed by a growth rebound. Generally, value does better coming out of a recession, therefore, it may take until the end of the current business cycle for value to persistently outperform. Technology stocks with high-flying growth rates have attracted a lot of investment and have helped drive the outperformance of growth style stocks, especially since the current economic expansion has not been as rapid as previous recoveries. Investors have preferred companies that can grow versus value companies. However, what will ultimately matter is whether investment managers are true to their own style.

Defined contribution plans aim to offer a concise, yet diversified, set of investment options allowing participants to build a portfolio reflecting their investment preferences in terms of equity style and market cap. Retirement plan investors should understand that both value and growth investing have their merits. Ultimately, it is difficult to predict what the market will prefer in terms of growth and value. Therefore, investors should be consistent and focus their investment strategies on the long term, rather than chase stocks that are in vogue, but do not meet their investment style.

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For more information on our services, please contact **Mike Volo,** Senior Partner, at **781.997.1426** or **mvolo@cammackretirement.com**.

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