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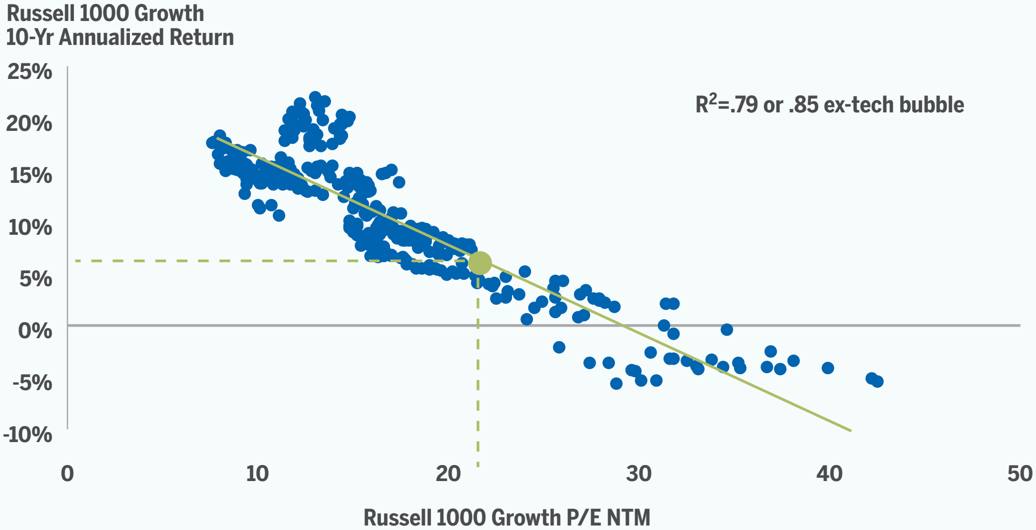
Alger On the Money
A View on the U.S. Market
LA FRANÇAISE

Growth Stock Valuations in Perspective

While higher valuations for growth stocks relative to the broader market cause some investors anxiety, historical data suggests current valuations may produce solid long-term annualized returns in the U.S. For example, as of the end of August the price-earnings ratio of the Russell 1000 Growth Index indicates a potential 10-year annualized return that we believe is attractive relative to our view of prospective fixed income returns, based on the historical relationship between valuation and long-term returns.

Aggregate Valuation Drives Long-Term Returns
December 1978 to August 2018



Source: FactSet. Each dot represents the P/E during that month and the returns generated over the subsequent 10 years. The starting P/E ratio is the price divided by the next 12-month earnings per share estimate at the start of each 10-year period measured. The tech bubble, represented by the 10-year returns beginning in April 1987-March 1990 and ending in April 1997-March 2000, skewed the regression by resulting in higher returns for given valuations than the historical relationship would imply.
Note: P/E is price-earnings ratio, which measures a stock's share price relative to its per-share earnings. NTM is next twelve months.

- R-squared, or the "coefficient of determination," denotes how much of the movement of one variable is attributable to another. In this case, nearly 80% of the Russell 1000 Growth Index's 10-year returns can be explained by the starting price-earnings ratio (P/E).
- Growth stock valuations are higher than those of the broad market as measured by the S&P 500 Index. There is good reason. Growth stocks have higher returns on capital, faster growth, and less debt (see p. 23 of the **Summer 2018 Capital Markets Presentation**).
- The higher absolute valuations of growth stocks can cause investors apprehension. Historically speaking, however, the current 21x P/E of the Russell 1000 Growth Index (as of 07/31/18) has been correlated with an attractive annualized 10-year return of approximately 7% shown in the above regression.

Inspired by Change, Driven by Growth.