Market Update
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RETHINKING STYLE DIVERSIFICATION

Daniel Chung, CFA

CHIEF EXECUTIVE OFFICER
CHIEF INVESTMENT OFFICER
PORTFOLIO MANAGER

Brad Neuman, CFA

SENIOR VICE PRESIDENT
DIRECTOR OF MARKET STRATEGY

Investors frequently blend value and growth stocks with other assets, such as bonds and real estate, to potentially improve the risk and return profiles of their portfolios. Since the performance of different types of assets or investing styles may not be correlated, the impact upon a portfolio of certain securities declining in value may possibly be offset by other securities generating gains. We believe that prudent diversification is important but based on the results of the past 10 or more years, we think the role of value equities in potentially improving a portfolio's risk and return profile should be reevaluated.

The issue is particularly timely because investors have made substantial investments in value stocks. Of the approximately $9.3 trillion in U.S. equity mutual funds and exchange traded funds, only $2.9 trillion is allocated to pure growth equities with the remainder of assets being allocated to value or blended portfolios, according to Morningstar data.

The strong emphasis on value investing, however, has yielded disappointing results. During the past 10 years, diversifying into value equities would have achieved the opposite goal of diversification—a portfolio with both lower absolute returns and a less attractive risk and return profile. Value equities dramatically underperformed during the 10-year period, a result, in part, of various flaws in the value "philosophy" in our view. First, there is a reliance on valuation metrics, which are often based on outdated accounting practices that form the foundation of the definition of "value." Second, and more importantly, investing according to "value" metrics tends to fail to appreciate the fundamental drivers of a company's business. Value companies may be the victims of "dynamic change" in our economy and their industries. As a result, investors in the value style category often are heavily skewed toward companies with legacy business models and stagnant management and product strategies.

Value investors thus become investors in areas such as brick and mortar retailing, print and TV advertising companies or oil and gas energy that in the real world, where business fundamentals of growth and innovation come first (not financial valuation metrics), are becoming victims of change: the disrupted not the disruptors. We believe this dynamic change is being accelerated by the Covid crisis as well as other ongoing trends and will continue to hurt the performance of value stocks.

Inspired by Change, Driven by Growth.

Value Stocks Disappoint

Value stocks have low prices relative to the value of their net assets, or book values, (price-to-book ratios) or earnings (price-to-earnings ratios). The financial media regularly explore the case for a value stock "comeback," which may fuel investors' preference for the category of equities. Oddly enough, it often seems that especially after periods when the value style of investing has underperformed, the chorus touting its merits strengthens. Publications may cite the "reversion to the mean" or the tendency for potential outcomes to return to averages over time. From 2009 through 2011, most articles that we found on the topic maintained that value stocks would outperform—for example, *The Wall Street Journal* October 2011 article "Why Value Will Outperform Growth"—though that didn't end up playing out as such.

Business and economic progress is not some mean-reverting process; it is more of a Darwinian one. Consumers did not "mean revert" to record players and cassette tapes after the CD and digital media were invented; they just left them—even as they bought the same content in a new form. Many companies were left in disarray as a result.

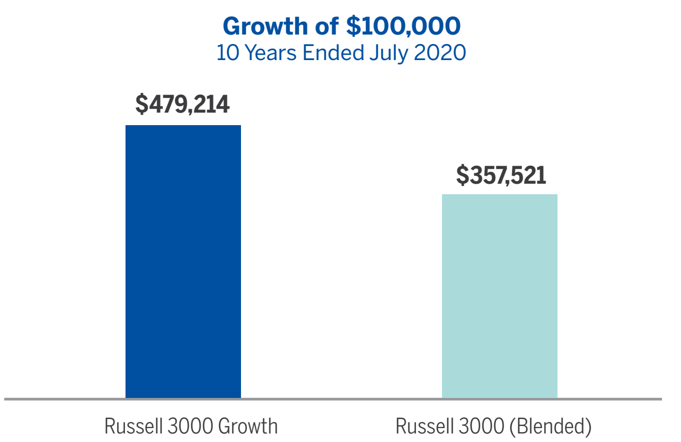
During the 10-year period ended July 31 of this year, value stocks generated an average annual return of only 9.9% as measured by the Russell 3000 Value Index compared to the considerably stronger return of 17.0% of the Russell 3000 Growth Index. This means that a diversified portfolio consisting of both value and growth stocks, as illustrated by the Russell 3000 Index, would have generated an average annual return of only 13.6%. Additionally, $100,000 invested in a blended portfolio would have grown to only $357,521 over 10 years compared to the considerably greater $479,214 that would have resulted from investing in a pure growth portfolio (see Figure 1). During the 10-year period, furthermore, growth leadership was consistent across large cap, mid cap and small cap equities.

Some investors may accept this underperformance in exchange for an improved risk and return profile but adding value stocks to growth equities failed to achieve that goal. Indeed, the addition of value equities would have subjected investors to greater declines in their portfolio values when markets retreated. Downside capture ratios, which simply measure the percentage of a market decline that a portfolio captures, illustrate this point. For example, a ratio in excess of 100% indicates that a portfolio has declined more than the market. For the 10-year period, growth stocks as measured by the Russell 3000 Growth index had an attractive downside capture ratio of 92% relative to the broad market as measured by the Russell 3000 Index. Adding value to growth stocks, however, would have increased the declines in portfolio values considerably with the Russell 3000 Value Index having a downside capture ratio of 109% (see Figure 2).

Value also disappointed during market rallies as measured by upside capture ratios, or the amount of market gains that an investment captures. The Russell 3000 Value Index had an upside capture ratio of only 91% compared to the strong 108% ratio of the Russell 3000 Growth Index.

Figure 1

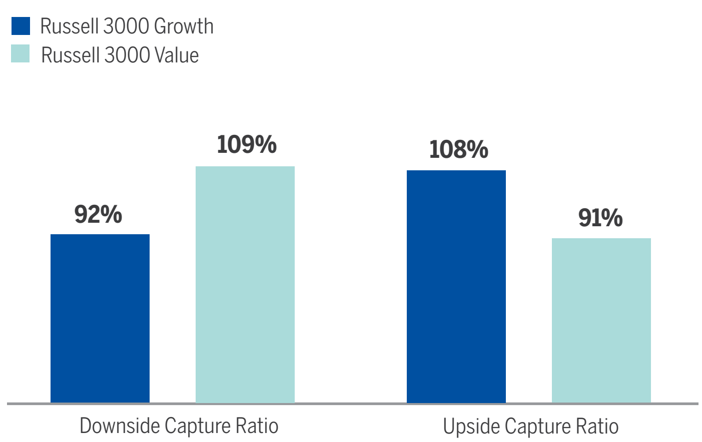
Growth Significantly Outperformed a Blended Index



Source: FactSet Research and Alger.

Figure 2

Value Disappointed on Upside and Downside



Ratios are relative to Russell 3000 Index during 10-year period ended July 2020.
Source: FactSet Research and Alger.

The failure of value equities to enhance a growth portfolio's risk and return profile is also illustrated by the Sharpe ratio, which measures an investment's return after considering the risk-free rate and an investment's standard deviation, or range or returns. In light of growth and value stocks having very similar standard deviations and growth stocks having much better returns, the Russell 3000 Growth Index had a Sharpe ratio of 1.15 compared to the Russell 3000 Value Index's considerably less attractive Sharpe ratio of 0.65 during the 10-year period. The Sharpe ratio that would have resulted from combining the two indices would have been 0.94, which is considerably less attractive than the ratio of just the growth index. The data illustrates that for the 10-year period, there was no benefit from diversifying a portfolio by adding value stocks to a growth portfolio.

Structural Changes Challenge Value Stocks

Businesses that are classified as value companies are typically cyclical or in highly commoditized and mature industries. Cyclical companies can potentially outperform during periods of economic expansion. As a result, some investors believe this is an appealing time to invest in value as our economy, however uncertainly and haltingly, recovers from the economic collapse triggered by Covid forced shutdowns. However, we think the market is much more nuanced than that. We certainly are looking closely with Alger's deep analyst team at "recovery" stocks, but we also note that the crisis has strengthened and expanded growth trends that were already successful before the Covid pandemic and, in many cases, we think will remain so even as this crisis fades in the years to come.

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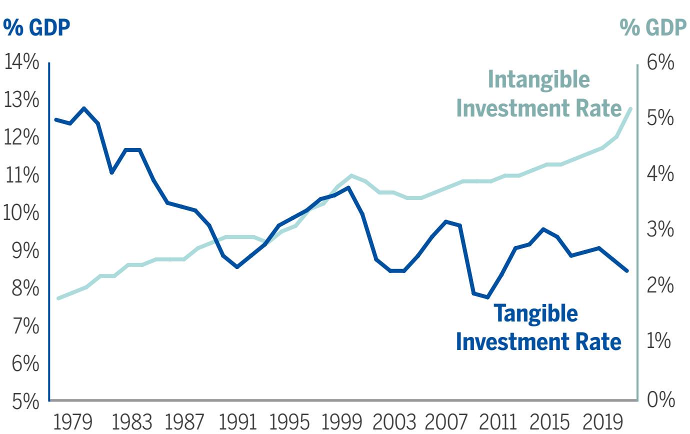
Figure 3

Tangible-Intangible Investment Rate



Source: U.S. Bureau of Economic Analysis and Alger.

Note: Intangible investment consists of intellectual property products and tangible investment consists of nonresidential structures and equipment.

Many of the companies we favor are industry leaders and disruptors by virtue of their investments in innovation. Unlike in the past, these investments are largely in technology and software to run their businesses (and those of others), not in factories or machinery. It is vitally important to recognize that accounting practices don't fully value intangible assets, so investments in research and development (R&D), software, patents, human capital, branding and algorithms are generally expensed and not capitalized. Consequently, earnings at such companies might be lower than at companies not investing in this way (i.e., resulting in a higher P/E ratio for the heavily investing innovator). Further, book value doesn't include the full value of intangible assets created by such investments versus those in plants and capital equipment. The P/B ratio, a key metric used by large benchmark providers in the classification of value and growth stocks, is obsolete in our view. This issue has grown more significant over the years due to increasing corporate investment in intangible assets. In 1979 investments in intangible assets represented just 2% of U.S. GDP. That has more than doubled to over 5%, while during the same time period, investment in tangible assets decreased from 12% to approximately 8% of GDP (see Figure 3).

These accounting issues may cause investors to inadvertently allocate capital based on business models—with more innovative New Economy companies, or those companies that utilize intangible assets, classified as growth irrespective of the true "value" they are creating in their business, while less innovative Old Economy companies that utilize tangible assets may be classified as value stocks. This practice may continue to be an incremental tailwind for growth investing and contribute to the underperformance of value.

Additionally, history suggests that the companies most directly impacted by a crisis are not the ones to lead the stock market in the eventual recovery. For example, while Financials briefly bounced off the bottom of the Global Financial Crisis, the sector generally underperformed for the next several years, from the fall of 2009 through 2015. Our view is that those industries that have been hurt the most by the pandemic, such as value groups like brick and mortar retail, airlines and hotels, are unlikely to lead the market higher over the next several years. We believe that the Covid crisis is accelerating the digital transformation that businesses and consumers are undertaking and has hastened the rate of investment in intangible assets, which is reinforcing the growth vs. value performance trend. From ecommerce to cloud computing and telemedicine to genetic testing and manipulation, the trends that have been in place have only been supported by the pandemic.

While traditional theory suggests there is a benefit from style diversification, the realities of the evolving economy suggest it may be time to re-think this concept. Indeed, investors may want to heed the last decade or more of data and construct portfolios around end-market diversification rather than style diversification, which is based on potentially outdated accounting and valuation relationships.

Daniel C. Chung, CFA
Chief Executive Officer
Chief Investment Officer
Portfolio Manager

Brad Neuman, CFA
Senior Vice President
Director of Market Strategy

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