SCHAFER CULLEN

CAPITAL MANAGEMENT

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MARKET COMMENTS

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VALUE VS. GROWTH

A QUESTIONABLE DISTINCTION

The new year has produced a debate in the financial press and among market strategists over value versus growth investing. About the subject, Charlie Munger, Warren Buffett's partner, recently said, **"The whole concept of dividing stocks into value and growth strikes me as twaddle. To me, all intelligent investing is value investing."** As portfolio managers, we agree with Mr. Munger. But for the investment planner who advises clients to allocate assets for diversification purposes, there may be some merit to the debate. Even here, though, there are some real questions about the distinction.

Why? First, mislabeling produces an overlap between value and growth stocks: Morningstar and Standard and Poor's, the best known firms categorizing stocks as one or the other, disagree a lot of the time. Second, the last time we checked, some of the stocks in the S&P BARRA Value Index had no earnings – hardly value by our definition. Equally important, the traditional equity categories for asset allocation between growth, value, small cap & international are misleading: **value is not so much an asset category as it is a discipline**. Value investors want to buy stocks, including "growth" stocks at attractive valuations, no matter how they are categorized.

For the long-term investor, a more useful and less subjective way to look at equities is to compare the rolling 5-year performance for the lowest P/E stocks (value) in the S&P 500 against the more popular, highest P/E stocks (growth). The study that follows shows the results of the comparison, which are overwhelming and surprised even us: **Value outperformed almost 90% of the time**.

THE RESULTS

S&P 500 Lowest vs. Highest P/E Stocks (1968-2005)

Rolling 5-Year Periods	Top 20% by P/E (Growth)	Bottom 20% by P/E (Value)	Value Outperforms	Growth Outperforms
'68 - '72	6.03%	**9.66%**	**+3.62%**	
'69 - '73	0.29%	0.00%	**- - - - - flat ***	**- - - - -**
'70 - '74	-4.31%	**1.11%**	**+5.42%**	
'71 - '75	2.71%	**12.44%**	**+9.73%**	
'72 - '76	2.44%	**17.81%**	**+15.38%**	
'73 - '77	-3.27%	**17.02%**	**+20.29%**	
'74 - '78	1.35%	**24.71%**	**+23.35%**	
'75 - '79	14.38%	**34.30%**	**+19.91%**	
'76 - '80	15.37%	**24.67%**	**+9.31%**	
'77 - '81	9.93%	**18.20%**	**+8.27%**	
'78 - '82	18.87%	**22.18%**	**+3.31%**	
'79 - '83	22.54%	**24.53%**	**+1.99%**	
'80 - '84	15.30%	**26.07%**	**+10.77%**	
'81 - '85	12.43%	**26.46%**	**+14.03%**	
'82 - '86	17.23%	**27.63%**	**+10.40%**	
'83 - '87	12.20%	**18.92%**	**+6.72%**	
'84 - '88	9.77%	**18.22%**	**+8.45%**	
'85 - '89	16.75%	16.29%	**- - - - - flat ***	**- - - - -**
'86 - '90	**8.57%**	6.14%		**+2.44%**
'87 - '91	**11.67%**	10.53%		**+1.14%**
'88 - '92	11.90%	**15.37%**	**+3.47%**	
'89 - '93	12.34%	**14.54%**	**+2.20%**	
'90 - '94	7.09%	**10.10%**	**+3.00%**	
'91 - '95	14.98%	**23.17%**	**+8.20%**	
'92 - '96	12.46%	**17.92%**	**+5.47%**	
'93 - '97	14.35%	**22.01%**	**+7.66%**	
'94 - '98	16.19%	**17.79%**	**+1.60%**	
'95 - '99	**21.84%**	18.22%		**+3.62%**
'96 - '00	**16.42%**	13.90%		**+2.52%**
'97 - '01	8.73%	**13.26%**	**+4.53%**	
'98 - '02	-0.26%	**4.74%**	**+5.00%**	
'99 - '03	2.62%	**12.14%**	**+9.52%**	
'00 - '04	1.53%	**16.01%**	**+14.48%**	
'01 - '05	3.01%	**15.39%**	**+12.38%**	
	ANNUALIZED RETURNS		AVERAGE OUTPERFORMANCE	
(37 Years) 1968-2005	9.27%	16.24%	**+8.87%**	+2.43%

** Flat = less than 1% difference* *Source: S&P Corp/FactSet Research/SCCM*

As you can see, not only did value outperform in almost all of the periods, but also outperformed by a substantial 8.9% a year. During the four

periods that growth outperformed, the difference averaged only 2.4% a year.

The worst two years for value were 1998 (value -2.3, growth +22.9) and 1999 (value +3.4, growth +26.8), when investors caught up in the tech bubble bailed out of value stocks. These two years resulted in the single worst 5-year period in the study for value (1995-1999) with growth +21.8 and value +18.2. Not bad for value's worst 5-year period, especially when one realizes that value outperformed in two of the next three 5-year periods that included 1998 and 1999.

Why Doesn't Everyone Use the Strategy?

In an earlier market letter, we did a study based on the advice of Ben Graham's sixty years of experience in the investment business. Graham recommended combining an investment discipline (Price/Earnings) with a long-term investment horizon (5 years). That combination produced extraordinary results, prompting the question, "Why doesn't everyone invest this way?" Our new study again raises the same question. One answer is that at any given time there is always a hot and seemingly irresistible area of the market which is exciting the press and investors. The table below shows how the hot-area phenomenon works in practice. The best performer over the 20-year span was value, *but it was only the best performer in 2 years*. For the other 18 years some other asset class was getting all of the headlines.

Ranked by Performance 1985-2004	Annual Performance	Number of Years **Best**	**Worst**
# 1 Large Cap Value	**+14.5%**	**2**	**0**
# 2 Foreign Stocks	+11.8%	6	7
# 3 Small Cap Stocks	+11.3%	6	6
# 4 Large Cap Growth	+ 11.1%	4	1
# 5 Bonds	+8.8%	2	6

Large Cap Value: Bottom 20% of stocks in the S&P 500 by P/E
Foreign Stocks: Morgan Stanley EAFE
Small Cap: Russell 2000 Small Cap Index
Large Cap Growth: Top 20% of stocks in the S&P 500 by P/E
Bonds: Lehman Brothers Aggregate Bond Index

The table suggests that investment planners certainly have their work cut out for them. All of the major asset classes tend to show big swings, and the swings are even bigger if the planner chooses to include gold, commodities and real estate among their clients' holdings. But the most significant problem facing investors is getting caught up in the headlines that create market euphoria and speculation. When this happens, price discipline goes out the window and stock prices are inevitably bid up to unsustainable levels. The result: the most popular stocks in any given year usually wind up becoming the worst performers a year or two later.

Asset Allocation

Our best/worst study demonstrates that the market is basically a coin flip on a year-to-year basis. However, diversification provided by the asset allocation process can be extremely valuable to help investors deal with the market's unpredictable short-term swings. As important, our work shows that the planner should also keep in mind the advantages of using a price discipline within the various asset classes he chooses for clients.

Summary

Rather than getting bogged down in the growth versus value debate, we believe time is better spent focusing on the most attractive stocks on a valuation basis (low P/E) that have good long term growth prospects regardless of the style. To stay the course, investors should resist the temptation to abandon a price discipline and chase the hot stocks.

Jim Cullen

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