

# Market Analysis, Research & Education

A unit of Fidelity Management & Research Company



Asset Class Update: U.S. Growth Stocks

## Equity Style Leadership Firmly in Growth Mode

### KEY TAKEAWAYS

- In the U.S. equity market, growth stocks have significantly outperformed value stocks so far in 2009, widening and extending a shift in style leadership that began in early 2008.
- Strong returns in the information technology sector boosted growth stocks, and poor returns in both financials and energy hindered value stocks.
- Growth stock valuations remain historically inexpensive relative to value stocks, and the current cycle of growth leadership could still be in its early stages.
- Investors should keep in mind that maintaining some exposure to both growth and value stocks can help minimize an equity portfolio's volatility over time.

Growth stocks are those of companies projected by analysts to have higher rates of earnings growth, and therefore are accorded higher valuations. Value stocks, on the other hand, tend to be those that trade at below-average valuations due to a company's current or expected slower pace of earnings growth relative to the broader market. When constructing a portfolio, style exposure can be an important consideration for investors because the magnitude of style performance leadership historically has tended to be significant over multi-year cycles. As such, being overexposed (or underexposed) to one style or the other can significantly influence the returns of a portfolio, regardless of whether you're an active or long-term investor.

### Spotlight on fundamentals

#### Sector exposure a key to style rotation

So far in 2009, the Russell 3000 Growth Index, a commonly used proxy for growth stock performance, has rallied 21%—well ahead of the 8% advance for the value-oriented Russell 3000 Value Index.<sup>i</sup> Why the sudden growth stock surge? A big reason is sector exposure. While growth and value stocks are found in every sector of the stock market, certain sectors historically have lent themselves to one style or the other. The Russell 3000 Growth Index has traditionally been more concentrated in the information technology and health care sectors. Today, these two sectors represent 31.5% and 17.5% of the growth index, respectively, but comprise a significantly smaller percentage of the value index (see Exhibit 1, right). That's an important distinction because the tech sector has been far and away the best-performing sector in 2009 (38.2% YTD vs. 13.0% for S&P 500 Index).<sup>ii</sup>

Tech stocks performed well because many larger companies have solid balance sheets and strong cash flows, a positive factor amid challenging credit-market conditions and a fragile economic backdrop.

Tech stocks also benefited from their perception as being both early cyclicals—meaning they tend to perform well in the early stages of a cyclical economic

#### EXHIBIT 1

##### 2009 Sector Weightings By Style

Sector	Growth	Value	Difference
Information Technology	31.5	5.7	25.8
Consumer Staples	15.3	5.6	9.7
Health Care	17.5	9.4	8.1
Consumer Discretionary	10.7	9.6	1.1
Materials	3.9	4.0	-0.1
Industrials	10.3	10.8	-0.5
Telecommunications	0.7	5.6	-5.0
Utilities	0.9	7.4	-6.5
Energy	4.2	18.0	-13.9
Financials	5.1	23.9	-18.8

Source: FMRCo (MARE) as of 7/31/09. 2009 weighting represents Russell 3000 style index weightings on 7/31/09.

recovery—and higher-beta investments—meaning their prices tend to move more drastically relative to the broader market. As the market rebounded sharply beginning in March on signs of economic stabilization, tech stocks soared. Other drivers: growing sentiment that corporate America may be inclined to increase tech spending to boost productivity; brisk sales of some innovative products; and increased merger speculation. For its part, the health care sector has returned 6.6% YTD.

By contrast, the two sectors that represent the biggest slices of the Russell 3000 Value Index—financials and energy—have advanced 10.2% and 4.3%, respectively, so far in 2009. Relatively weaker returns from these two sectors, which make up roughly 42% of the index, were a major detractor. Many financial stocks suffered during the first part of 2009 and faced concerns about their capital adequacy and mounting loan losses. Meanwhile, the energy sector suffered from falling commodity prices (e.g. crude oil down significantly from 2008 peak; declining natural gas prices), which are highly correlated to earnings.

than growth stocks) is due largely to recent quarterly earnings growth declines in the financial sector—which make this sector look more expensive on a P/E basis. Based on analysts' forecasts of future earnings over the next 12 months, the earnings of financials and value stocks are expected to rebound in coming quarters, which would make value stocks once again cheaper than growth stocks. However, even on a forecasted P/E basis, growth stocks are currently valued at the lowest levels on record relative to value stocks. Other valuation metrics, such as price-to-sales and price-to-book ratios, show that growth stocks remain below, but somewhat closer to their long-term average valuations relative to value stocks.<sup>iii</sup>

### A look at style rotation

Historically, most style leadership cycles tend to last for periods of two or more years. For the bulk of this decade (nearly eight years), value had outperformed growth, marking the longest cycle of style leadership ever. Leadership shifted in favor of growth in late 2007, and growth has now outperformed value on a two-year rolling basis since February 2008 (see Exhibit 2, below right). However, during the past few months the magnitude of the leadership by growth stocks has re-accelerated and the style performance gap has significantly widened. Thus, it is possible that the current growth stock cycle may have room to run.

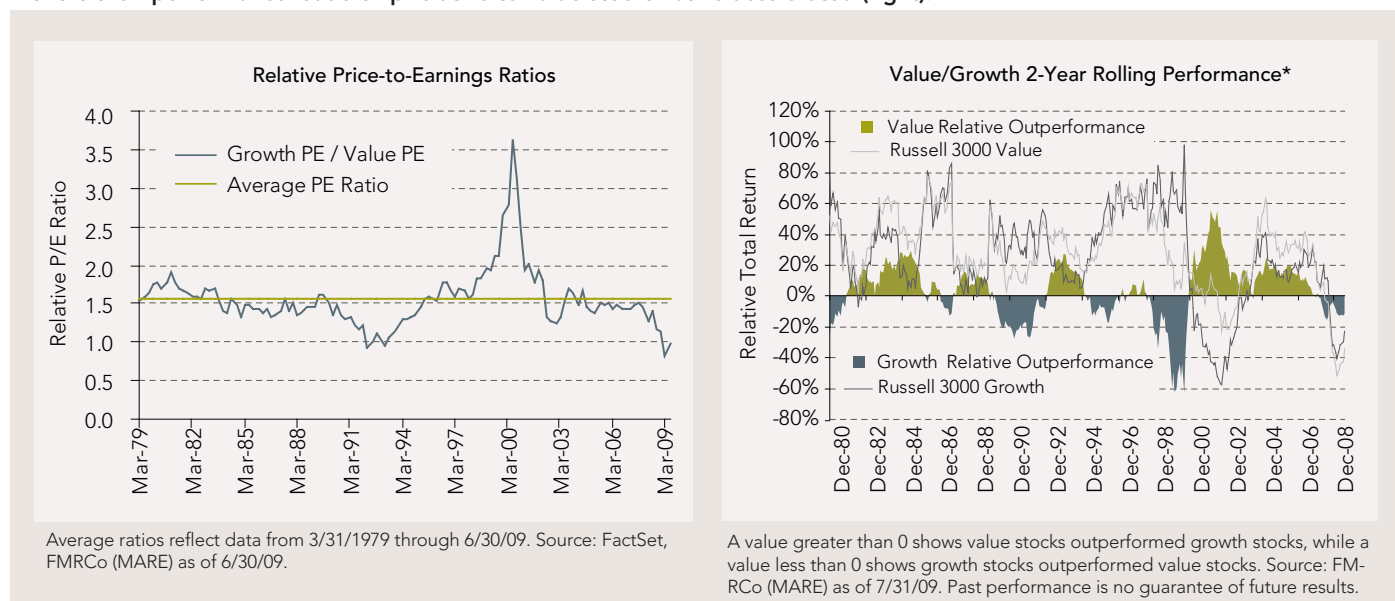
The beginning of the current cycle of growth style leadership bears at least some resemblance to the

### Assessing valuation and outlook

#### Growth stocks remain relatively cheap

As of the end of July, growth stocks were about as inexpensive on a price-to-trailing earnings (P/E) ratio basis relative to value stocks as they've ever been (see Exhibit 2, below left). This unusual valuation discrepancy (value stocks typically have lower P/Es

**EXHIBIT 2: Growth stock valuations were historically cheap relative to value stocks as of June 30, 2009 (left)....and in recent months their performance leadership relative to value stocks has re-accelerated (right).**



two previous big cycles of growth outperformance. The prior two multi-year growth stock cycles (1990-to-1993 and 1998-to-2000) were ushered in by a rapid deceleration of corporate profits, and growth stock leadership continued for years thereafter even as profit growth re-accelerated.<sup>iv</sup> Similarly, the recent cycle of outperformance for growth stocks was preceded by a period of decelerating corporate profit growth (in 2007 and 2008). In addition, the outperformance of growth stocks continued as corporate profits improved in the first half of 2009. Investors should note, however, that not every sudden decline in profit growth has preceded a period of growth-stock leadership. For example, from 2000-2001, earnings rapidly decelerated and value stocks outperformed.

### **Investment implications**

As shown, growth stock valuations on average remain compellingly low on a historical basis relative to those of value stocks. The current growth cycle is also shorter than most average leadership cycles have been in the past, and recently has been accelerating. That said, investors should keep in mind that style rotations are common, and that timing style rotations can be a challenging task. Maintaining an exposure to both styles can be an effective way to minimize equity portfolio volatility and allow one to participate in the historical long-term performance of both growth and value stocks. ■

## Know What You Own: Growth Stocks

### **Characteristics**

**High or accelerating earnings/sales growth:** The primary characteristic for a growth stock is a company that is growing its earnings (profits) or sales at a faster rate than the overall market. Some sectors, such as information technology and health care, historically have had a higher concentration of industries with a larger percentage of emerging and growth companies—those benefiting from a faster rate of sales and profits.

**Above-average valuation:** Growth stocks tend to trade at higher valuations (often referred to as a “premium”) because investors are typically willing to pay more for a higher rate of current earnings growth or the expectation of strong future growth.

**Little or no dividends:** Growth companies often reinvest a significant portion of their profits back into the business, with the hope that this investment can generate higher future earnings growth. As a result, growth companies tend to pay out smaller dividends than companies whose stocks are classified as “value.”

**Index methodology:** There are several market indexes that utilize various numerical characteristics to determine growth and value styles from a universe of stocks. One widely used source is the style index series produced by the Russell Investment Group. The market-cap-weighted Russell 3000® Index reflects nearly 100% of the broader U.S. equity market, and ranks each stock in this universe according to the following metrics:

- Price-to-book (P/B) ratio—a measure of a company’s market value (stock price) relative to its net worth (book value of assets)
- I/B/E/S forecast long-term growth mean—a measure of the consensus outlook for companies’ long-term earnings growth (typically five years) based on estimates by financial research analysts.<sup>v</sup>

Using these statistics, Russell classifies growth stocks as those with higher rates of forecasted earnings growth and higher valuations (P/B), and vice-versa for value stocks.<sup>vi,vii</sup>

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*Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.*  
Past performance is no guarantee of future results.

Growth stocks can perform differently from the market as a whole and other types of stocks and can be more volatile than other types of stocks.

All indices are unmanaged and performance of the indices include reinvestment of dividends and interest income, unless otherwise noted, are not illustrative of any particular investment and an investment cannot be made in any index.

[i] Source: FMRCo (MARE) as of 8/4/09.

[ii] All sector returns in this article represented by S&P 500 GICS sectors. Source: FMRCo (MARE) as of 8/4/09.

[iii] Source: Factset, FMRCo (MARE) as of 6/30/09.

[iv] Corporate profits: S&P 500 reported earnings. S&P 500 year-over-year earnings growth decelerated from a 15.8% rate in December 1988 to a negative growth rate of -8.4% in December 1989. S&P 500 earnings growth fell from 13.7% in September 1997 to negative growth of -9.9% in September 1998. Sources: Standard & Poor's, Russell.com, Factset, FMRCo (MARE) as of 7/31/09.

[v] Sources of methodology: Russell.com. I/B/E/S: Institutional Broker's Estimate System – a service provided by brokerage firm Lynch, Jones & Ryan.

[vi] Russell reconstitutes its indexes (meaning it recalculates market statistics via its methodology for each stock in its investable universe) once per year in order to accurately reflect market conditions. The company's revised lists of membership companies for each index becomes effective at the market close on the last Friday in June.

[vii] Interpretations of growth and value stocks can vary widely. Statistics used to assess growth and value characteristics also can vary widely. Certain statistical metrics can be considered more appropriate for certain sectors and industries than others.

\*The Russell 3000 Index offers investors access to the broad U.S. equity universe representing approximately 98% of the U.S. market. The Russell 3000 is constructed to provide a comprehensive, unbiased, and stable barometer of the broad market and is completely reconstituted annually to ensure new and growing equities are reflected. The Russell 3000® Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 3000 Value Index is an unmanaged index and measures the performance of those Russell 3000 Index companies with lower price-to-book ratios and lower forecasted growth values.

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The following is a definition of the S&P 500 sectors: **Consumer Discretionary** – Companies that tend to be the most sensitive to economic cycles. **Consumer Staples** – Companies whose businesses are less sensitive to economic cycles. **Energy** – Companies whose businesses are dominated by either of the following activities: The construction or provision of oil rigs, drilling equipment and other energy-related service and equipment, including seismic data collection. The exploration, production, market, refining and/or transportation of oil and gas products, coal and consumable fuels. **Financials** – Companies involved in activities such as banking, consumer finance, investment banking and brokerage, asset management, insurance and investments, and real estate, including REITs. **Health Care** – Companies in two main industry groups: Health care equipment suppliers, manufacturers, and providers of health care services; and companies involved in research development, production and marketing of pharmaceuticals and biotechnology products. **Industrials** – Companies whose businesses manufacture and distribute capital goods, provide commercial services and supplies, provide transportation services. **Information Technology** – Companies in technology software & services, and technology hardware & equipment. **Materials** – Companies that are engaged in a wide range of commodity-related manufacturing. **Telecommunication Services** – Companies that provide communications services primarily through a fixed line, cellular, wireless, high bandwidth and/or fiber-optic cable network. **Utilities** – Companies considered electric, gas or water utilities, or companies that operate as independent producers and/or distributors of power.