INDEX INSIGHTS

Value? Growth? Or Both?

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Key points:

- Growth and value styles offer different perspectives on potential investment opportunities, and each style has historically exhibited periods of performance leadership.
- Investors may benefit from combining styles within the context of a global multi-asset portfolio, by maintaining diversification regardless of which style is leading.
- Russell's growth and value indexes have been widely adopted as industry standards in style indexes, having been introduced in 1987 as the first growth and value indexes.

Russell's growth and value indexes have become widely adopted as industry standards for both active and index-based investments since Russell Investments introduced the first style indexes in 1987.[2] As of Dec. 31, 2013, approximately $227 billion in assets was invested directly in passive mutual funds and ETFs based on Russell growth and value style indexes, and a total of about $3.5 trillion in assets was benchmarked to Russell style indexes.[3]

Russell style indexes give investors better tools for more precise portfolio construction

Russell's growth and value style indexes enable investors to: 1) accurately measure the risk/return of the growth- and value-oriented segments of the market; 2) assess the skills of investment managers who focus on each style; 3) enable asset allocation analysis and decisions; and 4) efficiently gain exposure to each market segment by use of index-based products such as mutual funds and exchange-traded funds (ETFs).

Combining growth- and value-oriented investments in their portfolios gives investors an ability to implement a long-term strategic tilt toward growth or value while maintaining diversified exposure to both styles. Additionally, these tools give investors who have a near- to medium-term view the means to dynamically adjust their allocations as market conditions change.

[1] The author would like to thank Mat Lystra for his significant contributions to this research.

[2] The creation of the Russell growth and value style indexes in 1987 is described in Christopherson, Cariño and Ferson (2009), "Portfolio Performance Measurement and Benchmarking," pp. 275-323 and 329-31. A detailed documentation of the construction methodology of the Russell style indexes is available on the Russell Investments website at http://www.russell.com/indexes/americas/indexes/us-construction-methodology.page.

[3] Russell Investments, Morningstar Direct, as of Dec. 31, 2013.

This brief paper examines:

1. Growth and value perspectives and performance cycles
2. Benefits of combining growth and value investments within a diversified portfolio
3. The widespread adoption of Russell's growth and value style indexes

Growth/value styles give a view of investment opportunities through different lenses

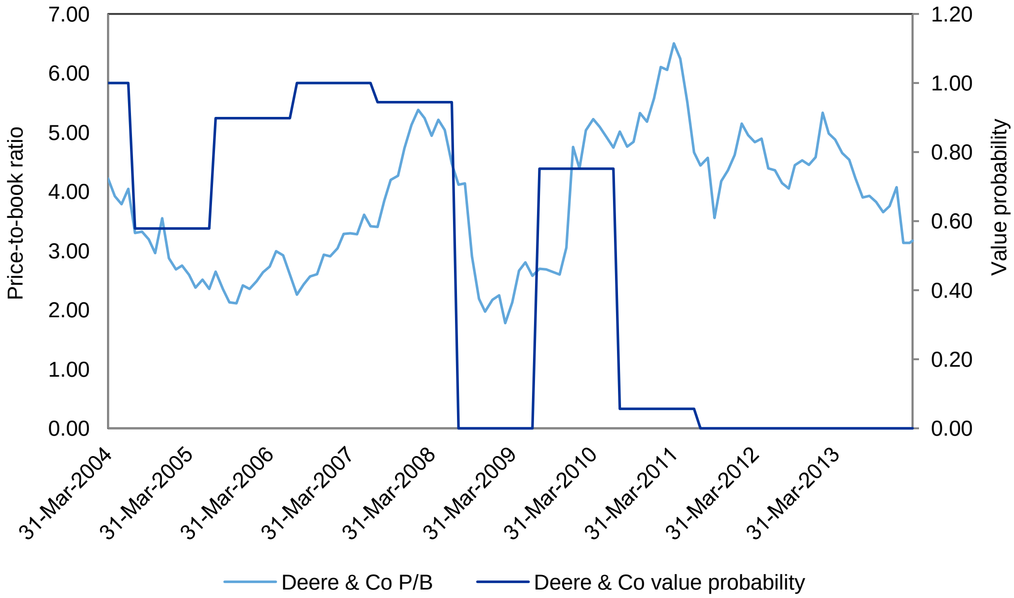
Growth and value investors tend to view investment opportunities from different perspectives and are often skeptical about each other's views. Value-oriented managers tend to be price sensitive and to focus on stocks with lower valuation characteristics, as they seek to analyze the intrinsic value of a company and whether its stock is priced above or below that value.

By contrast, growth-oriented managers tend to concentrate on understanding the sources of a company's earnings growth and then on forecasting its future growth potential. Relative to their value-focused counterparts, growth managers are often willing to pay higher price multiples for expected growth that they believe is not reflected in current valuations.

A result of these different perspectives is that growth and value investors may assess a stock differently at various points in its price and earnings cycle. Each style approach offers investment potential and is supported by empirical evidence and academic research. However, these differing viewpoints lead to market cycles for stocks across growth and value investors, as well as performance cycles for the growth and value styles themselves.

As examples of the valuation shifts underpinning this behavior, Figure 1a shows the price/book value (P/B) of Russell 1000 Index member Deere & Co. (light blue line) and the associated Russell value style probability (dark blue line). The P/B of Deere & Co. has fluctuated between lows around 2.0 and highs between 5.0 and 6.0. At a P/B of 1.8, Deere's valuation in 2009 would have been relatively more attractive to a value investor than its P/B of 6.5 in 2011. Russell's style indexes accurately tracked these shifts with a corresponding increase in Deere's value probability following the P/B lows in 2009 and a corresponding decrease in response to the higher valuations in 2011–2013.

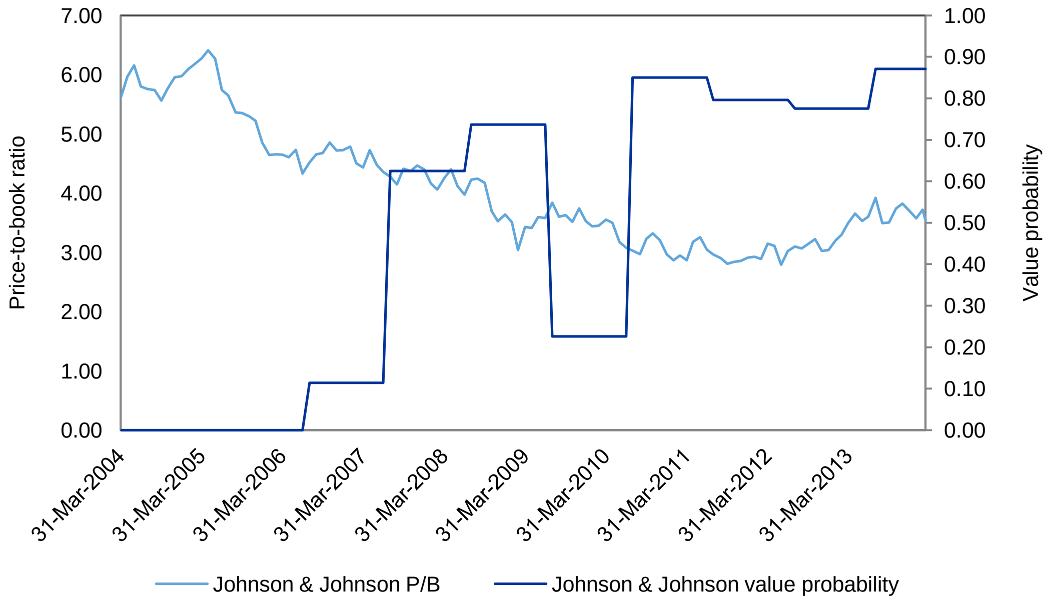
Figure 1a: Style orientation can shift from value to growth over time . . .



Sources: Russell Indexes and FactSet, as of Mar. 31, 2013.

In contrast to Deere's move from value to growth, Johnson & Johnson has experienced a long-term shift from growth to value. The P/B of Johnson & Johnson fell from highs around 6.0 in the mid-2000s to lows around 3.0 in recent years. Again we observe Russell's style indexes reflecting the change in valuation, with Johnson & Johnson transitioning from a 100% growth probability in 2004 to an almost 100% value probability in 2013.

Figure 1b: . . . or from growth to value over time

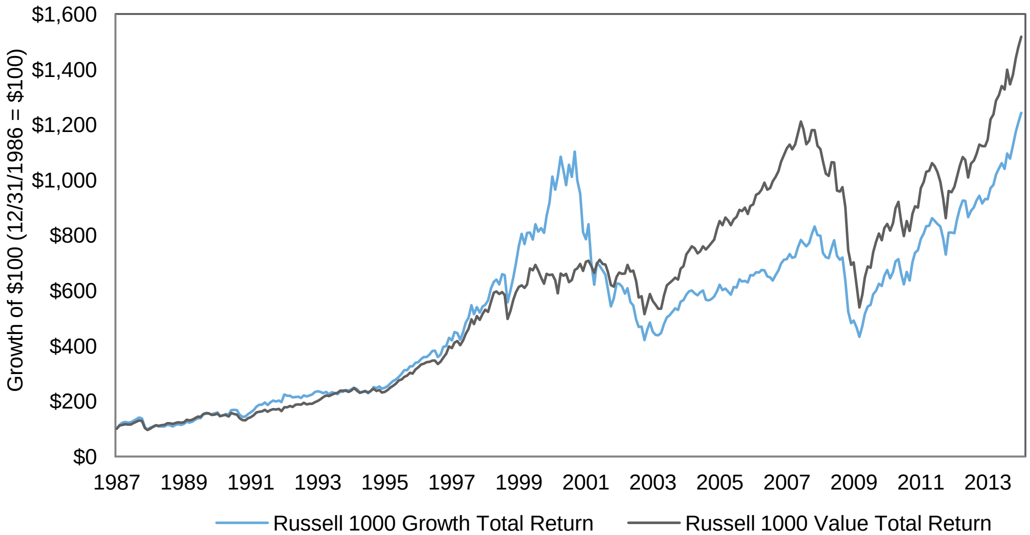


Sources: Russell Indexes and FactSet, as of Mar. 31, 2013.

Growth and value leadership tends to move in cycles over time

A wide body of research published by academics and market practitioners has focused on the "value premium," or the tendency for portfolios of stocks with lower initial valuations to outperform over the long term.[4] As illustrated in Figure 2, the Russell 1000 Value Index delivered a higher cumulative total return than its growth counterpart over the 27-year period from 1/1/1987 through 12/31/2013. (For the sake of brevity, we have focused on U.S. large cap styles throughout this paper, but the value premium has been found to extend across mid cap and small cap as well.)

Figure 2: Value has historically outperformed growth over the long term…



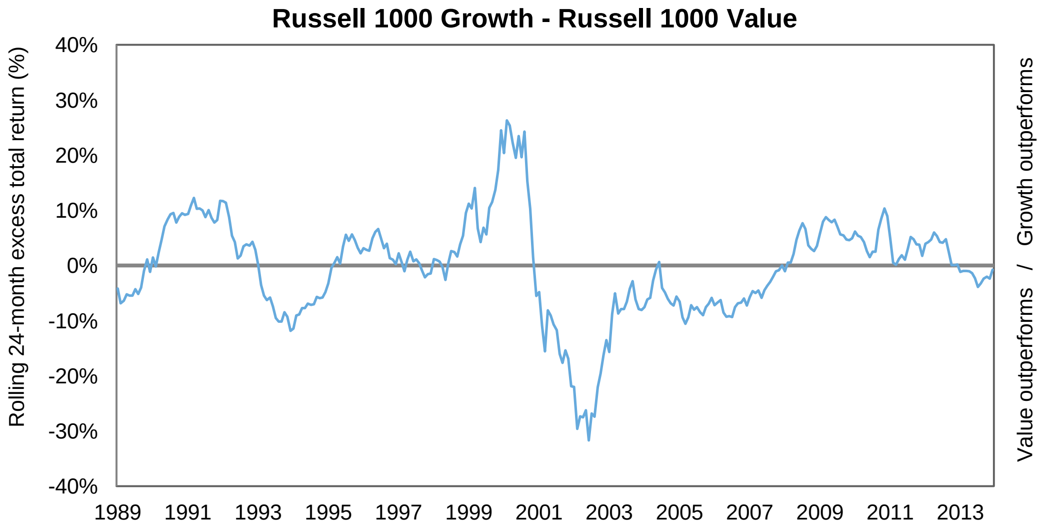
Source: Russell Indexes, as of Dec. 31, 2013. Index performance is for illustrative purposes only. One cannot invest directly in an index. Past performance is not a guarantee of future results.

The growth style should not be discounted, however, as style performance has tended to move in cycles, and growth significantly outperformed value during several periods over the past 27 years, as illustrated in Figure 3. The existence of these cycles underscores that the path of return distributions is important, because various investors might enter the market or need to sell their investments at various points over the cycle. A need to liquidate investments when one's favored style was underperforming would typically lead to a significantly different outcome than the historical long-term returns.

For example, growth was highly favored during the dot-com boom and bust of the late 1990s and early 2000s. Strong growth markets can occur in bursts at any time, and investors focused solely on value in that type of environment could suffer significant underperformance. By including both growth *and* value stocks in a portfolio, investors can still express a view about either style but maintain a diversified portfolio across growth and value performance cycles.

[4] See, for example, Basu, Sanjay, "Investment Performance of Common Stocks in Relation to Their Price-Earnings Ratios: A Test of the Efficient Market Hypothesis," *Journal of Finance*, 1977; Fama, Eugene, and K. French, "The Cross-Section of Expected Stock Returns," *Journal of Finance*, 1992; "Fama, Eugene, and K. French, "Common Risk Factors in the Returns on Stocks and Bonds," *Journal of Financial Economics*, 1993.

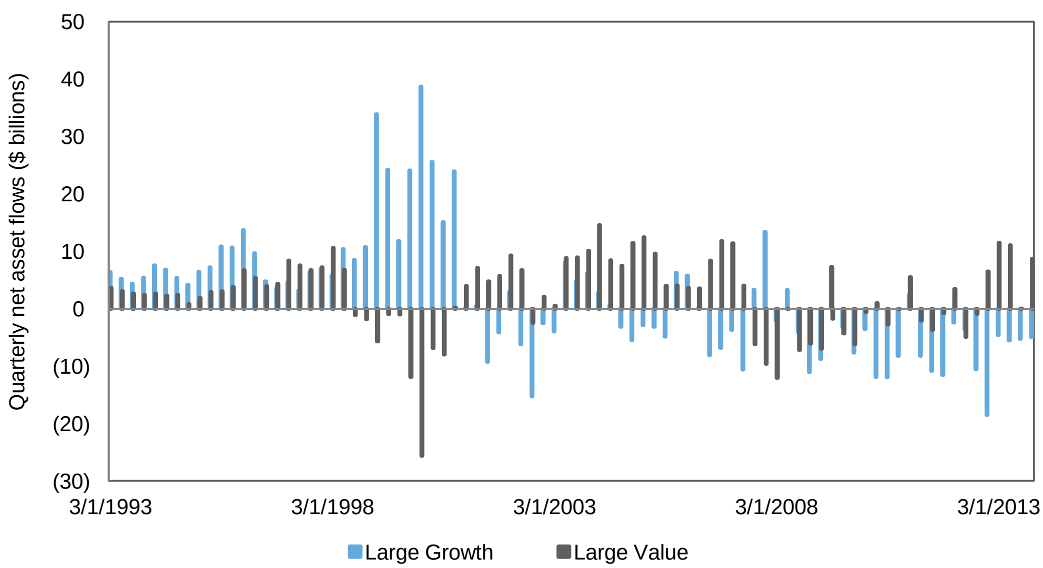
Figure 3: …but growth and value leadership tends to be cyclical. 24-month rolling excess total returns of the Russell 1000 Growth – Russell 1000 Value.



Source: Russell Indexes, Morningstar Direct, from 12/31/88 to 12/31/2013. Returns are rolling 24-month total returns using monthly data. Index performance is for illustrative purposes only. One cannot invest directly in an index. Past performance is not a guarantee of future results.

The cyclicality of growth and value leadership is also evident in asset flows. As shown in Figure 4, asset flows into growth and value stocks have often moved in opposite directions. At some time points, when asset flows into growth stocks have been strongly positive, they have been negative for value stocks, and vice versa. And when asset flows into both growth and value stocks have been directionally consistent, they have typically been of different magnitudes.

Figure 4: Growth and value cyclicality has also been evident in asset flows historically



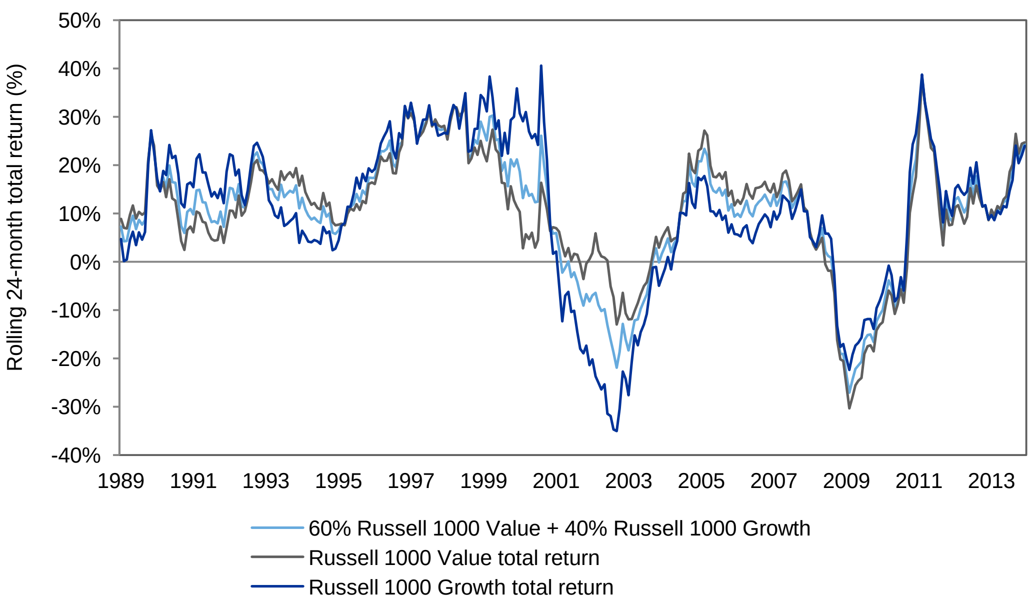
Source: Morningstar Direct, as of Dec. 31, 2013. Includes all U.S. active and passive open-end mutual funds and ETFs, excluding money market funds and funds of funds.

Combining styles lets investors express a view but maintain diversification

By combining growth and value strategies in a portfolio, investors are able to maintain exposure to both styles across performance cycles, regardless of which is leading at any given time. As a hypothetical example, we constructed a simple portfolio consisting of 60% Russell 1000 Value and 40% Russell 1000 Growth.[5] In this example, we assume that the investor wants to maintain a strategic value tilt based on a belief in the value premium, but recognizes that growth can outperform in the short term and thus wants to maintain meaningful exposure to growth-oriented stocks as well.

As shown in Figure 5, which compares the rolling 24-month returns of the blended portfolio to the returns of the Russell 1000 Growth and Value indexes, the blended portfolio's performance has tended to be between that of the growth and value portfolios, as would be expected. The blended portfolio typically advanced less than whichever style index was leading at any given time and fell less in market declines. Depending on individual views and beliefs, an investor could have tilted more toward either growth or value, in which case the blended portfolio's return pattern would have moved progressively toward that of whichever style had the largest weighting. Additionally, an investor might have taken a more dynamic approach and adjusted the blended portfolio's tilt toward or away from either style over time, which could have produced potentially very different results.

Figure 5: Blended portfolio participated in upside while moderating downside



Source: Russell Indexes, Morningstar Direct, from 12/31/88 to 12/31/2013. Returns are rolling 24-month total returns using monthly data. Hypothetical portfolio is for illustrative purposes only and is not a recommendation. One cannot invest directly in an index. Past performance is not a guarantee of future results.

[5] This hypothetical portfolio is for illustrative purposes only and is not a recommendation.

Including both growth and value in a portfolio provides potential diversification benefits

As reported in Table 1, the performance characteristics for the blended portfolio were mostly between those of the growth and value indexes. The blended portfolio's annualized total return was about 10.40% over the 27-year period 1/1/1987 through 12/31/2013, compared with 9.78% for the growth index and 10.60% for the value index. The blended portfolio's return came with lower volatility than that of the growth index, but slightly higher volatility than that of the value index, which led to a risk-adjusted return, as measured by Sharpe ratio, that was again between that of the two style indexes. Compared with the Russell 1000 benchmark, the blended portfolio's annualized total return was 5 bps higher for the period, while its standard deviation was 22 bps lower, leading to a slightly higher Sharpe ratio of 0.44 vs. 0.43 for the benchmark.

Table 1: Performance characteristics[6] (1/1/1987 – 12/31/2013)

	Total return (%)	Standard deviation (%)	Sharpe ratio	Up capture (%)	Down capture (%)	Maximum drawdown
Blended portfolio	10.40	15.30	0.44	98.92	98.07	–51.79
Russell 1000 Growth Index	9.78	17.52	0.34	104.59	110.48	–61.86
Russell 1000 Value Index	10.60	15.01	0.46	94.73	90.71	–55.56
Russell 1000 Index	10.45	15.52	0.43	100.00	100.00	–51.13

Source: Russell Indexes, Morningstar Direct, as of Dec. 31, 2013. Hypothetical portfolio is for illustrative purposes only and is not a recommendation. One cannot invest directly in an index. Past performance is not a guarantee of future results.

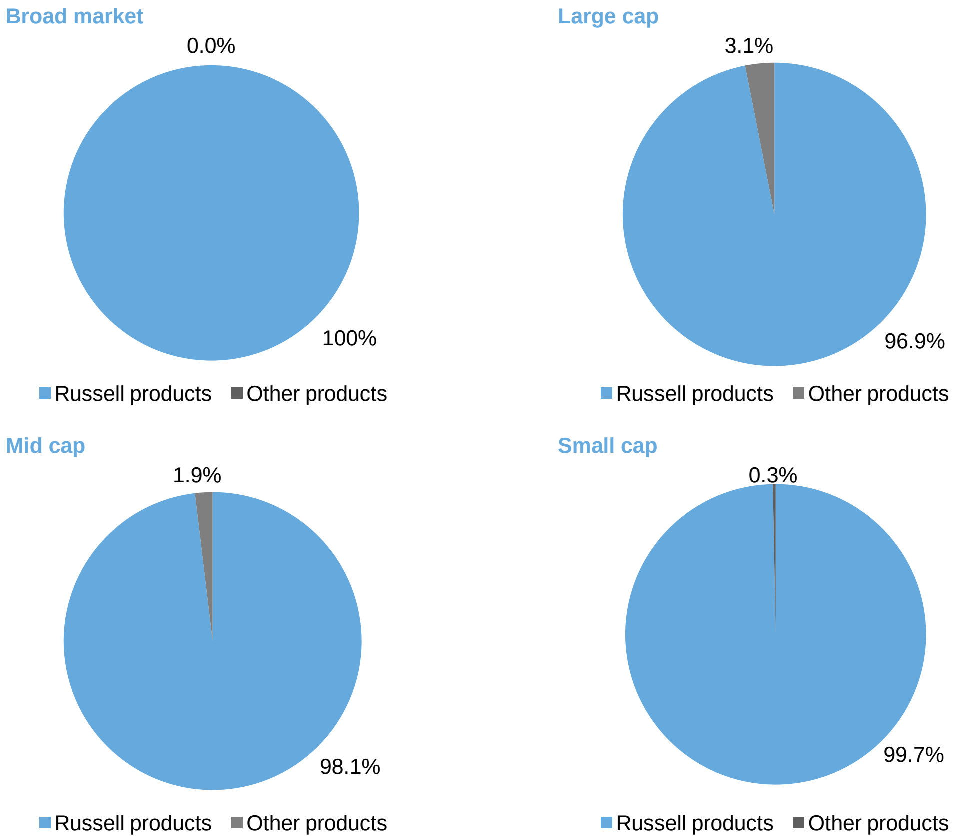
In terms of up/down capture ratios, the blended portfolio captured more of the upside of the Russell 1000 benchmark than the value index but less of the downside than the growth index, again ending up between the two style indexes. Notably, maximum drawdown for the blended portfolio was smaller than for either of the two style indexes alone, illustrating the potential diversification benefit of combining both the growth and value styles within a portfolio.

[6] Sharpe ratio (arithmetic) is calculated as annualized total return minus the annualized return of the risk-free rate, as measured by 3-month U.S. Treasury bills, divided by annualized standard deviation. Up and down capture are relative to the Russell 1000 Index and indicate how closely a portfolio tracks positive or negative benchmark returns. Each measure is calculated as the annualized return of a portfolio on only the set of days when the benchmark return was positive (negative) divided by the benchmark's annualized return on the same set of days.

Russell growth and value indexes are the style indexes of choice

Based on Russell's leadership in style investing, Russell's growth and value indexes have been widely adopted by both retail and institutional investors. As shown in Figure 6, the Russell style indexes enjoy extraordinary market share across the capitalization spectrum. Russell's style indexes represent nearly all institutional products based on style indexes in both the broad market and the small cap market segment. Additionally, in large cap and mid cap, 97% to 98% of institutional growth and value products are benchmarked to Russell style indexes.

Figure 6: Russell style indexes are overwhelmingly favored by institutional investors



Source: Russell Indexes, Morningstar Direct, as of Dec. 31, 2013.

Largest ETF in each style category is based on a Russell growth or value index

The widespread support for the quality of Russell's style index methodology is clearly evident in the assets invested in growth and value ETFs. As illustrated in Table 2, as of Dec. 31, 2013, the largest ETF in each style category was based on a Russell growth or value index. Collectively, these six ETFs represented approximately $66 billion in assets as of the end of 2013. These products allow investors to efficiently gain exposure to each style across the capitalization spectrum. Additionally, the high liquidity that results from this large asset base helps facilitate efficient entry and exit from positions and has led to tight bid/ask spreads that may help to control costs for investors.[7]

Table 2: Largest growth and value ETFs by AUM track Russell style indexes

	Value	AUM ($M)	Growth	AUM ($M)
LARGE CAP				
	1. iShares Russell 1000 Value ETF (IWD)	**20,723**	**1. iShares Russell 1000 Growth ETF (IWF)**	**22,673**
	2. Vanguard Value ETF (VTV)	12,461	2. Vanguard Growth ETF (VUG)	13,265
	3. iShares S&P 500 Value ETF (IVE)	6,512	3. iShares S&P 500 Growth ETF (IVW)	9,199
	4. Schwab U.S. Large-Cap Value ETF (SCHV)	820	4. Vanguard Mega Cap Growth Index ETF (MGK)	1,231
MID CAP				
	1. iShares Russell Mid-Cap Value ETF (IWS)	**5,515**	**1. iShares Russell Mid-Cap Growth ETF (IWP)**	**4,766**
	2. iShares S&P Mid-Cap 400 Value ETF (IJJ)	3,564	2. iShares S&P Mid-Cap 400 Growth ETF (IJK)	4,629
	3. Vanguard Mid-Cap Value ETF (VOE)	2,256	3. Vanguard Mid-Cap Growth ETF (VOT)	1,896
	4. iShares Morningstar Mid-Cap Value ETF (JKI)	166	4. Guggenheim S&P Midcap 400 Pure Growth (RFG)	805
SMALL CAP				
	1. iShares Russell 2000 Value ETF (IWN)	**6,184**	**1. iShares Russell 2000 Growth ETF (IWO)**	**6,113**
	2. Vanguard Small Cap Value ETF (VBR)	3,908	2. Vanguard Small-Cap Growth ETF (VBK)	3,637
	3. iShares S&P Small-Cap 600 Value ETF (IJS)	3,111	3. iShares S&P Small-Cap 600 Growth ETF (IJT)	2,981
	4. iShares Morningstar Small-Cap Value ETF (JKL)	349	4. SPDR S&P 600 Small Cap Growth ETF (SLYG)	349

Source: ETFGI, as of Dec. 31, 2013.

[7] Morningstar Direct. During 2013, the average daily spread for the iShares Russell 1000 Value ETF and iShares Russell 1000 Growth ETF was approximately 6 to 8 bps.

Conclusion

The decision for how to allocate among growth- and value-oriented stocks within the equity portion of a diversified multi-asset portfolio is a matter of one's investment beliefs, objectives and risk tolerance. While a wide body of research has found evidence of a positive value premium, or the tendency for portfolios of stocks with lower initial valuations to outperform over the long term, style leadership has historically been cyclical. Each style has exhibited periods of leadership as well as periods of underperformance. Growth has historically tended to outperform in bursts, and during those times all-value investors might have experienced some regret. A blend of both growth and value investments has the potential to minimize the chance that an investor might feel short-term regret over their allocation decisions. Using both growth and value investments allows investors to allocate assets both strategically and tactically, based on their individual objectives, while maintaining exposure to the potential benefits of diversification across styles.

About Russell Indexes

Russell's indexes business, which began in 1984, accurately measures U.S. market segments and tracks investment manager behavior for Russell's investment management and consulting businesses. Today, our series of U.S. and global equity indexes reflect distinct investment universes – asset class, geographic region, capitalization and style – with no gaps or overlaps. Russell Indexes offers more than three dozen product families and calculates more than 700,000 benchmarks daily covering 98% of the investable market globally, 83 countries and more than 10,000 securities. Approximately $5.2 trillion in assets are benchmarked to the Russell Indexes.

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Disclosures

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