OTHER VOICES

VIEWS FROM BEYOND THE BARRON'S STAFF

High Reward for Low Risk

Doesn't sound right? Maybe not, but that's what value stocks offer

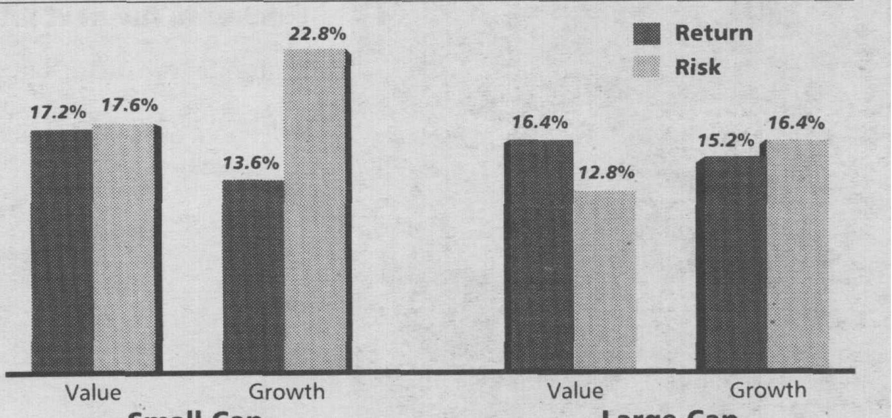
BY GEORGE C. PIERIDES • Everyone knows that in order to achieve above-average rewards, one must assume above-average risks. That's how it works when you roll the dice or bet the horses. It just seems fair that way. Well, in the U.S. stock market, life isn't fair. In a year like this one, when stocks have been buffeted by, shall we call it, "adverse volatility," investor focus shifts from greed to fear, or from reward to risk. Indeed, it is precisely this shift in focus that historically has resulted in value stocks' greater rewards and lower risk relative to growth stocks in both the small- and large-cap universes.

Contrary to popular belief, superior stock performance appears to be more a function of investment style than market capitalization. In my article in this space, "The Small-Cap Myth," last Dec. 4, I demonstrated that small-cap stocks' two-percentage-point-per-year advantage over large-cap stocks between 1926 and 1994 (12.2% versus 10.2%) was the result of only their three best relative and absolute years; excluding those years (1933, 1943 and 1967), no significant advantage accrued to small-cap stocks (9.2% versus 9.2%). Frank Russell Co.'s data supported this thesis: The annualized returns through 1994 (from inception in 1979) of the small-cap Russell 2000 Index and large-cap Russell 1000 Index were essentially identical (14.7% versus 14.6%). More to the point, the Russell data showed that value stocks, both small- and large-cap, outperformed growth stocks. This was especially evident in the small-cap universe: The small-cap Russell 2000 Value Index beat its growth counterpart by a greater margin (4.1% a year) than the large-cap Russell 1000 Value Index beat its growth counterpart (1.1% a year).

Value vs. Growth

Annualized Return and Standard Deviation By Style and Market Cap 1979-1995

▶Both value indexes, the small-cap Russell 2000 Value and large-cap Russell 1000 Value, outperformed their growth counterparts (small-cap Russell 2000 Growth and large-cap Russell 1000 Growth) did so with less volatility during the 1979-1995 period.



BARRON'S • Frank Russell

According to the popular belief that one must assume more risk in order to achieve greater rewards, value stocks should be riskier. However, the opposite is true. As the accompanying chart shows, value stocks are less risky, or less volatile, than growth stocks, as measured by standard deviation, a commonly used gauge of risk. According to the Frank Russell data covering the multiple economic and stock-market cycles during the 17 years through 1995, the standard deviation of small-cap value stocks (Russell 2000 Value Index) is less than that of small-cap growth stocks (Russell 2000 Growth Index) by a margin of 17.6% to 22.8%. Likewise, the standard deviation of large-cap value stocks (Russell 1000 Value Index) is less than that of large-cap growth stocks (Russell 1000 Growth Index) by a margin of 12.8% to 16.4%.

Value stocks' benefit of above-average reward and below-average risk can be demonstrated by using a simplified version of the Sharpe Ratio. On a risk-adjusted basis, the large-cap value group wins, small-cap value places and large-cap growth shows; small-cap growth comes in dead last. For each unit of risk assumed, a large-cap value investor can expect 1.3 units of reward, a small-cap value investor one unit, a large-cap growth investor 0.9 of a unit, and a small-cap growth investor 0.6 of a unit. Hence, not only do value stocks provide the better returns on an absolute basis but also produce less volatility than their growth stock counterparts and, thus, boast far superior risk-adjusted returns.

Surely, this observation cannot have escaped the notice of serious students of the U.S. equity markets. The question, then, is, "Why are investors drawn to growth stocks, given their poor relative risk-adjusted returns?" It appears that growth stocks' allure is related to the better perceived prospects of their underlying companies. Everyone wants to own a piece of a company whose prospects seem bright. This focus on fundamentals, however, overshadows the other crucial element of security analysis: valuation.

Basically, the current market value of a company should reflect the discounted net present value of its future cash flow or earnings. Of course, consistent accuracy in earnings forecasts is difficult, if not impossible, particularly the further out in time one goes. Value investors are, by nature, skeptics when it comes to growth investors' earnings and earnings-growth predictions and require a meaningful "margin of safety," as Benjamin Graham put it, to ensure against earnings shortfalls. In the end, the more conservative approach adhered to by value investors results in fewer disappointments and lower volatility.

Increasingly complicating these differences in investment style are the so-called momentum players, a subset of the growth-stock genre, who simply buy stocks that are appreciating and sell stocks that are depreciating; such "investors" know the price of everything and the value of nothing.

It should not be surprising, then, that growth stocks, whose underlying companies have better perceived prospects than those of the typical value stock, suffer greater volatility. Such stocks that benefit from hyperbole and whose prices are further enhanced by momentum players piling in are eventually subjected to precipitous declines from what are lofty, irrational valuations as the entire herd attempts to leave the corral all at once. Indeed, it is this phenomenon that, at times, drives overall market valuations and individual security prices too high and, ultimately, too low.

So the next time someone insists that in order to generate superior returns you have to incur increased risk, tell them how value stocks yield better returns with less risk than their growth-stock counterparts. If they don't believe you, then they'll continue to be at a disadvantage. Not to worry, though. Sometimes life isn't fair. ■

GEORGE C. PIERIDES is senior vice president and a senior portfolio manager with Fox Asset Management in Little Silver, N.J.

William Waitzman for Barron's