

The Value Premium

Investors building passive, beta-based portfolios should overweight value and underweight growth. By Craig L. Israelsen

NATURE VS. NURTURE, VALUE VS. GROWTH.... These are the endless questions of life. I don't have the right data to tackle the nature/nurture argument, but I will try my hand at the value vs. growth discussion.

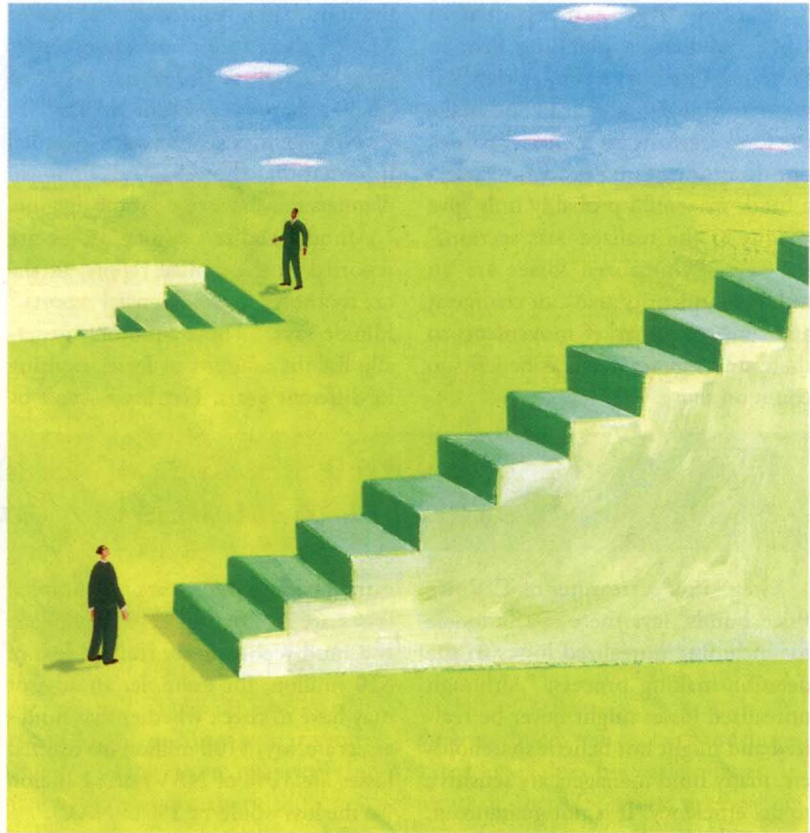
Which style has rewarded domestic investors the most, even in recent history? The answer is value, and this article quantifies the value premium among all three sizes of domestic equity indexes—large-cap equity indexes, mid-cap equity indexes and small-cap equity indexes—over the 29-year period from 1980 to 2008. So while industry experts might be trumpeting growth as the place to be when the market rebounds, advisors should remember that longer-term, the market values value, at least in passive portfolios.

A BROADER LOOK

First, let's examine the long-term performance of cash, bonds and equities. Over the 29-year period from 1980 to 2008, the S&P 500 returned 10.7% annually with a standard deviation of 18%. An initial investment of \$10,000 in 1980 grew to \$191,473 by the end of 2008 (not adjusted for taxes or inflation and assuming no additional deposits or withdrawals).

The return of three-month Treasury bills was 6%, with an annualized standard deviation of 3.45%. A similar investment of \$10,000 in 1980 grew to \$54,187.

The Barclays Capital (formerly Lehman Brothers) Aggregate Bond Index had an 8.9% annualized return with a 7.25% standard



deviation. An initial investment of \$10,000 in 1980 led to a final account value of \$118,117.

SIZE DOESN'T MATTER

Next, let's look at the returns of the six dominant style boxes (large growth, large value, mid-growth, mid-value, small growth and small value). Large-cap funds showed the smallest value premium. The 29-year annualized return of growth-oriented large-cap equity indexes was 8.9% (which represents the average of the Dow Jones Large Growth Index and the DJ Wilshire Large Growth

Index), exactly the same return as the Barclays Capital Aggregate Bond Index. By contrast, the two value-oriented large-cap equity indexes in this study returned 11.4%, on average, over the period from 1980 to 2008. In the aggregate, large-cap value generated a 255-basis-point premium over large-cap growth during this 29-year period. This value premium amounted to a differential in the final account value of more than \$113,000.

The value premium was higher in the mid-cap sector. The average 29-year return of the two mid-cap

value indexes (Dow Jones Mid Value Index and DJ Wilshire Mid Value Index) was 12.5%, considerably better than the 9.7% average return of the combined mid-cap growth indexes (Dow Jones Mid Growth Index and DJ Wilshire Mid Growth Index). Here, the difference in performance amounted to a value premium of over \$161,000.

But value really shone in the small-cap arena. Among small-cap equity indexes, the value premium over the 29-year period was an astonishing 452 basis points.

The average of the Dow Jones Small Value Index and the DJ Wilshire Small Value Index outperformed the average of the Dow Jones Small Growth Index and DJ Wilshire Small Growth Index 12.9% to 8.4%. With this 29-year annualized return of 12.9%, the small-cap value indexes turned \$10,000 into \$339,685, or \$235,806 more than the ending balance in small-cap growth indexes.

ROLLING ALONG

The data presented so far reflects performance from one point in time (Jan. 1, 1980) to another point in time (Dec. 31, 2008). Clearly, many investors won't invest for that length of time, so it's useful to examine performance by using snapshots of smaller time frames, such as five-year periods (see "Looking Out the Windows," at right).

On the chart, the performance premiums of value indexes and growth indexes are shown in separate columns. The premium (whether growth or value) for each five-year period is shown in basis points.

For instance, over the five-year period from 1980 to 1984, large-cap value equity demonstrated a 432-basis-point premium over large-cap growth equity. Among mid-cap equities during the same period, there was a value premium of 422 basis points. Among small caps, the

LOOKING OUT THE WINDOWS

More than 70% of rolling five-year periods from 1980-2008 showed a value premium.

FIVE-YEAR ROLLING RETURN PREMIUM
(IN BASIS POINTS)

Five-Year Period	U.S. Large-Cap Equity		U.S. Mid-Cap Equity		U.S. Small-Cap Equity	
	Growth ¹	Value ²	Growth ³	Value ⁴	Growth ⁵	Value ⁶
1980-1984		432		422		1,110
1981-1985		662		819		1,693
1982-1986		452		556		1,241
1983-1987		260		509		1,007
1984-1988		337		532		818
1985-1989		96		277		388
1986-1990	15			228		152
1987-1991	330		63		118	
1988-1992	118			18		18
1989-1993		44	130		9	
1990-1994	29		98			9
1991-1995		123	111		71	
1992-1996		330		228		377
1993-1997		243		360		519
1994-1998	602			263		214
1995-1999	1,217		897		831	
1996-2000	160			314		304
1997-2001		312		684		485
1998-2002		599		912		889
1999-2003		979		919		1,098
2000-2004		1,615		1,988		2,056
2001-2005		859		849		1,121
2002-2006		737		466		864
2003-2007		207	517		346	
2004-2008		287	102		112	
% of Periods with Premium	28%	72%	28%	72%	24%	76%
Mean Premium (bps)	353	476	274	575	248	756

¹ Average of Dow Jones Large Growth Index and DJ Wilshire Large Growth Index

² Average of Dow Jones Large Value Index and DJ Wilshire Large Value Index

³ Average of Dow Jones Mid Growth Index and DJ Wilshire Mid Growth Index

⁴ Average of Dow Jones Mid Value Index and DJ Wilshire Mid Value Index

⁵ Average of Dow Jones Small Growth Index and DJ Wilshire Small Growth Index

⁶ Average of Dow Jones Small Value Index and DJ Wilshire Small Value Index

Source: Author auditing Morningstar index data

five-year value premium from 1980 to 1984 was 1,110 basis points.

Considering all 25 five-year rolling periods, large-cap value showed a performance premium 72% of the time. The average five-year value premium was 476 basis points. Conversely, large-cap growth outperformed large-cap value 28% of the time by an average of 353 points.

Among mid-cap equity indexes, value outperformed growth 72% of the time by an average of 575 basis points. When growth outperformed value (again, 28% of the time), the margin of victory averaged 274 basis points. Among mid-caps, a value tilt has historically provided better performance than a growth tilt. However, during the two most recent five-year periods (2003 to 2007 and 2004 to 2008), mid-cap growth beat mid-cap value by 517 and 102 basis points respectively.

Among small-cap equity indexes, value beat growth 76% of the time by an average of 756 basis points. However, when small-cap growth outperforms (24% of the time), the difference can be large. For example, during the five-year period of 1995 to 1999, small-cap growth beat small-cap value by 831 basis points. Overall, however, when small-cap growth outperformed small-cap value, the average margin of victory was 248 basis points.

WHAT IT MEANS

These results don't mean financial that advisors should eliminate growth-oriented assets from their client portfolios. However, this analysis does suggest that overweighting value is a justifiable strategy over the long run. Indeed, a value orientation is a true value proposition for investors.

"Premium Frequency" (see above, right) illustrates the long-term advantage of a value tilt. As the length of the investing period increases (from one-year rolling periods to three-year

PREMIUM FREQUENCY

The longer the time periods, the more often you'll see a value premium.

Rolling Time Period (1980-2008)	Frequency of Value Premium Among...		
	U.S. Large-Cap Equity	U.S. Mid-Cap Equity	U.S. Small-Cap Equity
29 One-Year Periods	59%	62%	66%
27 Three-Year Periods	74%	67%	70%
25 Five-Year Periods	72%	72%	76%
23 Seven-Year Periods	70%	87%	91%
20 Ten-Year Periods	85%	95%	95%

Source: Author auditing Morningstar index data

periods to five-year rolling periods, etc.), the frequency of the value premium also increases.

For example, between 1980 and 2008, large-cap value indexes outperformed large-cap growth indexes 74% of the time over the 27 three-year rolling periods. Over twenty 10-year rolling periods, large value beat large growth 85% of the time. Among small-cap indexes, small-cap value outperformed small-cap growth 70% of the time over three-year rolling periods, but 95% of the time over rolling 10-year periods.

This analysis reflects the performance of value and growth equity indexes using a Dow Jones and a Wilshire methodology (Dow Jones absorbed the Wilshire Indexes in 2005, hence the "DJ Wilshire" title). As of April 2009, the DJ Wilshire Indexes were discontinued and were succeeded by the Dow Jones Total Stock Market Indexes.

The results of this study could be different if different indexes were used, such as Standard and Poor's indexes, Morningstar indexes, Russell indexes or Surz indexes. We chose Dow Jones and DJ Wilshire indexes because they have the longest performance histories within the six style boxes in this study. In addition, this study did not take into account the performance of actively managed

value and growth funds. The active versus passive argument is another debate entirely.

What has caused the robust value premium over the past 29 years? There are many opinions out there, but two explanations have reasonably broad support.

The first explanation is market-based. Since value stocks present more risk, they produce a risk-based premium. The second explanation is related to human behavior. Investors tend to overprice growth stocks and underprice value stocks—and this behavioral mispricing generates a value premium.

Based on the evidence of historical performance patterns, investors building beta-based portfolios that solely utilize index funds should overweight value indexes and underweight growth indexes. Doing otherwise demonstrates the insatiable urge to generate alpha—even in passive index-based portfolios. Alpha versus beta...that's another discussion. **FP**

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