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INVESTOR INSIGHTS – THIRD QUARTER 2018

GROWTH OR VALUE?

Perhaps the longest debate on how to invest in the stock market is the one centered on growth or value. Growth managers will tell you all the reasons why their stocks are better companies, they tend to have better top line growth, more exciting ideas and products, and have figured out the future in better ways. Value managers counter with a discussion on price discipline, telling us that paying too much for a stock will insure at best mediocre results. Growth managers often buy their stocks off the new high list while value managers tend to buy off the new low list. Both camps would tell you that successful investing requires study and discipline. The growth manager's discipline is in determining what will sell in the future and which companies can execute on the delivery of those goods and services. Value manager's discipline lies in their consistent application of only buying stocks at reasonable prices.

When you talk to the two camps, you are reminded of conversations on religion. Both sides firmly believe they have the answer, actually the only answer. We believe you do need to determine which camp you would like to be in. There are countless studies which have examined the value premium. They all look at data in a similar way, dividing stocks by valuation with value representing the low valuation group and growth representing the high valuation group. When you look at these studies over long periods, 30-50 years, the lower valuation group outperforms the higher valuation group consistently.

The problem with this long-term literature is that the premium that one achieves by buying lower valuation stocks is not linear; in fact, it is very bunchy. Value managers outperform in most 20 and 30-year timeframes, but they also go through long periods on underperformance. Now value advocates would say that if your time horizon is 20 or 30 years, this should not be a problem. Well it may not be a problem if we did not see investment returns daily in the written press and on television. If we assume we will outperform over the next 30 years, but we are in year 7 of outperformance by growth; human nature pushes us to want the higher returns. Daily valuation is a great thing for investors because they can have instant liquidity, but daily valuation plays with our emotions at times.

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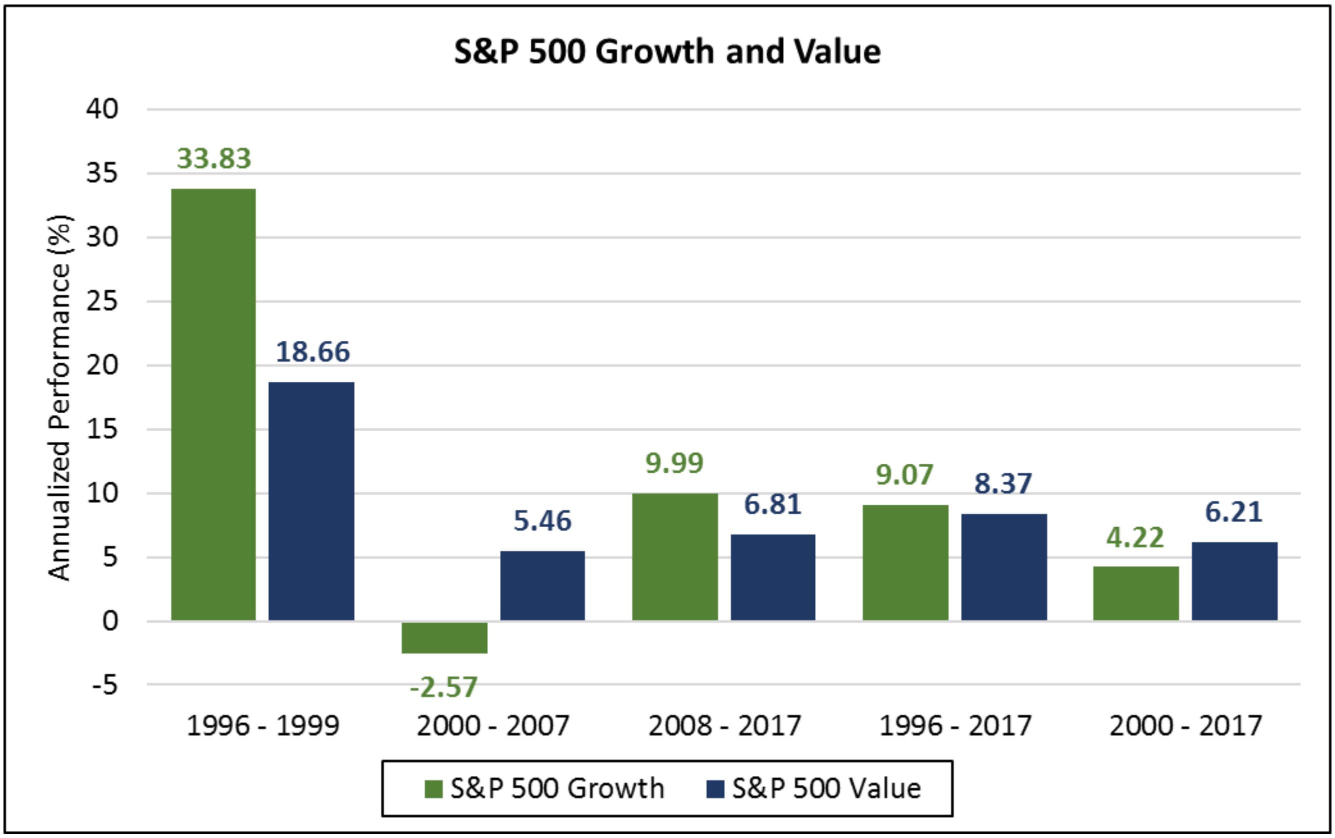
SUCCESSFUL INVESTING REQUIRES A LONG-TERM APPROACH

Let's look at growth and value cycles to get some perspective and where we are today. Standard and Poor's started calculating growth and value returns in 1996. Chart 1 shows how growth and value have performed from 1996-2017.

CHART 1



Source: Morningstar Direct

You will see we have divided this 22-year period into 3 distinct periods, 1996-1999, 2000-2007 and 2008-2017. Each of these represents a period of outperformance by either growth or value. The first period, 1996-1999, was the last 4 years of the Tech boom. Value stocks averaged 18.66% annually over this 4-year period, an 80% premium to the long-term return of the S&P 500 Index. Growth stocks, however, achieved an astonishing 33.83%, close to doubling the return of value. This is a bit of an odd period because while the breadth of stock market rose in 1996 and 1997, it did not rise in 1998 and 1999. The largest 12 stocks in the S&P 500 provided the entire return of the index in 1998 and in 1999 the same was achieved by the largest 7 stocks.

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So, growth managers and growth investors were thrilled with their returns in 1996-1999, but their euphoria was about to change as we entered 2000. For the 8-year period of 2000-2007 value stocks achieved a 5.46% return while growth stocks actually had negative returns, -2.57% per year.

The next period started out with a surprise. In 2008 growth stocks outperformed value stocks, -34.92% for growth and -39.22% for value. While both returns were devastating, value traditionally outperforms growth in periods of declines. The 8-year period of underperformance of growth by value significantly contributed to the performance of growth stocks in 2008. In an odd way, growth stocks offered price value.

The last 10 years have seen growth outperform value, 9.99% for growth and 6.81% for value.

When you review this entire period, 1996-2017, growth stocks had an annual return of 9.07% while value stocks had a return of 8.37%. We would make two observations on the results of the entire period. This period started with and ended with outperformance of growth over value. Whenever this occurs you would expect growth to outperform for the entire period. The same would be true if we started with and ended with a period of outperformance by value. Our second observation is to remember that long-term studies that begin with outperformance by one group and ends with outperformance by the other group show value outperforms over long periods because of their price discipline.

WHAT WILL THE FUTURE BE, GROWTH OR VALUE?

Let's start by looking at the end of the last period of growth outperformance 1999. This was not the Tech Boom, it was the Tech Bubble. The top 7 stocks in the S&P 500 in 1999, weighted as they are in the index, provided slightly more than the total return of the index. Said another way, the bottom 493 stocks were down slightly in 1999 when the index was up 21.0%. The same phenomenon occurred in 1998 but it was with the top 12 stocks, while the index was up 28.6%. So, yes you had a period of outperformance of growth over value, but only if you owned the right growth stocks.

The first six months of 2018 do look like 1998 and 1999. The S&P 500 Growth is up 6.6% while the S&P 500 Value is down 3.4%. But two stocks in particular have contributed to this return, Netflix was up 103.91% while Amazon was up 45.35% during the first 6 months of this year. The S&P 500 index was up 2.65% during this period and based on the weightings of Netflix and Amazon to the index, they contributed 2.15%. If you add in the next two largest contributors, Apple and Microsoft, these four stocks contributed 3.1% to the 2.65% return. In other words, the S&P 500 was up 2.65% for the first 6 months, but the S&P 496 was down .45%. If you look at this phenomenon in the S&P 500 Growth index it is even worse. The S&P 500 Growth Index was up 6.3%, and the contribution of these four stocks was 5.7%, so the S&P 496 Growth was up only 0.6%. The contribution of Amazon and Netflix alone was almost 4% of the 6.3%.

Now just like Microsoft was a great company with a remarkable future in 1999, Netflix and Amazon are great companies today. You would find it difficult to find a friend who did not have a Netflix subscription and Amazon seems to be redefining retail for all of us. The issue with these companies is not whether they are great companies, they are. The

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issue is the price at which they trade. Amazon trades at 226 times earnings and Netflix at 277, both higher than Microsoft in 1999. Scott Galloway has written a book titled The Four, in which he analyzes the history and potential of Amazon, Apple, Facebook and Google. It is an interesting and thoughtful analysis of these four companies and their future. While we would recommend the book, we would urge caution on the price of these stocks. The goal of an investment portfolio is to produce a good return, not to invest in the stocks that are making the headlines while trading at astronomical prices. The history of investing in stocks at 200 times earnings is horrific. Microsoft's annual return from 2000-2017 was 3.84% while the S&P 500 achieved a return of 4.22% and the S&P 500 Value Index was up 6.21% for the same period.

Will Facebook, Amazon, Apple, Netflix and Google face the same fate? Well, no one can answer that. It is possible that one of these firms defies reality at least for some time, but it is important not to utter the most dangerous words in the investment world: This Time it is Different. More people have been punished for that thought than any single idea.

THEORY IS THEORY, BUT PRACTICE IS HARD!

We agree. Our job is to help you achieve your financial goals over the long run, and that advice has proven to be very successful. Our equity strategy has achieved an 8.6% return from 2000-2017 while the S&P 500 has achieved a 5.4% return. Today, however, growth led by the FAANG stocks are the darling of investors, and their returns have been astonishing. These returns are reported in the press and on television daily, and we know all about it. So, focusing on the long-term is challenging, just like it was in 1998 and 1999. Investors can point to the returns of the S&P 500 and ask the simple question of why we cannot compete with that. It is a simple question with an answer that some find difficult to hear.

We have great passion for our ideas and we know over time our Growing Dividend Equity Portfolio will be proven right, but periods like the last 12 and 18 months are difficult. We get that and if we can help in any way, we would love to do so. It may not be intuitive to all investors that avoiding overpriced stocks even when they are achieving great returns is an integral part of a thoughtful long-term investment strategy.

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As always, information provided should be considered based on your personal needs to accomplish your goals. At EisnerAmper, we will be happy to discuss with you any questions and how these principals can be applied to meeting your financial plan. Feel free to contact Marc Scudillo, Managing Partner of EisnerAmper Wealth Management & Corporate Benefits, LLC; 908-429-0025 or email at mscudillo@eawmcb.com.

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