The Value vs. Growth Debate and its Impact on DC Plans and Participant Behaviors

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INTRODUCTION

The growth-versus-value investing debate is nearly as old as investing itself. Value investors have long held that a valuation-based discipline has historically led to long-term outperformance. Growth investors have long held that in the long run a growth discipline is what leads to outperformance. They are both right, depending on the time period being referenced. The relative outperformance of value and growth stocks has rotated cyclically over the course of market history.

Over the decade ending December 31, 2020, the winning strategy has been clear. During this ten-year period, the Russell 1000 Growth Index returned 17% annually whereas the Russell 1000 Value Index returned just 10%. The performance disparity was not limited to U.S. stocks. As of December 31, 2020, the MSCI ACWI Ex USA Growth Index outperformed its Value counterpart by more than 4% annualized over the trailing ten years. The COVID-19 pandemic increased the performance disparity between the two investing styles as value funds, which tend to be invested in more economically sensitive sectors, significantly trailed their growth counterparts through the majority of 2020.

Despite the underperformance for most of 2020, value-oriented investments did bounce back in the fourth quarter of 2020 and into 2021. According to Morningstar, value investments outperformed their growth counterparts in the first quarter of 2021 by the widest margin since 2001. In addition to the strong recent performance, value investments have outperformed growth over longer time horizons. Since its inception in 2000 through June 30, 2021, the iShares Russell 1000 Growth ETF returned a cumulative 355.67% compared to 334.93% for the iShares Russell 1000 Value ETF. As a result of the recent performance disparity between the two investment styles, some defined contribution plan sponsors have asked whether they should increase the number of growth investment options available in their plan, or if value investments are still a prudent investment option to offer to plan participants.

In this paper, we will review notable differences between growth and value investing and evaluate the recent performance trends while providing historical context. We will also explore how the recent outperformance of growth investing compared to value investing impacts defined contribution plans and plan participant behavior. Finally, we will provide conceptual arguments that support the cases for growth and value investing on a forward-looking basis.

HOW GROWTH AND VALUE INVESTING DIFFER

Value investing seeks to identify companies that are priced at lower valuation levels relative to the overall market. These companies may have stock prices that trade below the company's full fundamental worth or intrinsic value. Valuation can be measured in multiple ways, including price-to-earnings, price-to-book, and present value of expected future dividends. Value investors attempt to purchase stocks at depressed prices with the expectation that the market will eventually recognize their full value with a higher stock price.

In contrast, growth investing aims to identify companies that are rapidly growing revenues, earnings and cash flow. Growth stocks are usually more expensive, with higher price-to-earnings and price-to-book ratios, and lower dividend yields. Growth companies are often younger and faster-growing than value companies, which are usually more established and fall into a more mature phase of the growth cycle. Growth companies will often heavily reinvest in their businesses, sacrificing near-term profitability in order to fuel future growth in revenues and earnings. Growth investors attempt to purchase stocks of companies that are expected to rapidly grow in the future and are less concerned about the price at which shares are acquired.

U.S. and global monetary policy have fueled the growth rally over the last decade, as central banks have kept interest rates extremely low in the aftermath of the 2007 Financial Crisis and throughout the COVID-19 pandemic. These policies have allowed companies to borrow and invest at near-record low interest rates. Many big tech companies have used low-cost loans to build moats around their businesses, allowing them the ability to maintain competitive advantages over competitors, thereby protecting long-term profitability and market share.

The table below provides some of the other key differentiators between the two investment styles.

Characteristic	Growth Investing	Value Investing
Definition	Stocks focusing on fast-growing companies with less emphasis on valuations	Stocks perceived by investors as undervalued compared to the market
Price-to-Earnings Ratio	Higher	Lower
Upside Potential	High upside potential of stock price and capital appreciation	Upside potential of stock price driven by the extent of the undervaluation
Dividend Yield	Companies generally pay low or no dividends	Dividend yields are comparatively high
Fundamental Risk	Downside risk if actual growth results are below lofty expectations	Downside risk if business conditions deteriorate more than expected
Representative Stocks	Facebook, Apple and Netflix	JPMorgan Chase, Exxon and Pfizer

PERFORMANCE OVERVIEW

Outperformance for value and growth stocks have rotated over certain time periods. The chart on the following page shows the historical performance of both large cap (Russell 1000) and small cap (Russell 2000) value and growth over the past four decades.

Index	1980-1989	1990-1999	2000-2009	2010-2019	2020	2021 (through 06/30/2021)
Russell 1000 Growth Index	15.38%	20.32%	2.47%	15.22%	38.49%	12.99%
Russell 1000 Value Index	17.97%	15.57%	-3.99%	11.80%	2.80%	17.05%
Russell 2000 Growth Index	11.50%	13.51%	-1.37%	13.31%	34.63%	8.98%
Russell 2000 Value Index	17.45%	12.45%	8.27%	10.56%	4.63%	26.69%

There is very little consistency in the outperformance of growth vs. value when performance is reviewed over decade-long periods. During the 1980s, value outperformed growth, driven by very low equity valuations at the start of the decade coupled with high interest rates. Conversely, growth stocks outperformed value in the 1990s driven by the Dot-Com bubble of the late 90s. The 2000-2009 period was unique in that investor preferences for growth/value differed by capitalization, with large growth outperforming large value, while small growth underperformed small value. Over the past two decades, growth investing has significantly outpaced value investing regardless of market capitalization. In the U.S., the sharp rotation into value stocks that began in November 2020 has been driven by the effects of states reopening their economies, increased vaccination rates and significant growth in the money supply, as the Federal Reserve (Fed) and U.S. government have both pumped trillions of dollars into financial markets and household bank accounts.

Despite the cyclical nature of value vs. growth stock outperformance historically, the steadiness and magnitude of growth stock outperformance over the past two decades cannot be downplayed. While value briefly outperformed growth after the Dot-Com bubble burst in the early 2000s, growth's current stretch of dominance spans mostly uninterrupted from 2007 through 2020. In the face of seemingly overwhelming recent evidence favoring growth investing over value investing, we can nevertheless still seek to understand the drivers of this phenomenon so that we can make a reasoned assessment of the likelihood that these same drivers will persist into the future. For the past decade specifically, many market observers would agree that slow economic growth and a low interest rate environment have fueled investor willingness to "pay up" for tech disrupters that can deliver significant long-term capital appreciation. We will explore some of these performance drivers in more depth shortly.

THE EVOLVING COMPOSITION OF THE U.S. STOCK MARKET

Increased globalization over the last 40 years has caused a shift in the United States from a traditionally manufacturing-based economy to a technology-driven and service-oriented economy. Sector weights of the Russell 3000 Index, which measures the performance of the broad U.S. stock market, have changed significantly over this period. As the U.S. economy has shifted away from production sectors such as Energy and Materials to more service-oriented sectors such as Information Technology, Health Care and Financial Services, sector weights in the Russell 3000 have shifted accordingly. In 1980, seven of the ten largest companies in the S&P 500 were Energy stocks, while today there are none. Conversely, today's five largest companies in the S&P 500 are all classified as growth stocks and account for roughly 18% of the total weight of the Index. The shift in the composition of the U.S. economy is certainly illustrated in the changing sector allocation of the value and growth benchmarks.

Benchmark construction has played an important role in the trend of growth's outperformance over value prior to this year. As of June 30, 2021, the three sectors that have outperformed the S&P 500 Index return the most in in the last three years are the Information Technology, Communication Services and Consumer Discretionary sectors. These three sectors account for about 70% of the Russell 1000 Growth benchmark. Conversely, the bottom three performing sectors (Financials, Utilities and Energy) make up less than 8% of the Russell 1000 Growth benchmark while accounting for roughly 30% of the Russell 1000 Value Index. Value and growth indices used to be more balanced by sector, and their respective sector composition differences were much smaller than they are today. Over time, and as the economy has changed, indices have become increasingly concentrated by sector, and nowhere is that more apparent than in Information Technology and Communication Services. As a proof point, the Information Technology and Communication Services sectors constituted about 18-20% of the Russell 1000 Value Index back in 1990, and they constituted about the same proportion of the Russell 1000 Growth Index. By contrast, these two sectors make up more than 50% of the Russell 1000 Growth Index today, and less than 20% of the Value Index. Because of this, we are witnessing greater performance dispersion between these indices.

Sectors	Russell 1000 Value Weight	Russell 1000 Growth Weight
Basic Materials	3.07%	1.0%
Consumer Discretionary	5.66%	18.13%
Financial Services	20.69%	7.38%
Real Estate	4.76%	1.87%
Communication Services	8.70%	12.78%
Energy	5.15%	0.31%
Industrials	11.63%	6.31%
Information Technology	10.37%	38.94%
Consumer Defensive	7.64%	4.26%
Healthcare	17.57%	8.98%
Utilities	4.76%	0.03%

Weights as of 06/30/2021

THE CASE FOR VALUE INVESTING

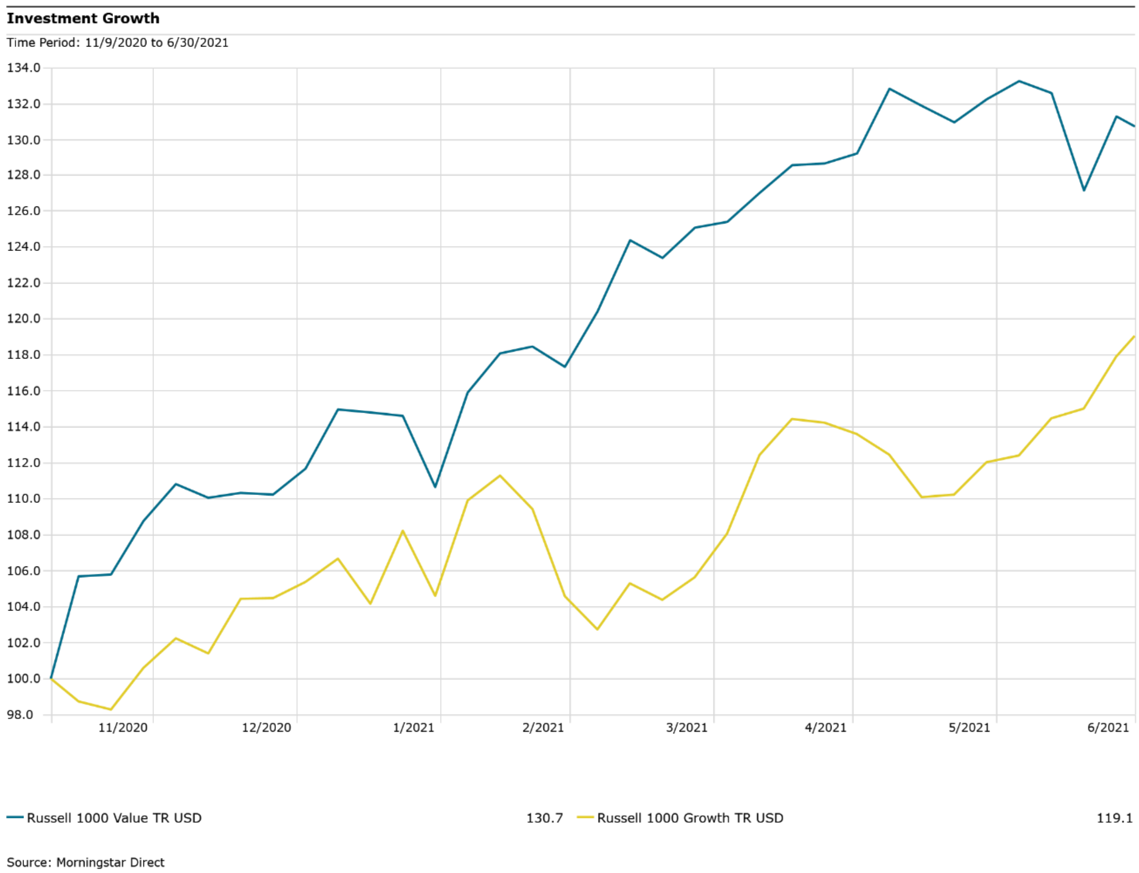
The calls for the death of value investing grew louder in 2020 as several value managers, including AJO Partners, who managed $10 billion in client assets at the time of closing, shuttered. Despite the recent performance disparity between growth and value investing, SageView believes the calls for the demise of value investing are exaggerated, for several reasons that we will discuss.

First, valuation spreads between growth and value stocks were at historically high levels at the end of 2020. In the past, extreme valuation spreads in favor of growth have preceded periods of strong performance for value investing. According to research from Bank of America, when valuation dispersions have been this high or higher, value stocks have outperformed growth stocks 95% of the time over the subsequent 12-month period.

Additionally, periods of value stock underperformance are often followed by periods of strong outperformance. In the late 90s and early 2000s, similar claims were made that value investing was dead as the economy changed and technological innovation exploded. During the Dot-Com era, investors chased the “Big 5” tech names (Microsoft, Cisco, Intel, Oracle and IBM). Up until recently, investors have been chasing the performance of five different tech stocks, the so called “FAAMG” stocks (Facebook, Apple, Amazon, Microsoft and Google). Today’s stock market bears some similarities to the late 1990s Tech Bubble, which ended with the Russell 1000 Growth Index falling by more than 20% between 2000 and 2001 after returning more than 33% in 1999. After the peak of the Dot-Com bubble in 1999, the Russell 1000 Value Index went on to outperform the Russell 1000 Growth Index in each of the next seven years.

Growth stocks have also benefited greatly over the past decade thanks to the fact that technology companies have been lightly regulated and taxed. Conversely, Financials (typically considered a “value” sector) experienced increased regulation and taxation over the same period. With the change in administration, we expect that big technology names may encounter a less accommodative tax and regulatory environment during the upcoming years.

Furthermore, value stocks tend to be more sensitive to economic expansion and contraction and have tended to outperform growth stocks during economic recoveries. On Nov. 9, 2020, Pfizer and BioNTech announced the successful production of an effective COVID-19 vaccine, fueling a value stock rally. Since the vaccine announcement the Russell 1000 Value Index has handily outperformed its Growth counterpart by 11.65% as shown in the chart on the following page.



Specifically, value stocks like airlines Delta and Southwest, along with oil companies like Chevron and Exxon, have seen their share prices rally in anticipation of increased travel as a result of the economy reopening. These companies, like many value companies that rely more heavily on in-person interaction, have benefited from the economic reopening and have significantly outpaced the pandemic "stay at home" beneficiaries like Docusign and Zoom. The recent rebound in relative performance for value has been touted by some as the start of a new value market cycle. Finally, the Russell 1000 Growth Index is also a much more concentrated benchmark than the Russell 1000 Value Index. The top ten holdings in the Value Index make up roughly 17% of the benchmark while the top ten holdings in the Growth benchmark make up 45% of the benchmark. While the more concentrated nature of the benchmark has been beneficial for returns in recent years with the success of the largest holdings, this creates a potentially dangerous situation. Any trend change in these large holdings at the top could derail growth's long run of outperformance.

THE CASE FOR GROWTH INVESTING

While a strong case can be made for value investing due to their current valuations and economic sensitivity, a case can be made that growth stocks may continue their decades-long period of dominance, even if the economy continues its post-COVID-19 rebound. The COVID-19 pandemic accelerated and may have solidified many trends that were already in place. Technology, growth's largest sector, expanded rapidly in 2020 as Americans increasingly worked, learned, and shopped from home. And while travel for work and leisure has shown improvement in 2021, many employers and employees are beginning to embrace a work-from-home or hybrid approach, which provides a more flexible work schedule and the added benefit of reducing business expenses. In addition, broad adoption of technology-based meeting alternatives like Zoom and Microsoft Teams indicate future business travel will drop from previous pre-pandemic highs, which may have a negative effect on value sectors like energy, hospitality, airlines and other travel-related stocks.

Central banks in the U.S. and abroad will continue to play an important role in equity markets over the coming years. Interest rates will likely remain low in the short-term as the Fed implements its new inflation policy and cautiously digests what it feels is transitory inflationary data. Consistently low interest rates will continue to impact banks and other financial firms that benefit from spread income and will make it more difficult for banks to substantially grow revenue. Low or declining short-term interest rates have historically benefitted growth stocks, as low interest rates correspond to lower discount rates, which causes the present value of future earnings to increase.

Another factor that could benefit growth stocks is the gaining popularity of Environmental, Sustainability and Governance (ESG) investing. ESG asset growth continues to rise and tends to focus primarily on growth-oriented stocks. The FTSE4Good U.S. Select Index, a leading ESG index, held an allocation to the Technology and Consumer Discretionary sectors of over 48% as of May 31, 2021. With the Department of Labor expected to provide clarity and additional flexibility for defined contribution plans to offer ESG investments, we expect this trend to continue into the future.

IMPACTS TO PLAN SPONSORS AND PLAN PARTICIPANTS

In order to provide plan participants with the ability to diversify their portfolios, most defined contribution plans offer a selection of both U.S. value and growth-oriented funds. At a minimum, most plans offer an actively-managed large cap value and large cap growth fund and compliment them with small and mid-cap value and growth fund options. Reports from major retirement plan record keepers support this claim. Fidelity, the largest defined contribution recordkeeper in the U.S., reports that the majority of their clients in the $100 million-$250 million range offer both a large cap value (91%) and a large cap growth fund (97%) in 2020. Vanguard's annual "How America Saves 2021" report reveals that 87% of Vanguard client plans offer a large cap value fund and 90% offer a large cap growth fund. From a utilization perspective, 10% of the participants on Vanguard's platform used large cap value investments; 14% used large-cap growth investments.[1]

While we have not seen a seismic shift in assets to growth-oriented funds through exchange activity, participants hold a higher allocation to growth funds due to stronger returns from growth stocks over the last several years. Of the more than 1,200 defined contribution plans on which SageView advises, 13.5% of assets reside in U.S. growth funds, while only 4.8% are invested in large cap value funds. Information from Fidelity Investments paints a similar picture, with 13.1% of its corporate 401(k) assets being invested in U.S. growth funds and only 3.1% in U.S. value funds. Much of this allocation difference can be attributed to the performance disparity outlined above. While this overweight to growth benefitted plan participants in recent years, it could lead to lower or more volatile returns if we experience a long-term reversion to the mean, favoring value-oriented funds. We see an education opportunity to remind and educate participants about the benefits of diversification and periodic rebalancing.

The historically unprecedented performance disparity between value stocks and growth stocks has not driven participants to increase exchange activity. In recent years, participant exchange activity has continued to decline, with fewer than 10% of participants making an exchange in any given year. While exchange activity increased in 2020 during the COVID-19 pandemic, it has remained low. This lack of participant activity is commonly attributed to participant inertia and the dramatic rise in popularity of target date funds over the last decade. Target date funds, including the industry's largest offerings from Fidelity, Vanguard, T. Rowe Price and American Funds, generally tend to keep allocations to growth and value at similar levels and periodically rebalance between the styles. At times, these funds may make slight tactical overweights to value or growth, but generally provide for fairly equal allocations to both styles.

We have not seen any impact on defined contribution menus from the disparity in returns of value and growth. Despite the outperformance of growth over the last decade, we have not advised clients to make structural changes to their plans' investment menus. While no one can accurately predict short-term market trends, SageView continues to believe the best approach for plan sponsors is to provide a diverse number of plan investment options that include both value and growth disciplines spanning all market caps, including large, mid and small cap stocks. We recommend using passive options to cover the blended categories, while offering active management for value and growth options. For international options, we believe offering a diverse, actively managed large cap fund, a passively managed international index fund and an emerging markets fund will satisfy most participants' needs.

From a participant standpoint, we continue to recommend maintaining an equal allocation to value and growth fund options and to avoid market timing or tactical overweighting. For inexperienced investors, utilizing the age-appropriate target date fund option offered in their Plan remains an excellent option providing them with the benefits of professional fund management, appropriate asset allocation and periodic rebalancing.

While we cannot predict future market performance, at SageView, we continue to believe that both value and growth options will play important roles in defined contribution plans. Market conditions, interest rates, investor trends, political initiatives and innovation will surely favor one style or the other over different market cycles for years to come, as they have the last several decades. Neither style is likely to dominate indefinitely.

[1] Vanguard How America Saves 2021