

Value vs Growth: Eye-Popping Divergence

The second quarter rebound in the markets has been almost as spectacular as the first quarter decline in terms of magnitude and speed of change. On June 3rd, the NASDAQ breached new highs in the face of historically high unemployment and hugely negative GDP, while other parts of the market remain extremely depressed. On the surface, these diametrically opposed behaviors do not make any sense. Yes, many parts of the economy have started to reopen, but capacity remains extremely low and tentative. How can some sectors of the market be so strong in the face of exceptionally weak data and the threat of a second wave of Covid-19 returning? How does an investor navigate in such uncertain times? The answer to both questions lies in understanding the sources of strength and weakness in the economy and pairing that with a strategic stock sector selection.

The Great Divide between Value vs. Growth: The stock market has always been a leading indicator of the direction of the economy. Admittedly, it is not always correct, but it is one of the best barometers of where future growth will develop. When the Covid-19 crisis hit, every sector of the market fell hard (down nearly 30-40%) as the entire economy was forced to shut down. But for those companies in sectors such as Technology and Communications that could quickly adapt to or adopt a new operating model, they were able to resume almost all their daily business. However, many other businesses like Retail, Travel/Leisure and Manufacturing were unable to adapt and had to shut down operations entirely. The result has caused a great divide in productivity, revenue, and profitability. This divide is particularly evident when looking at the sector performance within the stock market, specifically between Growth and Value stocks.

Eye-popping Divergence: Growth stocks have been outpacing Value stocks for many years, however, since the Covid-19 hit, this performance gap has increased dramatically. **Growth stocks have outperformed Value stocks by over +21% year to date.**

Performance	YTD	3 Year	5 Year
Large Growth	5.4%	12.5%	9.7%
Large Value	-15.7%	-3.2%	0.8%
Spread	+21.1%	+15.7%	+7.9%

Not only has Growth outperformed by a wide margin, but several Growth stocks have ascended to all-time new highs while many Value stocks have barely budged off their March lows. The chart below shows the change of a \$10k investment in a Growth Index (QQQ, blue line) and a Value Index (VTV, red line) since January 1st, 2020. The QQQ investment is now worth \$11,235, a +12.35% return. Whereas the VTV investment is now only worth \$8,464, or -15.36% return. Clearly sector selection can make or break the portfolio!



Value vs. Growth Risk? Historically, Value companies are considered less risky and have lower volatility because they have already proved their business model and trade at a lower Price/Earnings valuation. In contrast, Growth stocks are considered to have more risk and higher volatility, as they are dependent upon future success and they trade at a high valuation. Intuitively, one would assume Value stocks would hold up better than Growth when the economy crashes. However, that is not what we have seen in today's environment.

Value companies are slow moving in terms of adapting because it hard for them to quickly change their business model. Airlines, Retail, and Manufacturing business are examples of Value companies that ride the wave of the economy and are currently struggling to survive in this new operating environment.

In contrast, a business that is considered a **Growth stock** is quite agile, aggressively spending revenue on gaining market share and product development. They are on the cutting edge of change and innovation and therefore are generally more insulated from the economic cycle. A good example this is Amazon, which has focused not only on growing their retail shopping service but has also expanded into the delivery and entertainment area. They continue to adapt to change and adopt new practices to facilitate future growth.

Which Stock Sector Should I own today? That is the tough question. Value stocks (less risk) got pummeled when the virus hit and are trading at ridiculously cheap valuation. This can either be a real bargain or signaling the economy is in for an exceptionally long period of weakness ahead. Meanwhile, Growth stocks (more risk) fell much less and have rebounded strongly to now historically high valuation levels. This sector is betting on new areas of big growth in the economy. Can both sectors be right about the direction of the economy? Possibly. Perhaps they are signaling a new construct of an economy that will be even more adaptable and fluid. Change is happening faster every day!

Caution Ahead: The extreme performance differential between Growth and Value is startling and conflicting, warranting caution ahead. Previous economic contractions were measurable and could be addressed with normal monetary policy action. There is little normal about the current economic contraction as it is still unfolding. The length and depth cannot be fully quantified because it is very much dependent on containing a virus we still know little about. It is indeed a challenging market environment with large swings in both directions likely over the next twelve months.

Investment Strategy: In late March, exposure was increased to Growth sectors with the view the strong companies will get stronger while the highly leverage and/or slow growth (Value) companies would falter. This overweighting in Growth sectors proved to be a good strategy. The rally that ensued pushed even further the overweighting in Growth sectors such that it was time to rebalance and move some stock exposure back into Value. Looking ahead, the strategy is to stay near neutral on risk exposure and nimble with sector allocations.

Keep Asking! Many of you have asked questions about the markets and portfolio strategy recently. I am delighted you are paying attention and happy to discuss in detail. It is my highest priority to be transparent and clear on how we manage risk and how we develop/implement your investment strategy.

These are my thoughts. Your feedback is always appreciated.

Happy Summer!
Best Regards,
Barbara

Barbara HS Huff, CEO
New Albany Investment Management
614-216-6139
bhuff@newalbanyinvestment.com