

Introduction

Over the long run in the US, value stocks have outperformed growth stocks, a premium that has averaged roughly 200 basis points annually over the last four decades. Since May of this year, growth stocks have exhibited strength over value stocks, as evidenced by the MSCI USA Value and Growth Indices. In fact, the growth premium has averaged 14 percentage points annualized over the last four months—June, July, August, and September. In this article, we put this recent development in historical context and briefly discuss its differences from past periods and its possible drivers.

The Long-Run Value Premium

Over the long run, value stocks have traditionally outperformed growth stocks, as evidenced in the earliest literature (see Fama and French, 1992)¹. Figures 1A and 1B display the long run Value-Growth spread, i.e. the value premium, as evidenced by the MSCI USA Value and Growth Indices since 1978.²

Figure 1A

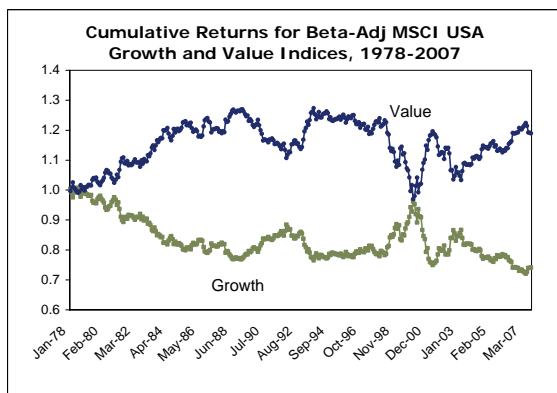
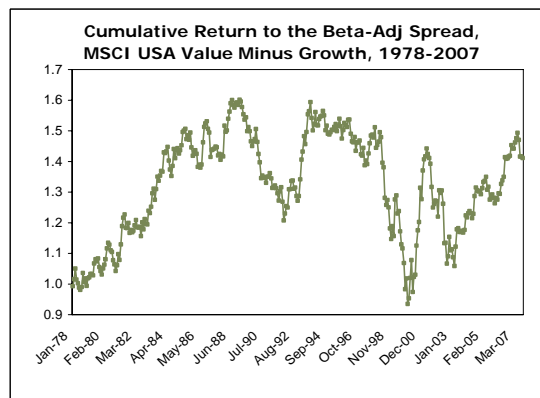


Figure 1B



Despite the long-run value premium, there have been notable periods where growth stocks have outperformed value stocks. The relative attractiveness of growth stocks depends on many factors such as their perceived opportunities for financing and expansion, their borrowing costs, etc., so expected and unexpected interest rate changes, expected economic growth, and market uncertainty have been all been suggested as factors that affect how they perform relative to value stocks. Here we do not examine the impact of macroeconomic variables³ on the value-growth relationship but rather we focus on understanding their drivers within the asset space.

¹ The well-known Fama-French three-factor model extended the traditional CAPM to explain excess returns not just with market beta but also with a small-stock and value-stock premium. See Fama, Eugene F., French, Kenneth R. "The Cross-Section of Expected Stock Returns." *The Journal of Finance*. Vol. XLVII, No. 2. (June 1992).

² In these charts, the index returns are beta-adjusted for illustration; we calculate the rolling 3-year monthly betas of the MSCI USA Value and Growth Indices to the MSCI USA Index and subtract the beta-adjusted market return from the Value and Growth returns.

³ The relationship between macro variables and asset prices encompasses a large body of literature and is highly dependent on the data used and both frequency and timing assumptions. See MSCI Barra Research Insight, "Macroeconomic Factors in a Fundamental World" (2007) by Melas and Liu for a discussion of these issues.

The Current Growth Premium

Over the last several months, a sizable growth premium has emerged and persisted. Table 1 highlights the size of this premium, while Figures 2A and 2B shows how rapidly this spread has evolved.

Table 1: Average Return (Annualized) to Value and Growth

	MSCI USA Value Index	MSCI USA Growth Index
January 1975 to September 2007	13.2%	11.4%
January 2006 to September 2007	15.2%	11.3%
June 2007 to September 2007	-5.9%	8.2%

Figure 2A

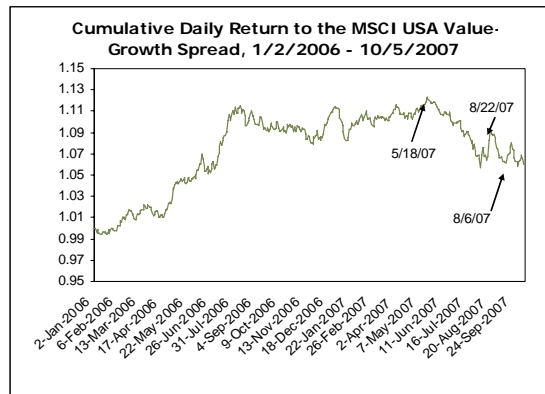
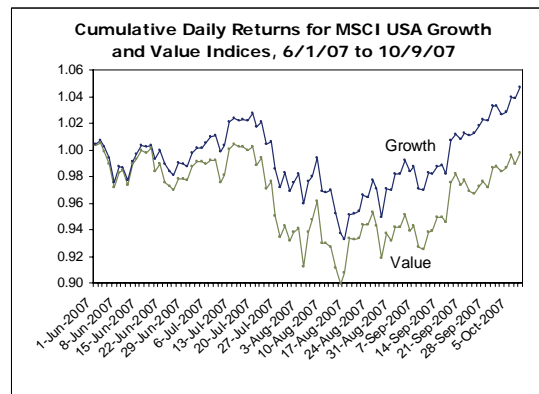


Figure 2B



The current size of the growth premium is not out of context historically. There have been large retrenchments of the value premium, for instance throughout 1989-1991, and 1999-2001. Historically, periods where growth stocks outpace value stocks can persist for some months. The last major period, which extended over two years, began in 1998. Since that 1998-1999 era, growth premium runs have been short-lived, with the last one which having been relatively mild in 2006. The question remains whether this current growth premium will continue to extend on par with the 1998-1999 run or whether it will echo the last three spurts. In the next section, we examine the sources of return of the MSCI USA Value and Growth Indices to uncover what has driven the most recent premium.

Sources of Return

Attributing the returns of an index or portfolio allows us to understand what sources the returns are coming from, be they industries, common style biases, or idiosyncratic risk. Here we decompose the MSCI USA Value and Growth Indices, which allows us to have a better understanding of the forces behind the recent growth premium. We decompose the constituent-level MSCI USA Value and Growth Indices along the dimensions of the Barra US Equity Model (USE3) factors.⁴

⁴ We use Barra Aegis Performance Analyst to attribute the performance of the two indices at the constituent-level each month. The model we use is the Barra Long-term US Equity Model (USE3L).

Table 2 shows the key sources of return for the two indices using monthly data since 2000, against a market benchmark (the MSCI USA Index).

Table 2: Sources of Return, January 2000 – September 2007*

Source of Return	MSCI USA Value Index		MSCI USA Growth Index	
	Return (%)	Risk (%)	Return (%)	Risk (%)
Total Return	5.74	14.72	-1.44	16.48
Active Return	3.40	4.77	-3.78	4.93
Beta Policy	0.04	1.50	-0.15	1.55
Styles	1.84	1.98	-1.99	2.04
Industries	0.39	2.98	-0.45	3.10
Asset Selection	1.13	2.34	-1.19	2.41

* Annualized numbers shown using monthly data.

In Table 2, we see that the strong performance of the MSCI USA Value Index over the last six years, and in contrast, the poor performance of the MSCI USA Growth Index relative to the MSCI USA Index. The risks of the two Indices have been approximately similar. Much of the return differential in Table 2 comes from “Styles,” which denotes the style common factors in the Barra model. This set of 13 factors includes explicit Value and Growth factors.

Next, Table 3 shows the sources of return using daily data for just the most recent period, June 1, 2007 to October 8, 2007.

Table 3: Sources of Return, June 1, 2007 to October 8, 2007*

Source of Return	MSCI USA Value Index		MSCI USA Growth Index	
	Return (%)	Risk (%)	Return (%)	Risk (%)
Total Return	-2.36	17.05	13.89	15.14
Active Return	-8.73	2.73	7.53	2.92
Beta Policy	0.84	0.35	-1.00	0.63
Styles	-8.28	1.39	6.62	1.87
Industries	-1.02	1.76	0.82	1.43
Asset Selection	-0.28	1.17	1.09	1.04

* Annualized numbers shown using daily data.

If we compare Table 3 against Table 2, we see a number of developments unique to this most recent period. Traditionally the MSCI USA Value Index has earned positive returns relative to the MSCI USA Index while the MSCI USA Growth Index has earned negative returns. In the last several months, not only has this relationship been flipped but the switch in performance has been extreme. The growth premium has been driven by the style factors in the Barra Model, which include not only the Barra USE3 Value and Growth factors but also other important systematic sources of return including Momentum, Earnings Yield, and Volatility.⁵ Thus, nearly

⁵ In Table 2, the return coming from risk indices is 1.84% for Value and -1.99% for Growth, accounting for more than half of the active returns of 3.40% and -3.78% respectively. Industries meanwhile play a more insignificant role in Table 2 whereas Asset Selection, reflecting the stock-specific differences between the two indices, is quite important. In Table 3,

all of the recent growth premium is explained by the Barra USE3 style factors, and to a lesser extent, industries. Asset selection, that part which is idiosyncratic to stock returns, has had a much smaller role.

Further drilling down, we show in Table 4 the main style and industry drivers over the most recent period.

Table 4: Key Style/Sector Sources of Return for MSCI US Value and Growth, June 1, 2007 to October 8, 2007*

	MSCI USA Value Index		MSCI USA Growth Index	
	Return (%)	Average Exposure	Return (%)	Average Exposure
Value	-3.1	0.41	2.88	-0.34
Leverage	-1.93	0.21	0.37	-0.04
Yield	-1.33	0.4	1.87	-0.51
Earnings Yield	-1.15	0.28	1.67	-0.36
Momentum	-0.78	-0.1	1.38	0.16
Growth	-0.43	-0.14	0.77	0.23
Financial	-0.98	14.04	1.4	-15.06
Technology	-0.98	-12.07	1.08	10.79
Health Care	-0.43	-3.46	0.58	3.41

* Annualized numbers shown using daily data.

The major drivers of the recent growth premium appear to be confined to six of the thirteen USE3 style factors—Value, Growth, Leverage, Yield, Earnings Yield, and Momentum. These same style factors, in particular Value, Earnings Yield, and Momentum, were largely negatively impacted by the recent quant meltdown (see MSCI Barra Research Bulletin, “Risk Management During Turmoil”, August 2007). In relative terms, the aggregate effect of Momentum, Earnings Yield, and Yield factors have been as important as the Value and Growth factors themselves.⁶

Also in Table 4, we highlight several sectors which have been major drivers of the growth premium. These sectors include Financials, Technology, and Health Care. Financials is one sector which has been hit by the subprime meltdown and deteriorating credit conditions. Interestingly, credit crunches typically dampen the opportunities for growth and can negatively impact growth firms’ perceived value. In this case, the recent Fed interest rate reduction has mitigated any fears of tightening credit markets. Thus while certain credit-sensitive industries have been hurt in recent months, growth stocks have remained in favor.

Conclusion

Value stocks continue to demand a premium over the long run relative to growth stocks. However, growth stocks exhibit periods where they are in favor over value stocks as we have

the returns from risk indices are -8.28% and 6.62% for Value and Growth, accounting for nearly all of the active returns (-8.73% and 7.53%).

⁶ The Value factor in USE3 reflects book-to-price; stocks with high book-to-price performed particularly poorly over the last several months. Growth in the Barra factor model is measured by multiple descriptors including payout ratios, capital structure variability, asset growth, historical earnings growth, and predicted earnings growth. The Barra Growth factor has been less important a driver than the Value factor in recent events.

seen since the middle of this year. We link the recent growth premium to the systematic factors in the Barra US Equity Model. Value and Growth as defined in the Barra factor model explain a large amount of the spread that has developed between the MSCI USA Value and Growth Indices. Other factors including Earnings Yield, Yield, Momentum, and Leverage have also had an impact, as well as certain industries which have impacted by the credit crunch.

Historically, periods where growth stocks outpace value stocks can persist for multiple years. The last major period, which extended over two years, began in 1998; since then, these periods have been short-lived. With the current growth premium now extending into its fifth month, the question remains whether it will continue to extend, spurred by falling interest rates and a healthy bull market, or fizzle out as the recent quant contagion effects slowly fade away.

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