WHAT THE INDEXES REVEAL ABOUT THE CHARACTERISTICS OF STYLE

By Jennifer Openshaw

Understanding style characteristics is important when making investment decisions, because portfolios that follow a particular style tend to favor certain industries, and do better during certain economic environments. One way to understand the differences is to examine the characteristics of growth and value stock indexes.

Although "growth" and "value" investment styles have been around for many years, individual investors are becoming more careful about distinguishing between the two.

Understanding the characteristics and distinctions between styles is important when making investment decisions, whether they concern an approach to investing in individual stocks or evaluating a mutual fund manager's discipline. Portfolios that follow a particular style will tend to favor certain industries; they also tend to do better during certain kinds of economic environments and worse during others. In addition, these style characteristics may change based on the size of the company—for instance, a portfolio of large-company growth stocks will differ in industry composition from a portfolio of small-company growth stocks.

While many investors are aware of the general distinctions among growth and value stocks of larger firms, much less attention has been paid to distinctions at the mid-cap and small-cap level.

One way to understand the differences is to examine the characteristics of growth and value stock indexes. This article focuses on Wilshire's "style" indexes, built from the Wilshire 5000, a broad market index that covers over 7,000 stocks. These style indexes gauge the performance of growth and value within the three size categories—small-, medium-, and large-capitalization stocks—and range from 150 to 250 stocks. Although these indexes are not covered by any general circulation print publication, they can be accessed by the general public from the Wilshire Web site at www.wilshire.com [go to Indexes and click on Annualized Index Returns].

DEFINING STYLE

What is meant by growth and value? The terms mean different things to different people, but the truth is, most people use them casually. When the style indexes were created in 1987, there was no standard definition of growth or value.

The definitions used for the Wilshire indexes are by no means the only definitions, but they are clear and concise for the purposes of discussion. They are based on the Wilshire 5000 index, the broadest representation of the U.S. stock market and includes all U.S.-headquartered stocks with readily available pricing information. The definitions are based solely on quantitative criteria; subjective aspects do not come into play.

Under the Wilshire definition, growth stocks have these characteristics:

- Above-average earnings and sales growth histories—firms that have enjoyed long and successful growth trends would fit this profile; and
- Companies that have higher-than-average returns on equity or levels of profitability—rapidly growing companies like Microsoft and Oracle are good examples.

Value, on the other hand, is defined as those stocks that, when compared to other stocks, are attractively priced based on earnings, book value, and

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TABLE 1. WILSHIRE STYLE INDEX SECTOR WEIGHTINGS (AS OF 12/31/98)

Index	Capital Goods (%)	Consumer Durables (%)	Consumer Non-Durables (%)	Energy (%)	Financial (%)	Materials & Services (%)	Technology (%)	Transportation (%)	Utilities (%)
Large Co. Growth	8.7	0.7	44.9	0.9	8.8	3.9	28.2	0.6	3.3
Mid-Cap Growth	7.4	5.7	22.0	2.8	15.5	21.4	19.2	3.5	2.4
Small Co. Growth	9.1	4.6	22.7	1.2	7.7	25.6	23.3	4.9	1.0
Large Co. Value	1.8	8.6	5.8	12.3	40.7	8.3	3.2	2.4	16.9
Mid-Cap Value	6.0	4.3	14.6	2.5	23.1	15.7	3.1	2.3	28.6
Small Co. Value	7.5	8.8	16.9	1.5	24.0	17.9	3.2	3.6	16.6

dividend yield. Ford Motor is a prime example of a value stock.

Because the definitions rely on multiple factors, Wilshire uses a "style metric" to put a score on a stock's style, which helps to distinguish, without any subjectivity, the extent to which a stock is a growth or value stock. The metric measures the "distance," in a statistical sense, between each stock and a "typical" growth or value stock.

Although some investors find it comforting to classify all stocks as either growth or value, the Wilshire methodology does not do so, and hundreds of stocks fail to fall into either category.

On the other hand, a stock may indeed be considered both a value and a growth stock. It is possible that a stock with a high historical growth rate and other characteristics of growth stocks has a low price-earnings ratio, a characteristic of value stocks. In fact, about six to eight companies will fall into growth and value categories at any given time. Recently, companies like Brunswick and Dana Corporation passed strict screens for both growth and value. [This may prompt some readers to wonder if this type of stock has some special features that lead to a unique performance advantage, but historically this has not been the case.]

SMALL, MEDIUM, AND LARGE

As with "style," there are many different definitions of "size." By Wilshire's definition, large caps are those whose market capitalization (defined as shares outstanding multiplied by market price as of the prior June 30) places them among the 750 largest companies in the Wilshire 5000 index. Currently, this would mean a market capitalization of over $1.9 billion.

Small caps are the next 1,750 stocks and currently include those in the $190 million to $1.9 billion range.

Wilshire defines mid-caps as companies 501 to 1250 of the Wilshire 5000, which overlaps both the large and small caps; currently, that translates into a market capitalization between $645 million to $4.3 billion.

CHARACTERISTICS

Since size and style play such an important role in a stock portfolio's characteristics, it is useful to look at the characteristics of the six size/style categories: small growth, large growth, mid growth, small value, large value, and mid value.

In terms of composition, these six indexes include stocks from various economic sectors, from capital goods and consumer durables to energy, financial, and technology stocks, but a look at the dominant sectors within each category tells us much about where these quadrants are getting their returns, as shown in Table 1.

Large growth, for instance, is dominated by consumer non-durable stocks, which make up 44.9% of the index. Similarly, mid-cap and small-cap growth stocks are weighted heavily toward consumer non-durables, although to a lesser degree, as well as the technology and materials & services sectors.

Large value is dominated by financial stocks, which make up 40.7% of

TABLE 2. WILSHIRE STYLE INDEX INVESTMENT CHARACTERISTICS (AS OF 12/31/98)

Index	Price-Earnings Ratio (%)	Dividend Yield (%)	Price-to-Book Ratio (%)	5-Year Payout Ratio (%)	5-Year Earnings Growth (%)	5-Year Return on Equity (%)	5-Year Sales Growth (%)
Large Co. Growth	34.8	0.8	9.3	24.8	17.7	26.7	20.4
Mid-Cap Growth	19.8	0.9	4.4	12.7	18.9	16.8	24.6
Small Co. Growth	21.8	0.2	5.5	4.4	16.0	17.6	28.6
Large Co. Value	14.6	2.7	2.7	40.8	14.2	14.5	11.0
Mid-Cap Value	15.8	2.9	2.2	39.0	9.2	13.3	9.2
Small Co. Value	14.7	2.6	2.2	36.0	7.9	13.2	10.3

TABLE 3. WILSHIRE STYLE INDEX ANNUALIZED RETURNS FOR VARIOUS PERIODS

	Annualized Returns (%)					
Index	**1979-1983**	**1984-1988**	**1989-1993**	**1993-1998**	**Last 10 Years**	**Last 20 Years**
Large-Cap Growth	17.1	13.8	15.9	27.9	21.8	18.6
Mid-Cap Growth	25.6	9.0	16.5	13.8	15.1	16.1
Small-Cap Growth	27.2	6.6	15.1	11.8	13.4	14.9
Large-Cap Value	18.7	19.2	13.5	19.0	16.2	17.6
Mid-Cap Value	25.2	18.5	15.9	14.9	15.4	18.6
Small-Cap Value	28.5	20.8	15.9	13.0	14.5	19.4

the index. The small- and mid-cap value stocks are also weighted towards financials, but to a lesser degree.

Size also plays a role in the investment characteristics of the different style indexes (see Table 2). Although not historically the case, large-cap stocks within the growth style currently have much higher price-earnings ratios and price-to-book ratios than their mid- or small-cap counterparts. This is due, in part, to the fact that over the past five years, large growth stocks have enjoyed a much higher return on equity. Because these companies have been able to significantly improve their profit margins, investors have been willing to push the prices of these stocks to higher levels. On an earnings and sales basis, these larger companies have not been inherently faster growth companies. Small- and mid-cap growth stocks tend to reinvest dividends to help fuel growth, thus leading to the lower dividend yield and payout ratio.

Within the value style, most stock characteristics tend to be quite similar regardless of size. For instance, the price-earnings ratios and price-to-book value ratios among large-, mid-, and small-cap value stocks do not vary much. On the other hand, large-cap value stocks have had faster earnings growth than mid- and small-cap value stocks.

PERFORMANCE TRENDS

Examining the performance trends of these size and style categories is also interesting. Table 3 shows the annual returns of the six categories over the last 20 years for various time periods and illustrates the shifting performance patterns among the various styles. You can see that large-cap growth stocks have done exceptionally well over the past five years with returns of 27.9%, but similar returns were produced by the small- and mid-cap stocks in the earliest 1979–1983 period. Value stocks were the place to be in the 1984–1988 period. Over the 20-year period, the average annual returns of all six categories are much closer together, but small-cap value stocks have the edge and small-cap growth performed the worst.

Table 3 hints that size plays a big role in relative performance, and Figure 1 further illustrates the small- and large-cap cycles by showing the relative performance of small-cap stocks versus large caps. From late 1979 to 1983 and from fall 1990 to 1993, small companies were in favor, yet from 1983 to September 1990 and again from 1993 to the present, large caps have been in favor.

In this regard, it is interesting to examine the relative price-earnings ratios of small- and large-cap stocks (Figure 2). Historically, there have only been three times in the last 20 years or so—the end of 1998 being the third—in which the valuations of small-cap stocks are extremely attractive relative to large caps. In 1979, 1990, and again in 1998, the price-earnings ratios of small caps fell to large-cap levels, as indicated by the 1/1 ratio of the price-earnings ratios and the downward spikes. When this occurred in the previous two periods, small-cap stocks outperformed large caps by about 8–10 percentage points per year for the following three years.

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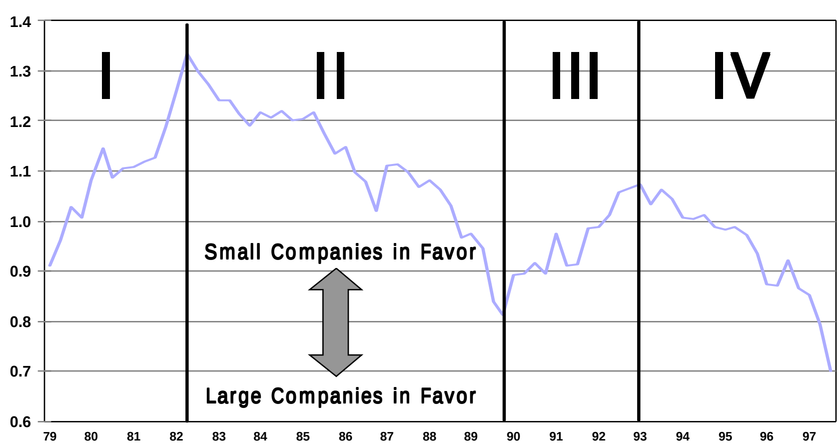
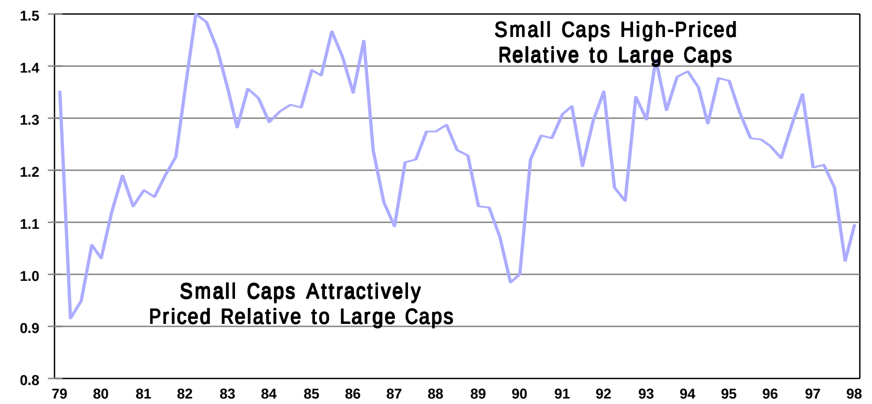
FIGURE 1. RELATIVE PERFORMANCE OF SMALL COMPANIES VS. LARGE COMPANIES



Source: Wilshire Associates

FIGURE 2. RELATIVE PRICE-EARNINGS RATIO OF SMALL COMPANIES VS. LARGE COMPANIES



Source: Wilshire Associates

investment approach is so strong, it can have a very definite impact on the behavior of stock investors, both individuals managing their own stocks or mutual fund managers. Some investors, upon noticing the improving performance of growth stocks, for example, might shift their portfolio in that direction. This is called "style drift," and it can occur with both stock size and style. The problem is that when a portfolio shifts focus, the investor is not getting true exposure to the style intended. This can be a particular problem if you are invested in a mutual fund that has drifted and is no longer following the style that you desire. Comparing your own stock portfolio or a mutual fund portfolio to a style index can help you judge whether you or your fund has drifted from its original approach.

WHAT THIS MEANS

Portfolios with different investment styles will have different compositions and characteristics, and consequently will do well at different times. There are many ways—not all of which are suitable to every investor—to manage one's wealth to take advantage of these style fluctuations.

The best approach, however, is to develop a long-term strategy that is consistent with your own risk and return needs and resources. The strategy should then be implemented in a disciplined fashion and followed through all market environments.

The style indexes can provide you with some clues as to how a portfolio that is following a particular style may perform, and what kinds of stocks it is likely to contain.

In addition, the style indexes can provide you with a benchmark to judge whether your own stock or fund portfolio is sticking to the original investment objective in all market environments or has drifted from the stated approach. ✦