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INVESTMENT COUNSEL

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INVESTMENT POLICY: MORE ON GROWTH VS. VALUE

In the investment management world, investment "style" refers to a process by which the adviser invests in a class of equities that have common characteristics. The most common segmentations are by expected growth or market valuation, the so-called growth or value styles, and by market capitalization (i.e. large, mid, small, or micro). Despite having much in common as investment professionals, value managers and growth managers are distinct breeds. The value manager tends to think first of asset values, price to earnings multiples, price to book value, and free cash flow. Expected growth is clearly important to value managers but it often becomes a secondary consideration for them. Growth managers on the other hand tend to think first and foremost about the growth inherent in a business or economic sector, with the price paid for that growth often only a secondary consideration. Given the differing thought processes, it is perhaps not surprising that both types of managers tend to speak of the other - - and their stocks - - in tones conveying feelings ranging from bemusement to mild contempt. Indeed, many growth savants or value mavens hold near religious conviction in the absolute correctness of their approach to the exclusion of any other analytical framework.

Despite the depth of conviction of both the growth and value schools, academic literature and the actual results of several leading investment organizations suggest quality practitioners of either discipline can and do out-perform the broad market indices over long periods of time. In any one year, however, one style is likely to be superior to the other, sometimes substantially so. 1998 was such a year, with

the median growth manager outperforming the median value manager by 22% according to analysts. Equally disquieting for the style out of favor, one style can outperform the other consistently for multiyear periods. For example, growth has

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outperformed in the 1997-1999 period, while value outperformed in the 1992-1994 time frame. Thus, there is a boom-bust quality to either style even as practiced by the best managers.

The avoidance of the deeply cyclical nature of pure growth or pure value investing is a critical element of Trees Front Associates' investment philosophy. Since its inception, our firm has structured the equity portion of portfolios under its supervision with a *blend* of stocks from both the growth and value sectors of the market. Our research focuses on identifying the stocks in each sector offering the best risk/return over our investment time horizon. And by balancing client's portfolios between growth and value, we hope to provide more consistent results across the inevitable investment cycle.

From the beginning, we also felt we could add value over separately managed growth or value portfolios by *tilting* client holdings in the direction of whichever style we believed was likely to perform more favorably given our macro economic outlook and market valuation analysis. We would allow the portfolios to tilt as far as 65% in one direction or another. Fifty-fifty was deemed neutral reflecting what was then a fairly even split between growth and value stocks in the investment universe. Because client's portfolios held both growth and value stocks, we felt our stock investment process allowed us to achieve broad diversification without compromise, giving us the option to select from among the strongest companies in either sector rather than being limited to just one sector. Tilting, or so-called active style management, has worked for us and for our clients. However, in recent years, investment style management has become more and more specialized. Today, there are large-cap growth managers, small-cap value managers, and every permutation in-between in what has become an increasingly complex and sophisticated business. For better or worse, clients judge a manager's performance in comparison with a benchmark as opposed to an absolute standard. For our clients, this benchmark is the Standard & Poor's 500 Composite Index. Therein lies the issue at hand. The S&P 500 is no longer as evenly balanced between growth stocks and value stocks as it once was. It has, in fact, become a large capitalization growth index.

Broadening the Range

So how should we now approach the growth vs. value issue? Should we simply split the S&P 500 in half, possibly by price/earnings ratio or price/book ratios, and arbitrarily define the upper half as growth and the lower half value, much as several large index fund managers have done? We believe there is a better way, more in keeping with our philosophy to stick with clear-cut definitions of growth and value but allow our process to tilt a bit further than heretofore in one direction or the other. We have, therefore, decided to increase the range of our tilt from 65%-35% to 70%-30%. Clearly, we are not advocating an increase in our weightings in high-flying growth stocks at this time. In fact, we believe we are approaching a point when, for a time, value stocks are likely to provide better relative returns than they did in 1998. As we noted in our January letter to clients, value stocks should begin to firm as we approach the millennium and we look ahead to more synchronous global growth in the year 2000, if the Y2K bug does not bite.

The most important thing to keep in mind is that as the world continues to transition from a resource – based economy dominated by manufacturing companies to one more dependant upon technology and information, the broad market averages will gradually reflect these structural changes. This process is inexorable. Thus, as investors, we must allow ourselves more leeway to embrace what is happening both in the real world and in the benchmark against which our clients and we measure our performance.

The S&P Has Changed

To identify the important changes in the composition of the S&P 500, analysts compare it with traditional sectors of the economy. The most obvious long-term growth sectors are consumer staples, healthcare and technology. Twenty years ago, these three sectors accounted for about 25% of the S&P 500 weight; ten years ago, a third; now nearly 50%. The trend is clear. The six relatively pure value sectors are basic materials, financials, consumer cyclicals, energy, transportation and utilities. Twenty years ago, these six sectors accounted for 60% of the S&P; ten years ago about 45%, and now only about a third. Again, the trend is clear.

There are two additional economic sectors to consider: communication services and capital goods. In our opinion, one cannot generalize about the individual stocks that fall into these two sectors. Some are growth stocks others are value and

some have or are changing their characteristics. A decade ago, the telephone stocks were viewed as value stocks. Today, that categorization is debatable. For example, Bell South sells at 5 ½ times book value, 27 times earnings and provides a divided yield of only 1.7%. Is this a value stock? We think not. With regard to the capital goods sector, historically it has been considered a value sector. But its largest component is General Electric. GE Chairman and CEO Jack Welch would probably take umbrage at the suggestion that GE was anything but a growth stock. Our client's portfolios also hold Tyco International, a diversified manufacturing company which is also categorized as a capital goods company. Tyco is a growth stock without question. In both instances company management has made the difference, turning what otherwise might have been prosaic businesses into growth vehicles. Above average growth rates may not persist indefinitely, but then, very few growth stocks in any sector remain unblemished decade after decade. The economy changes and so does the competition. While these companies are in a growth mode, however, it would be unfair to classify them along side traditional value stocks.

Additionally, it should be noted, the S&P is not an "unmanaged" index. Each year, some companies are eliminated as a result of mergers, for market capitalization considerations, or even because of bankruptcies. Others are added in their place. Not surprisingly, the companies that are added often are engaged in growing sectors of the economy while those that are dropped tend to fall into the value category. The most extreme illustration of this phenomenon took place at the end of last year when Venator (formerly know as Woolworth Co.) was deleted from the S&P and America Online took its place. Other S&P discards included Pennzoil, Armco Steel, Inland Steel, W.R. Grace, Echlin and Chrysler - - all value stocks. In contrast, new additions to the index have included Peoplesoft, Ascend Communications, and BMC Software. Dell Computer and Lucent Technologies have been added to the S&P in the last three years. The more value-oriented companies are likely to be simply dropped from the index or as has been the case recently, acquired by a non-U.S. company such as Daimler (Chrysler), Scottish Power (PacifiCorp), Aegon (Transamerica), and British Petroleum (Amoco).

Low Inflation Favors Growth

As we have written numerous times, the decline in inflation and interest rates over the past decade has also tended to favor both the fundamentals and valuations of growth stocks. The lack of corporate pricing power has crimped earnings in the value sector much more than in growth. The value sector has been generally much more dependent upon price increases than has the growth sector. While we do not rule out a modest uptick in the inflation rate later this year as global economies strengthen and the Fed's recent liquidity infusion broadens its reach, we believe that low inflation - - or possibly a whiff of deflation along the way - - will be a constant in our economy for years to come. Historically, low inflation does not augur well for value stocks (or small caps for that matter). Moreover, low interest rates, which typically accompany low inflation rates, also favor growth stocks by allowing investors to capitalize earnings at a higher multiple. Low inflation is the enemy of value stocks, the friend of growth stocks. While our bias toward growth continues, valuation disparities will eventually work to more closely align performance results over time.

Finally, in most years, the performance differential between growth and value shares has not been as great as it was in 1998. Thus, in order to capitalize on those periods when there is a marked difference in performance, our decision in favor of a stronger tilt is clearly desirable. Stay tuned!!

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