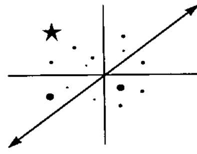

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# Equity Style Management in a New Economy World

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The market's split personality rise during 1998-99 may have been about a lot of things, but (despite the pronouncements of many) it was not about fundamental earnings growth. Conversely, this year's domestic stock market weakness hasn't really been about the end of earnings growth.

A simple case in point: Just over one year ago, someone with a spare $630 billion to invest could have purchased the entire capitalization of two company group portfolios. Portfolio A would have been a "classic" diverse collection of 70 Old Economy firms, ranging from Aetna to Wisconsin Energy. You would have owned firms with $747 billion in collective revenues, assets with a combined book value of $321 billion and, most importantly, $43 billion in combined earnings. Portfolio B would have consisted of just two blue chip New Economy companies, Microsoft and AOL. Collective book value would have been $31 billion, combined revenues were $35 billion and, most importantly, current earnings totaled only $7 billion. Portfolio A was being valued by the market at a trailing **P/E of 14.7x**, which equates to a current earnings yield of 6.8%. Portfolio B didn't offer anything like the same current return factor, since it was being valued at a trailing **P/E of 90x.** The common "spin" was that Portfolio B offered investment value because of the superior future earnings growth these two stocks so clearly offered as compared to the earnings growth power of companies like those in portfolio A.

Let's test that proposition: Suppose the diversified value stock Portfolio A can only grow its future earnings at 8.3% per year, which just so happens to be the trailing 23 year average earnings growth rate for stocks comprising the S&P Value index. Next, let's suppose that the superior business mix and management of Microsoft and AOL will enable them to average superior earnings growth of 25% per year for the next 10 years, slowing down to "only" 15% per year for five years and 10% thereafter. Over 23 years, this equates to an average annual growth rate of 17.4%, or about *double* the last 23 year's average for stocks in the S&P **Growth** index (8.9%).

Given the above, when would the annual earnings of Portfolios A and B finally be equal? It would take 20 years for the superior AOL/Microsoft businesses to finally earn as much as the plodding Old Economy portfolio! Then, if we've been right about earnings growth for twenty years, Portfolio A will be growing at its same old 8.3% rate, but Portfolio B



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will be growing at 10%. Thus, some 20 years from now, Portfolio B will finally represent a clearly better investment value (same earnings, but higher growth rate).

Does anyone really think that savvy Growth Investors, many of whom turn over their entire portfolio holdings in much less than two years, are buying companies with Year 21 earnings in mind? No way! You buy companies, even great companies, at 75-150x earnings multiples for one logical reason; you simply expect someone else will soon come along to take it off your hands at a higher price, for whatever their reasons. In ancient times (pre-1997), this was often referred to as the greater fool theory.

The S&P's tech sector companies increased earnings by an average of 14% per year during 1998 and 1999. Their average P/E was 81x at the end of last year. The two-tiered market was not, and is not, about earnings or earnings growth. It is all about price momentum and speculative trading, and has been for some time. This year's tech/telecom/media weakness is akin to air leaking out of a previously over-inflated balloon, rather than fundamental concerns about whether 2000-2001 earnings growth will be up to expectations. How could it be, if the current growth stock price multiples implicitly assume consistently superior earnings growth through 2020? What difference can one year of earnings make (up or down), when you still need at least 19 more superior years ?

Institutional investors know all about the above example. They could probably fill 20 pages with comparisons like this one. But, they also know that most growth stocks, especially tech stocks, looked fundamentally expensive at the end of 1997 - only to advance 35% in 1998 and 34% in 1999. From their perspective, what's to say that this experience doesn't continue? Or (cynically), what's wrong if it doesn't continue, as long as your accounts perform similarly to everyone else's?

For some time we've counseled that the growth vs. value experience of 1998-99 would not continue, in either relative or absolute terms. Further, we don't believe that 2000's differential year-to-date returns have snapped matters back into balance from a "fundamentals" perspective. However, no one has a crystal ball and everyone (including Chartwell) wants to be a believer.

It ultimately boils down to picking your poison and understanding the implications of your decisions *if you are wrong*. For example:-

- Allow any "temporary" equity overweighting to continue, and you'll underperform your targets if the equity market's continue to weaken (a double negative, since *your losses will be larger* than they might have been);



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- Increase your growth style exposure (relative to value) and you'll underperform if high P/E growth stocks (tech, telecom, internet) continue to stall out (i.e., *your losses will be larger* than they might have been);
- Cut back on your domestic equity exposure and you'll underperform if the bull market re-emerges (i.e., *your gains will be less* than they might have been);
- Tilt your style exposure toward value and you'll underperform if tech, telecom and media stocks resume their meteoric rise (i.e., *your gains will be less* than they might have been).

Of course, none of these outcomes is purely desirable. Our preference is always to have done the right thing in advance. But, perfect foresight doesn't exist. Therefore, it is much more prudent to assume an outcome along the lines of these four possibilities will occur. By orienting your plan's asset/style mix with an eye to which "failure" is most acceptable, or least unacceptable, you will help to ensure that performance *surprises* are mostly on the upside.

Give us a call if you'd like to discuss how to best orient your portfolio as we head into 2001. Until then, have a great holiday season!

Richard Shaffer, CFA

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