New Minerva Report

Growth or Value?

The last six months have seen a change in the UK market. Last year and earlier in this, it was the small and mid sized shares that were doing all the running. But in the last six months the FTSE 100 Index has risen 5.96%, the Mid 250 Index rose just 0.15% and the Small Cap Index fell 2.91%. Another interesting thing that has occurred in the market is what is being termed "p/e contraction". Back in the days of the technology bubble, the difference between the highest and lowest p/e's was seven times. Remember, the p/e is the price of a share divided by the earnings per share. The higher the p/e the more expensive the share is. Now the difference between the lowest and highest p/e's is closer to 3 times. This means that the value of 'growth' stocks and 'value' stocks have moved together. Some would therefore argue that growth stocks are undervalued. This in turn would mean that funds that are 'growth' orientated rather than 'value' based will do better in the near term, as they would expect p/e's to start diverging again. We are not convinced by this argument. We think that the contraction in p/e's is a sign that investors are taking on board the fact that we have moved into a new era. The potential for growth has been reduced and investors want to get income from investments as well as potential capital growth. History has shown that very few companies retain the mantle of a growth company. This is logical. Any industry that is making above average returns, attracts new participants into it. This in turn creates competition within that industry, which then reduces profitability for all concerned. There used to be an argument that big companies can withstand this, and see off new competitors. However, with the increased globalisation, this is no longer true. Additionally, modern technology has meant that many competitors can spring up from virtually nowhere. We are therefore likely to see p/e compression remaining. Fund managers that stay wedded to 'value' or 'growth' only styles will not do as well as those that are stock-picking style agnostics. Only if you take dividend payments as a measure of value could you argue for a 'value' style bias outperforming a 'growth' style. There has also been a contraction in the p/e's between small and large cap companies. Some have argued that this means that smaller companies are now too expensive. This view comes from looking back over too short an historical time period. Whilst over the past 15 years the average p/e of a smaller company has been at a discount to larger companies. Before the 'big bang' in 1986 it was the other way round. They were actually at a premium to larger companies. The logic then was that a good smaller company was more likely to grow their profits faster than a large company. It was only after the changes to the Stock Exchange in 1986, that the discount started to be accepted as a norm, on the basis that smaller companies were less liquid, and therefore ought to be priced at a higher risk. Again there will always be times within an economic cycle, when smaller and larger companies part company, but in the future the variance will not be so great. Smaller companies are becoming recognised by larger institutions as an area where they can generate better performance. Stock-pickers will always find smaller companies more fertile ground for their style of management. Funds that can move up and down the capitalisation spectrum should be able to outperform.

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