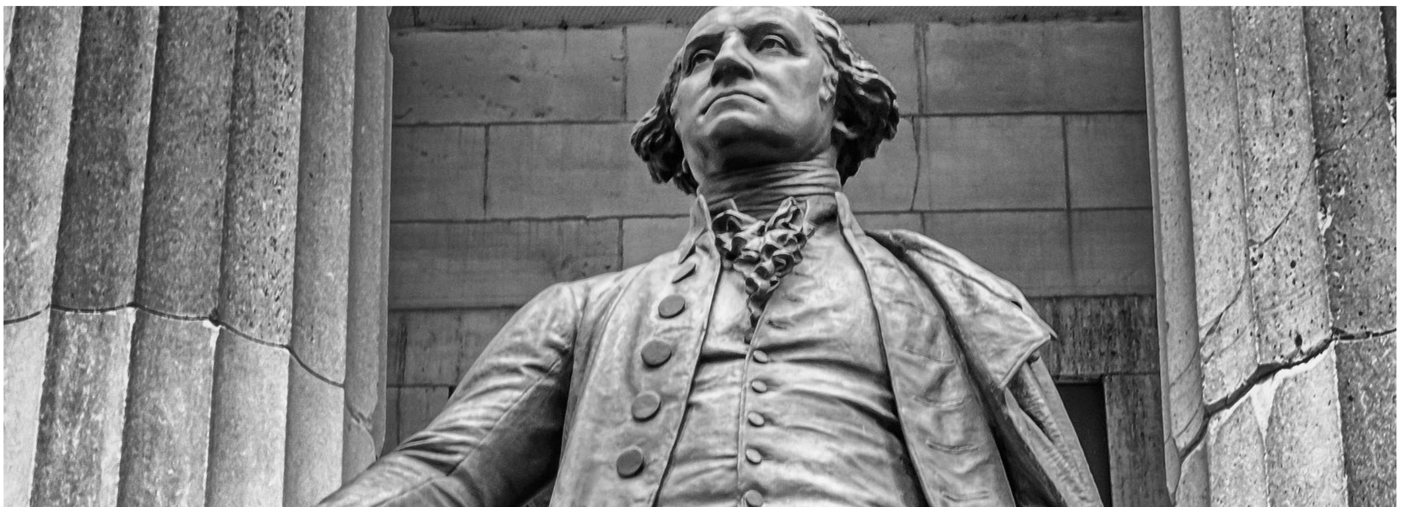
# MARKET COMMENTARY

ASKING BETTER QUESTIONS



**Just because something is popular does not mean it is right.** Take, for example, the ubiquitous use of the "value and growth" labels in investing. Most portfolios end up classified as either value, growth, or somewhere in-between. However, this labeling is a false choice and can force bad behavior. Those who blindly chase faulty "style benchmarks" can expose clients to unwanted risk or sacrifice return. This week, we argue that there is a better way to manage portfolios because most "value" or "growth" indices are badly flawed by design.

## WHAT'S THE PROBLEM?

There are three main problems with "value" and "growth" indices.

**Problem 1:** Very expensive firms can be classified as "cheap" because debt and other liabilities are overlooked.

**Problem 2:** Non-growing companies can be mistaken for growing ones because of how equity value and earnings are measured. This problem is exacerbated by today's common practice of share buybacks.

**Problem 3:** The biggest problem is a logical one. The growth-value distinction suffers from a fundamental internal contradiction: "growth" and "value" are not part of the same logical continuum and should be considered separately. Yet, index providers muddle these different traits together. Growth is not the opposite of value, just as apples are not the opposite of oranges.

## "STYLE" INDEX BASICS

When dividing the market into "value" and "growth," index providers focus on accounting concepts like "book value" and earnings growth. Book value is the net of a company's assets minus liabilities, expressed on a per-share basis. Earnings are also expressed on a per-share basis, which can skew profit growth. While subtle distinctions exist among index providers, the basic process is to consider a stock's multiple of book value and earnings growth. Low multiples and growth rates are considered "value" and high multiples and growth rates are considered "growth."

## PROBLEM 1

***"Value" Ignores Debt***

When a private firm assesses the purchase of another firm, debt is always part of the calculation. No sophisticated investor would ever buy another company without first considering the liabilities. If a company's stock can be purchased for $100 million, but there is another $100 million of debt, no reasonable buyer would ignore the money owed to others.

Most value stocks end up in value indices because the stock price is low compared to book equity value (book equity value = assets - liabilities). While this makes for a convenient expedient and is not wrong, per se, it does assign heavily debt-financed companies to "value" indices. Fixation with "not paying a high price" (a seemingly conservative investing trait) can lead to owning risky stocks with lots of debt.

## PROBLEM 2

***"Growth" Can be an Illusion***

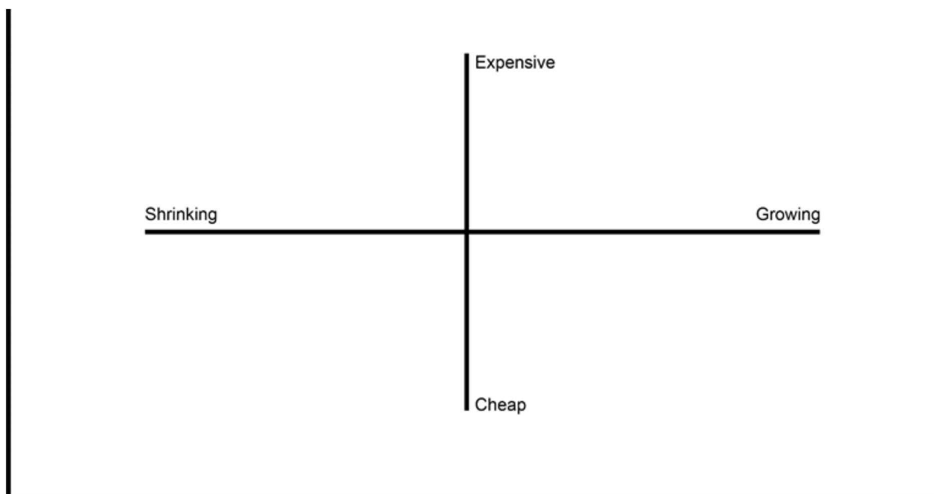
Investors looking for *growing* companies can be misled, too. Let's imagine Company A and Company B. Now imagine both companies reported $100 million in earnings last year and are expected to earn another $100 million this year. The growth rate for both companies, therefore, is zero. Neither company is "growing."

Now, let's assume Company B begins to buy back shares of its own stock (a common practice these days). Two things happen here. First, the buyback reduces the book value per share, and the price/book value ratio increases, all else equal. Second, the company's total earnings are now divided by fewer outstanding shares after the buyback. It is worth noting here that buybacks are not a small issue, either. They are reshaping corporate America in significant ways. Consider that S&P 500 companies have spent about $500-800 billion yearly buying back shares in the past decade. In the past year, buybacks reached $985 billion, according to Ed Yardeni of Yardeni Research, Inc.[1]

Ongoing, large-scale share buybacks are creating a growth illusion for many companies that might otherwise be deemed "value." In our above example, Company B will show growth in earnings per share while Company A will not. Company B will be more likely to be categorized as a "growth" than "value" because the multiple of "book value" is higher and its earnings per share are also rising.[2]

**CHART 1**

**WCA VIEW OF VALUE AND GROWTH**




## PROBLEM 3

***Serious Logic Problems***

The biggest problem with "style" indices is a logical one. For a value-growth continuum to exist in the first place, the two features must be measured on the same scale. For example, "tall" and "short" represent points along a continuum — "Value" (aka. "Cheap") and "Growth" do not lie on the same continuum. The current practice is akin to using a scale to measure both height and weight. Height should be measured using one device (a ruler) and weight another device (a scale). The current practice is like trying to measure someone's height by using a scale.

It is not surprising then that many are looking for an alternative to traditional "style indices." It is also not surprising that firms like J.P. Morgan have moved away from "value" and "growth" return predictions in their long-term forecasting.[3] The rapid movement to "multi-factor" indices also betrays an industry-wide dissatisfaction with the usefulness of "value" and "growth." Investment managers who persist in tracking their "value or growth" indices risk incorporating these logical inconsistencies into their investment process. This is why we have built our own processes and custom benchmarks for managing portfolios day to day.

## A BETTER SOLUTION

Instead of perpetuating the faulty "value-growth" framework, we offer a better solution. There should be two primary dimensions for thinking about stock investment. One dimension focuses on whether the company is growing or not, visualized as a movement along a horizontal axis from "shrinking" to "growing" (chart, above). The other dimension would be "value," which focuses on overall firm value (as opposed to a narrow focus on book value) and plots along a vertical axis. In this view, we separate the two different concepts of "value" and "growth" to underscore their independent nature.

At Washington Crossing Advisors, this "better solution" makes good sense to us. It is how we view essential aspects of investments like "growth" and "value." If we had our druthers, we might also add another critical dimension of "quality" to the mix (a three-dimensional plot), but that is a topic for another day.

# CONCLUSION

Long ago, the investment world adopted the "value-growth" framework, and now untold trillions of dollars are managed according to that way of thinking worldwide. While we do not like the "value-growth" framework, which has propagated around the investment world for decades, we know we are likely stuck with it for now. We will be "aware" of how the "value" and "growth" indices perform, but not be wed to them. A better solution is a return to fundamental investing focused on the price paid in exchange for perceived quality and growth.

*1. Corporate Finance Briefing: S&P 500 Buybacks & Dividends, Yardeni Research, Inc., August 12, 2022*

*2. It should be noted that this is not true in all situations, but it is true in most cases. If a stock is bought back at a discount to book value, however, the multiple could contract. However, this has seldom been the situation for most stocks in recent years.*

*3. J.P. Morgan Asset Management Long-Term Capital Market Assumptions 2022*

WCA Fundamental Conditions Barometer Description: We regularly assess changes in fundamental conditions to help guide near-term asset allocation decisions. The analysis incorporates approximately 30 forward-looking indicators in categories ranging from Credit and Capital Markets to U.S. Economic Conditions and Foreign Conditions. From each category of data, we create three diffusion-style sub-indices that measure the trends in the underlying data. Sustained improvement that is spread across a wide variety of observations will produce index readings above 50 (potentially favoring stocks), while readings below 50 would indicate potential deterioration (potentially favoring bonds). The WCA Fundamental Conditions Index combines the three underlying categories into a single summary measure. This measure can be thought of as a “barometer” for changes in fundamental conditions.

**Standard & Poor’s 500 Index (S&P 500)** is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. S&P 500 Growth Index and S&P 500 Value Indices are designed to provide a comprehensive measure of global equity growth and value performance.
**S&P High Beta Total Return Index** is designed to measure the performance of the constituents of the S&P 500 that are most sensitive to changes in market returns.
**S&P Low Beta Total Return Index** is designed to measure the performance of the constituents of the S&P 500 that are least sensitive to changes in market returns.

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**FOR MORE INFORMATION, PLEASE CONTACT US:**


**Washington Crossing Advisors**

- **Kevin R. Caron, CFA,** Senior Portfolio Manager | (973) 549-4051
- **Chad Morganlander,** Senior Portfolio Manager | (973) 549-4052
- **Matthew Battipaglia,** Portfolio Manager | (973) 549-4047
- **Steve Lerit, CFA,** Senior Risk Manager | (973) 549-4028
- **Suzanne Ashley,** Internal Relationship Manager | (973) 549-4168

**Sales and Marketing**

- **Eric Needham, Director,** External Sales and Marketing | (312) 771-6010
- **Jeffrey Battipaglia,** External Sales and Marketing | (973) 549-4031

**Municipal Fixed Income**

- **Paul B. Clark, CFA,** Senior Portfolio Manager | (415) 364-2635
- **Richard K. Marrone,** Senior Portfolio Manager | (415) 364-2917
- **Daniel W. Urbanowicz,** Senior Portfolio Manager | (973) 549-4335


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