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U.S. MARKET COMMENTARY

U.S. VALUE STOCKS MOVING OUT OF THE MARKDOWN AISLE

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U.S. Value Stocks Moving Out of the Markdown Aisle

Value managers in 1999 largely faced redemptions by tech-hungry retail investors, forcing them to sell rather than buy. Those few value managers that had an occasional buying opportunity must have felt like they were shooting fish in a barrel. The cheapest 10% of stocks in the overall Russell 1000® Index had a price-earnings (P/E) ratio of 10 or less, while the overall index had a P/E of 31. Today, the cheapest 10% of stocks in the Russell 1000® Index still have a P/E ratio of 10.5 or less, but the index as a whole is priced at less than 17.5 times earnings (Table A). The dispersion of valuations has shrunk markedly over the past eight years, making the prices of healthy, stable growers relatively similar to those of many cyclically strong or even troubled firms.

How Did We Get Here?

The valuation spread between growth and value (and related to that, between quality and junk) stocks may owe its compression to several factors, including the following:

- **Longer and less severe economic cycles.** In recent years, the economic cycle has whipsawed American companies and their shareholders much less than it once did, thanks in part to globalization (the volatility of GDP growth over the past decade is about half as high as it was during the 1980s[1]), and perhaps shareholders have begun to price in less of a discount for cyclical firms.

- **Easy access to financing for lower-quality firms.** Lower-quality firms with heavy debt levels or uneven profitability have benefited from the ease and low cost of raising capital. Credit spreads remain very tight, and the loan spigot has been wide open (despite slight lender pushback in recent weeks on some highly leveraged buyout deals).

- **A buyout premium.** For firms that have faltered, or that have maintained conservative balance sheets, the promise/threat of a leveraged buyout has kept a floor on valuations of "value" stocks.

- **Cash flow shift from growth to value managers.** Perhaps the most important factor behind the shrinking value discount/growth premium has been investor cash flow away from "growth" mandates and toward "value" mandates.

The growth style began to underperform in mid-2000, and this underperformance was very strong in calendar 2000-02 (Table B). Retail investors were by no means blind to this underperformance, as they began shifting huge sums of money out of the growth funds that had been the darlings of the late 1990s to chase strong performers. From 2002 through the first quarter of this year, U.S.-registered mutual funds classified by Lipper Inc. as large-cap growth saw cumulative outflows of $140 billion. Over the same time, U.S. equity funds excluding the large-cap growth category gathered an *inflow* of $418 billion, and funds investing in non-U.S. equities pulled in $384 billion (Table C). This flow pattern, with U.S. value and non-

[1] Paul Rissmann, "Nowhere to Go but Up," AllianceBernstein, May 2007.

U.S. equity funds gaining assets at the expense of large-cap growth funds, has shown no sign of abating. The institutional side of the money management business has experienced a similar, if less pronounced, trend, where net flows by tax-exempt portfolios into active mandates favored growth managers in 1998 through 2000, but have leaned toward value managers since then.[2]

The money moving out of the growth style had the effect of replacing the punch bowl with the coffee urn as the party was ending. The new sobriety is evident by examining valuations of the most expensive stocks, which are much lower today than they were in 2000. The 95th percentile stock in the overall Russell 1000® Index in 2000 had a P/E twice as high as the 95th percentile stock at the end of 2006.

The Sector Square Dance

The popularity of value stocks has lifted valuations enough to shift some stocks that previously made the rounds of the value index to the ranks of the growth stock index. Four sectors traditionally thought of as value denizens—energy, materials, industrials, and utilities—have nearly doubled their representation in the Russell 1000® Growth Index over the past four years. These four sectors have grown from 12.5% of the index at the end of 2002, to 22.4% as of year-end 2006. They have done so largely at the expense of health care, which shrunk from 26.7% of the index in 2002 to 17.5% at the end of 2006 as the market capitalization of health care firms withered relative to other sectors. The transformation of the Russell 1000® Growth Index continued in late June during the Russell index reconstitution process, as the index weightings of energy stocks grew by more than 3 percentage points while health care shrank by an additional 1 percentage point.

The makeup of today's Russell 1000® Growth Index certainly looks clean and sober, relative to the same index at the height of the tech bubble. The index's largest holdings include (to highlight a few examples) Procter & Gamble, with a P/E ratio of roughly 22; Johnson & Johnson, with a ratio of 18; IBM, at 17 times last year's earnings; and Altria, at 14 times. Not exactly a rogue's gallery of speculative names. The growth indices have hefty helpings of "quality" defensive stocks, as they did prior to the tech bubble.[3]

Valuations—It's All Relative

The complexion of the two Russell 1000® style indices has changed markedly over the past several years, and the valuations of both have come down as well, of course. How do the valuations of the two indices look relative to one another now? The picture is not universally favorable to growth, but according to several relevant metrics, large-cap growth may be cheaper *relative* to large-cap value than ever before.

[2] Ibid.
[3] Richard Bernstein and Kari Pinkernell, "Large cap growth returns," Merrill Lynch, May 21, 2007. Bernstein and Pinkernell note that 73% of the S&P/Citigroup Growth Index was in high-quality stocks as rated by S&P, versus only 65% for the value index, while at the market's peak in 2000 S&P/Citigroup Growth was 50% quality and S&P/Citigroup Value was 58% quality. Merrill defines "quality" as an S&P quality ranking of B+ or better. S&P ranks stocks according to the stability and growth of earnings and dividends over time.

The P/E ratio of the Russell 1000® Value Index is about 70% of that of the Russell 1000® Growth Index, a bit less than the average discount over the past three decades. The normalized P/E ratio, which strips out much of the cyclical variation of earnings by dividing the current price by the average earnings over the past ten years, indicates a similar result. The value index's price-to-book ratio is much closer to that of the growth index than it has been over much of their history (the current value "discount" is nearly 2 standard deviations narrower than the average discount since 1979). The price-to-sales (P/S) ratios and price-to-forecast earnings ratios also show growth stocks as being cheap versus value stocks (sell-side analyst earnings forecasts have been notoriously over-optimistic, but this optimism is likely true for both growth and value stocks). The value "discount" for P/S is more than 2 standard deviations tight relative to its historical average (Table D).

The dividend yield of the Russell 1000® Value Index is 2.1 times as large as the yield of the growth index, in keeping with historical norms (Table E), but the yield on the Russell 1000® Growth Index has increased meaningfully from a *de minimis* 0.3% as the bubble popped in 2000 to 1.1% today—still modest, no doubt, but certainly a much bigger jump than the Russell 1000® Value Index's yield increase from 2.0% to 2.4% over that time.

Can Value Continue to Dominate?

Large, defensive growth companies certainly are looking cheap relative to junky value names (and a fair value in their own right). But are there valid reasons for the value discount (or growth premium) to remain narrow? Could growth stocks get even cheaper relative to value? The following are some of the factors that would favor continued value dominance:

- **Continued cheap leverage.** Regardless of whether credit spreads *should be* as tight as they currently are, the fact remains that they are quite narrow. Companies can borrow a little bit of money cheaply, and a lot of money almost as cheaply. Companies with unstable cyclical earnings can borrow at little incremental cost relative to healthy, stable earners. Growth stocks have little competitive advantage currently when it comes to the ability to borrow in order to invest in the business, acquire complementary businesses, or manage a high dividend payout ratio. Credit spreads are likely to remain tight for as long as risk aversion and defaults remain scarce (which could be for a few months, or several years or longer).

- **Strong profitability.** While growth stocks have consistently enjoyed higher profitability than have value stocks (the net margin of the Russell 1000® Growth Index averaged 10.8% over the past two decades, versus 8.2% for the Russell 1000® Value Index), the long-running profitability advantage of growth stocks has evaporated (for now at least). The Russell 1000® Value Index's net margin is essentially at a par with that of the Russell 1000® Growth Index for the first time since our data began two decades ago (Table F). The Russell 1000® Value Index's return on equity, meanwhile, is running at 15.1%, 1 standard deviation above the 12.4% average over the past three decades. Year-over-year earnings growth for the value index is 18.5% versus 10.8% for the growth index. Value-stock profitability has benefited from robust equity markets over the past four years (boosting the financials sector), from sustained high commodity prices (which are beneficial to many energy and materials stocks), and from healthy global demand for aircraft, heavy equipment, and industrial products (capital goods stocks are tipped by the sell-side to grow earnings by 13.2% in 2007 and 13.8% in 2008). These positive forces are largely sensitive to economic growth and would be expected to be sustained so long as the economy remains on solid footing.

- **Buyouts keep booming.** High-yield debt investors pulled in their reins a bit in June, forcing buyout sponsors to scale back the size of a few bond and loan offerings, and to abandon some of the more aggressive terms that had become common (such as payment-in-kind features and covenant limitations), but sponsors have perhaps $400 billion in funds committed and waiting to be tapped,[4] and they do not earn fees until that capital is called down. The boom and its accompanying bid premium may be showing its age, but it probably still has legs. To the extent that buyout companies continue to target traditional publicly traded value stocks, value should be the primary beneficiary; however, long-depressed health care stocks could begin to show more appeal.

- **Hunger for income.** Investors, particularly retail investors, have shown little inclination to shift away from stocks and other securities with hefty income streams. In fact, in February, Eaton Vance completed the largest offering in history of a closed-end fund, raising $5.5 billion to buy dividend-paying stocks (and write calls on them to boost the fund's dividends). The Russell 1000® Growth Index has outperformed its value counterpart by 181 basis points since the beginning of the year, but it is unlikely that modest growth outperformance will shake investor belief that value is the place to be. If investors continue to take billions of dollars from growth allocations and use it to buy big dividend streams, then the value discount could continue to shrink.

The sustainability of today's profits and margins casts perhaps the longest shadow over the likelihood that the value discount will narrow further.

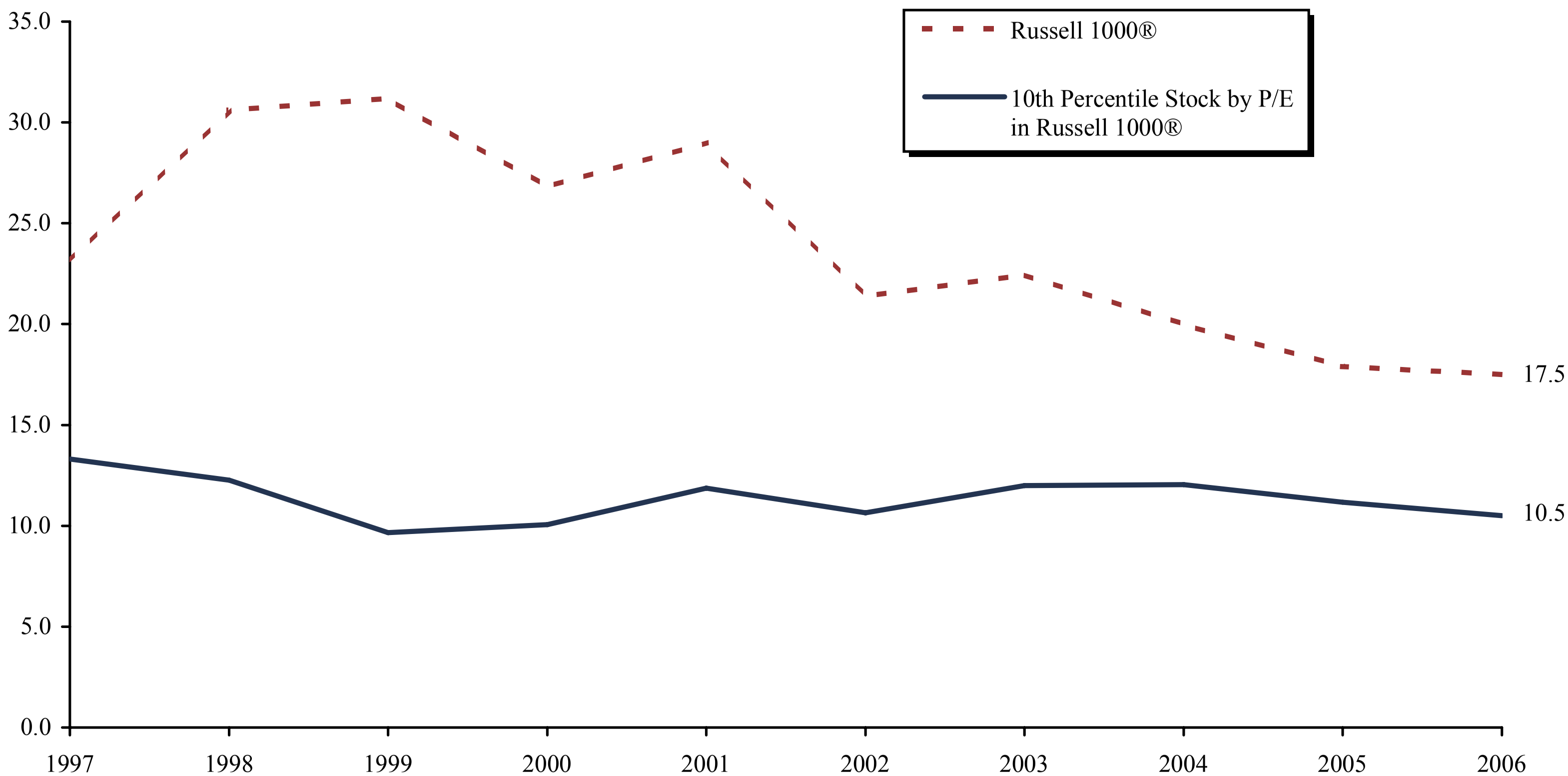
Defensive, high-quality stocks, like many of those in the mega-cap slice of the large-cap growth universe, provide excellent positioning if the environment sours. The current environment provides an opportunity to upgrade the quality of the portfolio at a very modest premium. While both could probably get you to work on time the following day, we believe that it makes little sense to buy a rusty Pontiac if a shiny Lexus is selling for nearly the same price.

[4] David Kostin et al., "Private Equity and the GS LBO Model," Goldman Sachs, March 22, 2007.

Table A

PRICE-EARNINGS RATIO OF RUSSELL 1000® INDEX AND OF THE LOWEST-DECILE STOCK IN THE RUSSELL 1000® INDEX BY VALUATION

December 31, 1997 - December 31, 2006

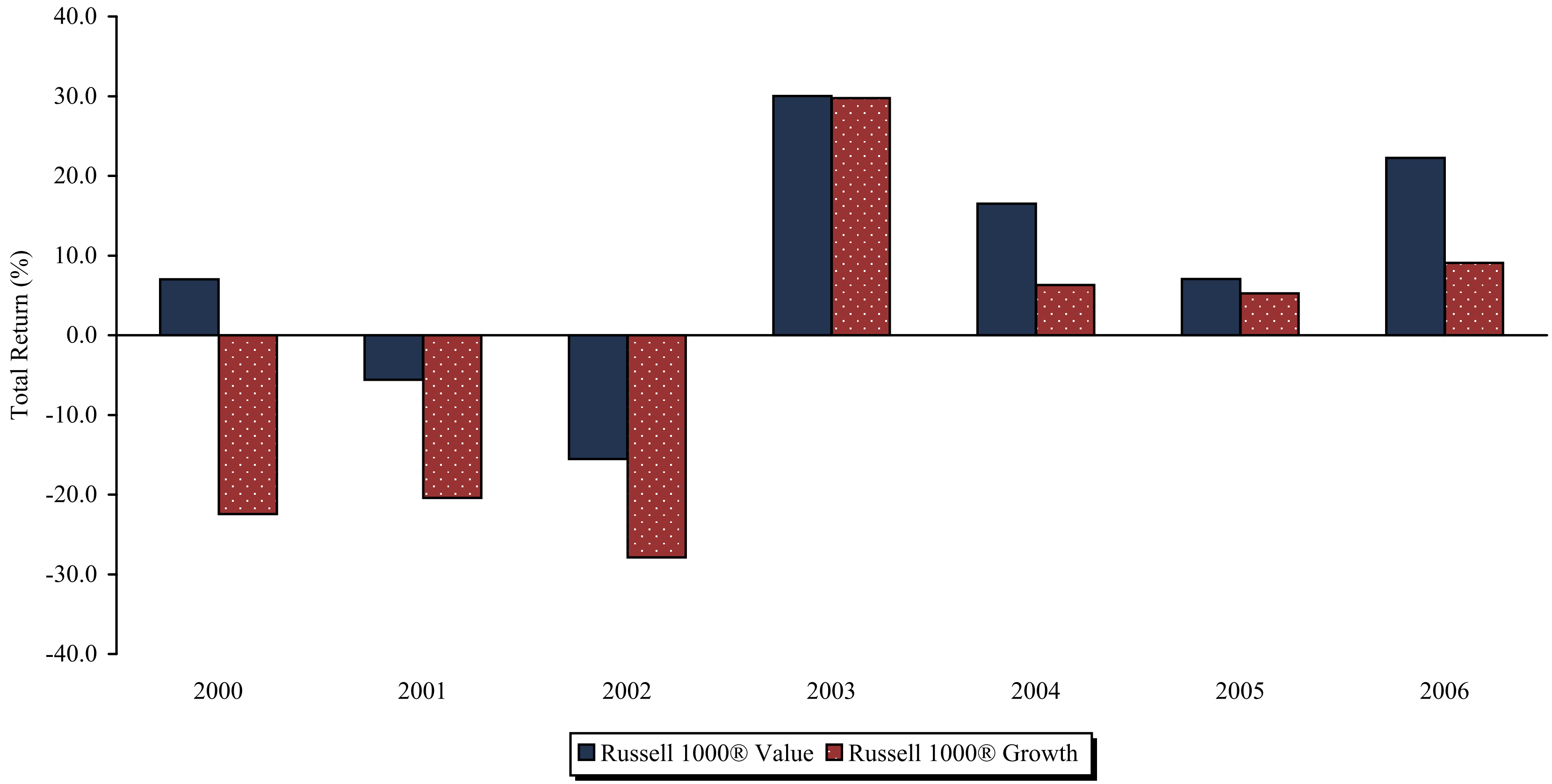


Sources: Factset Research Systems and Frank Russell Company.

Note: Data represent all positive price-earnings ratios in the index as of the specified date.

Table B

ANNUAL RETURNS OF RUSSELL 1000® VALUE AND RUSSELL 1000® GROWTH INDICES



Sources: Frank Russell Company and Thomson Datastream.

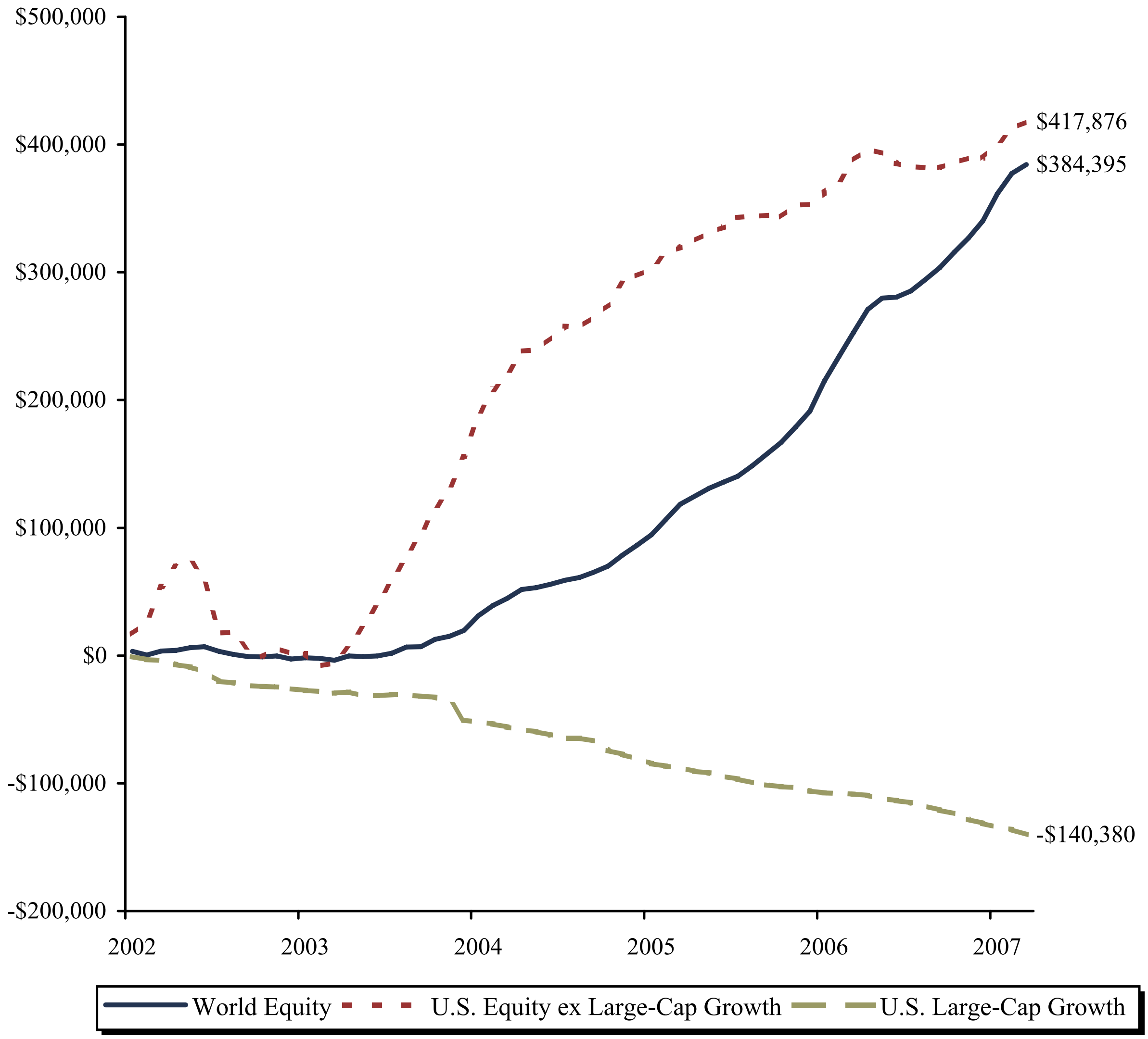
Note: Returns represent annual returns through December 31, 2006.

Table C

U.S. EQUITY EX LARGE-CAP GROWTH, U.S. LARGE-CAP GROWTH AND WORLD EQUITY MUTUAL FUNDS CUMULATIVE FUND FLOW

January 1, 2002 - March 31, 2007

($) Millions



Sources: Investment Company Institute and Lipper Inc.

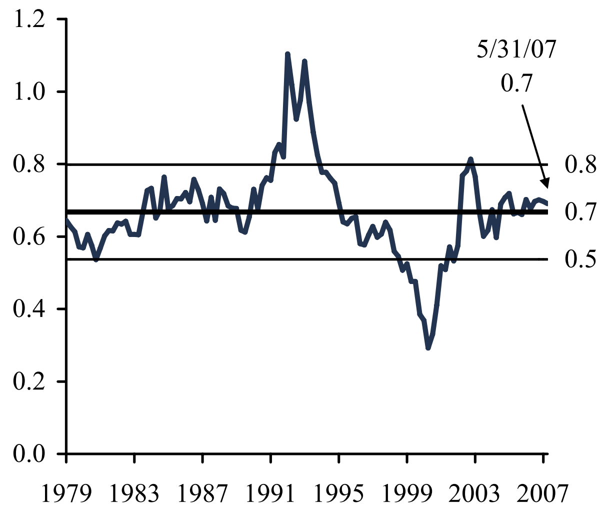
Notes: Represents net flows into U.S.-registered mutual funds. Timing the market using mutual fund flows or other sentiment metrics is inadvisable.

Table D

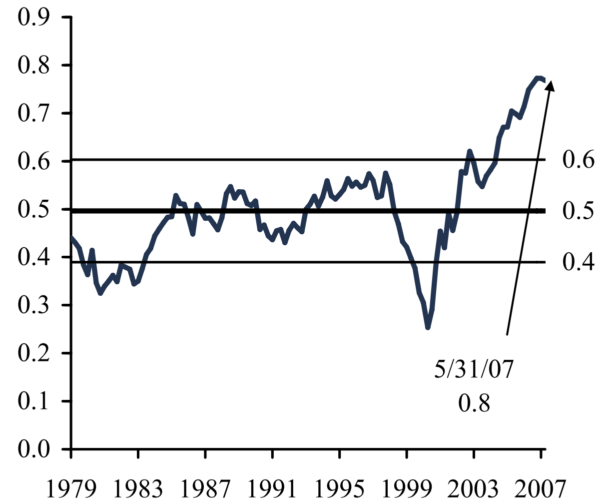
RUSSELL EQUITY MARKET VALUATIONS:
1000® VALUE RELATIVE TO 1000® GROWTH

March 31, 1979 - May 31, 2007

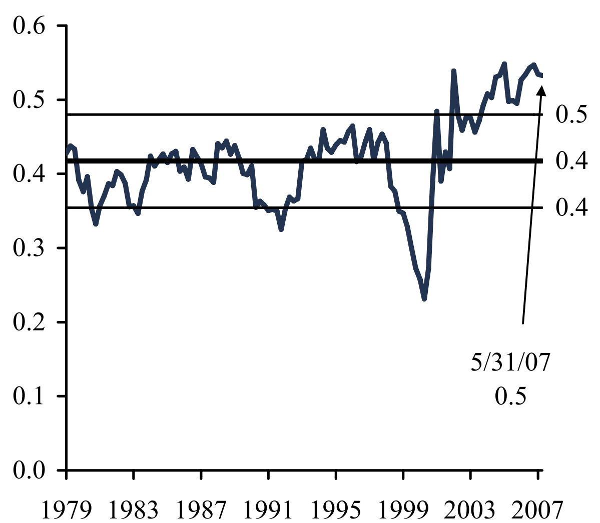
Price-to-Earnings



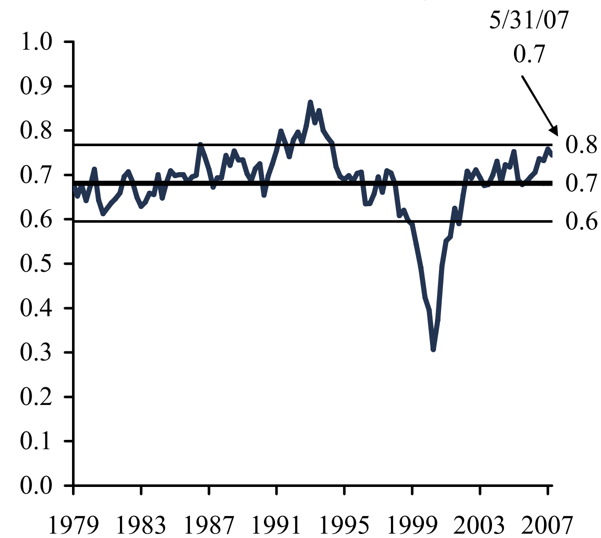
Price-to-Sales



Price-to-Book Value



Price-to-Forecast Earnings



Mean
One Standard Deviation

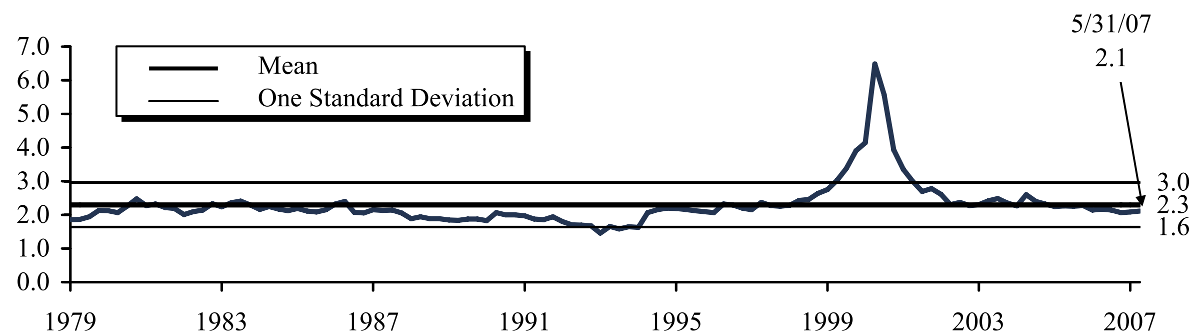
Source: Frank Russell Company.

Table E

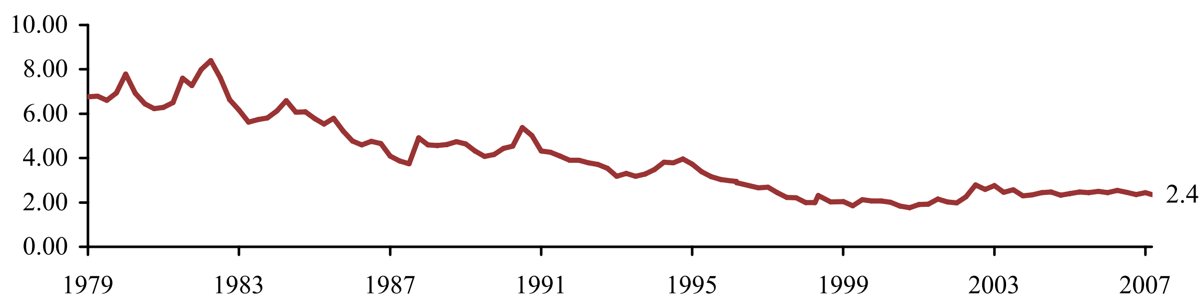
RUSSELL 1000® VALUE AND RUSSELL 1000® GROWTH DIVIDEND YIELDS

March 31, 1979 - May 31, 2007

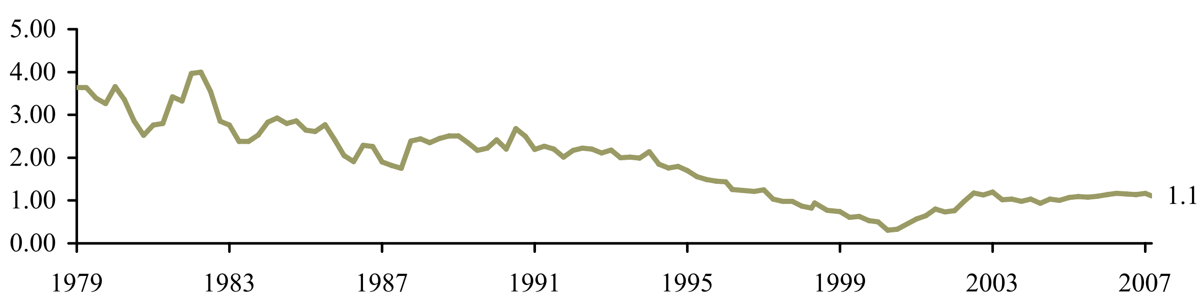
Dividend Yield of Russell 1000® Value Relative to Russell 1000® Growth (%)



Dividend Yield of Russell 1000® Value Index (%)



Dividend Yield of Russell 1000® Growth Index (%)

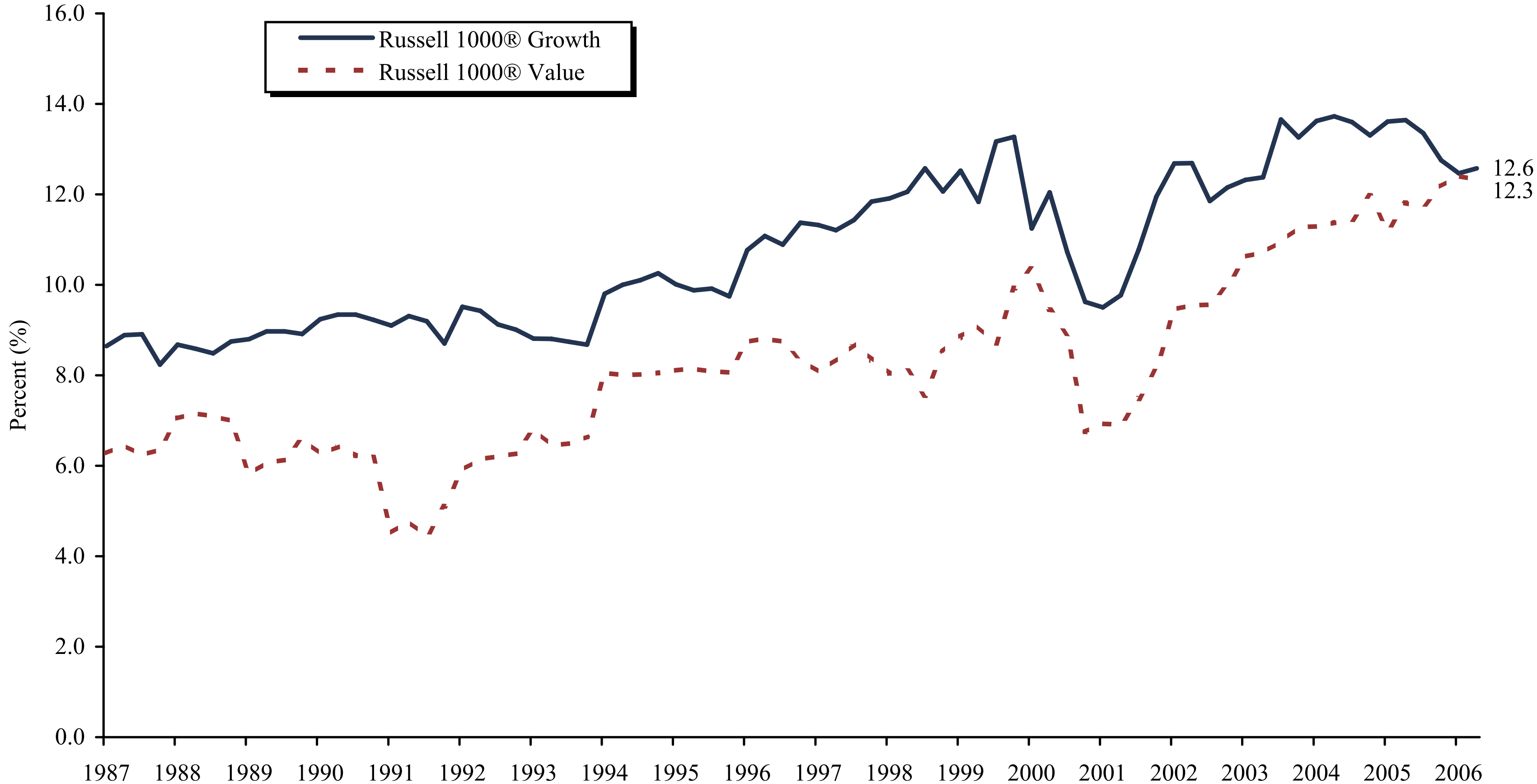


Source: Frank Russell Company.

Table F

NET MARGIN OF RUSSELL 1000® GROWTH AND RUSSELL 1000® VALUE INDICES

December 31, 1987 - March 31, 2007



Sources: Factset Research Systems and Frank Russell Company.

Note: Represents quarterly data through March 31, 2007.