GROWTH STOCKS: WILL THEY CLEAR THE HURDLE?

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Does valuation matter? It's an interesting question to consider. True, we can remember times like the late 1990's where the way in which stocks were measured—i.e. relative to dividends or earnings—was said to be "outdated" and that we had a "new economy." We all remember what happened next in 2000 to 2002 as the situation corrected.

At the same time, it is difficult to have the degree of patience that is sometimes required to wait for the value style to come back. In the US there are acronyms like FAANG[1] that describe a subset of growth-oriented stocks. We can also look at Japanese equities or emerging markets equities and note that yes, valuations are low, but trends of underperformance in those markets relative to global equities have continued.

At the end of the day, we admit that it is getting more and more difficult for us to continue to buy into the hype that surrounds today's growth stocks in the US. The ever-higher hurdles that these businesses have to clear will eventually become too difficult.

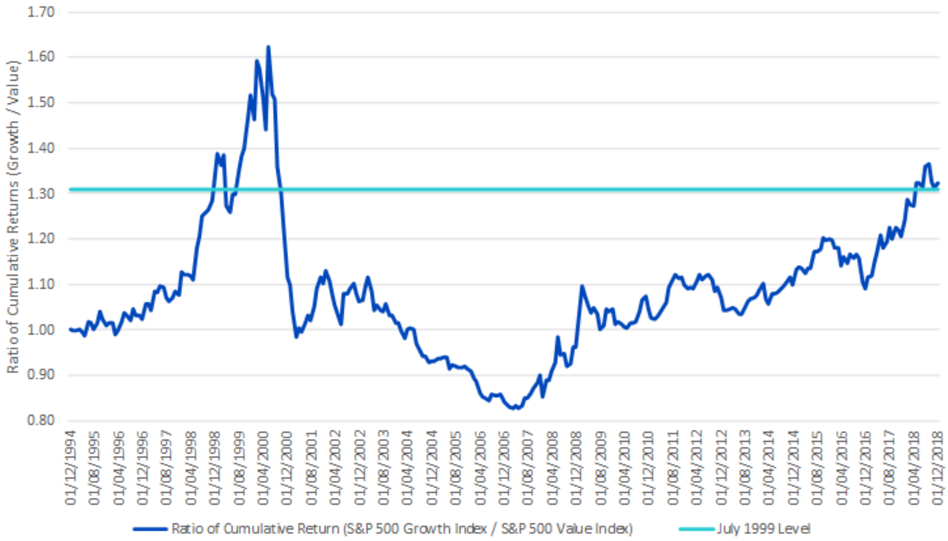
Face it: the magnitude and duration of the multiyear clobbering of value strategies by growth stocks in the current cycle is second only to the legendary 1994–2000 "new economy" years. That epic mania for growth as an investing style began about a year before the 1995 Netscape IPO[2], at which point the tech boom began to rage. That rally took the S&P 500 Growth Index 376% higher (30.1% annualized), trouncing the S&P 500 Value Index's gain of "only" 183% (19.2% per year)[3]. When the rug was ripped out from under the market in the 2000–2002 crash, value stocks picked up thousands of basis points of outperformance.

Today, the cumulative gap between the two indices, which has been stretching out since 2006, is once again in triple digits. From 31 July 2006 through 31 December 2018—more than 12 years—the S&P 500 Growth Index returned 157% (or 7.9% annually), more than doubling the 58% appreciation of the S&P 500 Value Index (3.7% annually).

That's a difference of 99 cumulative percentage points.

Before we begin thinking about the high hurdle, consider the striking picture that figure 1 paints. As a reminder, the NASDAQ, about as focused on growth an index as can be constructed, started its crash in March 2000, while the S&P 500 Index topped out later that summer. When they did, the rotation to value stocks was a flood.

Figure 1: S&P 500 Growth Total Return Index relative to S&P 500 Value



Sources: WisdomTree, Bloomberg, with period from 31 December 1994 to 31 December 2018. "Growth" refers to the S&P 500 Growth Index. "Value" refers to the S&P 500 Value Index. You cannot invest directly within an index.

Historical performance is not an indication of future performance and any investments may go down in value.

Piggybacking on WisdomTree's prior Dividend Growth work

We do a lot of analysis relating to the debate over "growth" versus "value." In some of that, we dive into the interaction of return on equity (ROE) with earnings retention and dividend payout ratios to determine the bottom-line drivers of shareholder wealth.

The interrelationship between profitability and dividend policy is critical.

Figure 2 shows profitability and growth metrics for the S&P 500 Growth, S&P 500 and S&P Value Indexes.

Figure 2: S&P 500 Growth, Core and Value metrics

Index Name	Return on Equity (ROE)	Est. Price/Earnings Ratio	Fwd. Earnings Yield	Fwd. Div. Yield	Div. Payout Ratio	Earnings Retention (%)
	Net Income as % Equity	Next Year	Reciprocal of Price /Earnings	Next Year	Div. Yield Divided by Earnings Yield	100% Minus Div. Payout
S&P 500 Growth Index	21.9%	19.16x	5.22%	1.69%	32.4%	67.6%
S&P 500 Index	16.0%	15.30x	6.53%	2.22%	34.0%	66.0%
S&P 500 Value Index	13.3%	12.52x	7.99%	2.80%	35.0%	65.0%

Source: Bloomberg, as of 11 January 2019. Past performance is not indicative of future results. You cannot invest directly in an index.

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The critical equation

Our analysis has identified profitability (ROE) as the key driver of dividend growth, presenting the critical equation recreated in figure 3.

Figure 3: The critical equation

Retention Ratio x ROE = Implied Dividend Growth

Figure 4 uses the critical equation to calculate "long-term" dividend growth. We added quotation marks to "long-term" because, frankly, looking into the future involves a lot more art than science.

Figure 4: Implied dividend growth estimate

Index Name	A Earnings Retention (%)	B Return on Equity (ROE)	=A x B Implied LT Div. Growth
S&P 500 Growth Index	67.6%	21.9%	14.8%
S&P 500 Index	66.0%	16.0%	10.6%
S&P 500 Value Index	65.0%	13.3%	8.6%

Source: WisdomTree, using data from figure 2 and the critical equation in figure 3. Data as of 11 January 2019. Past performance is not indicative of future results. You cannot invest directly in an index.

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Can the S&P 500 Growth Index achieve long-term dividend growth of 14.8%? And how long is long-term? No one knows. But we can engage the numbers to get a feel for whether we want to pay around 19.0x forward earnings for growth stocks when value stocks are on offer for around 12.5x earnings.

From our work with Professor Jeremy Siegel, WisdomTree's Senior Investment Strategy Advisor and Professor of Finance at The Wharton School of the University of Pennsylvania, we always think back to an important foundation of equity investing: Over the long run—usually measured in decades for these purposes—the real return experienced within equities has tended to have a close relationship to the earnings yield of those stocks. A lower Price/Earnings ratio necessarily means a high earnings yield, and while future returns are never a sure thing, why not take advantage where you can?

Source

1 Facebook, Apple, Amazon, Netflix and Alphabet's Google.

2 The famed 1995 Netscape Initial Public Offering (IPO) is widely regarded as one of the first newsworthy events of the dot-com boom.

3 Bloomberg, for the period 30 April 1994–31 March 2000. Return in gross total return terms due to data availability.

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