BUSINESS LEADS

Investors favor growth stocks

Trend marks shift of sentiment for a market coming out of a recession

By Mark Jewell
THE ASSOCIATED PRESS

BOSTON — Growth is in, value is out. And it's likely to stay that way this year.

Investors who loaded their portfolios with growth stocks were rewarded in 2009. Those stocks gained an average 37 percent, nearly twice as much as value stocks.

Growth's notable performance was largely fueled by technology stocks, the biggest part of the growth category. Experts say those companies will continue to prosper as customers ramp up tech spending coming out of the recession. But experts caution a tech rally as big as last year's is unlikely.

There's no pat definition for growth stocks, but typically they generate revenue and earnings at an above-average rate. Examples are Apple and Google. Value stocks generally produce steady earnings, often pay out dividends and are considered cheap based on their price-to-earnings ratios. Companies like Bank of America, McDonald's and Wal-Mart fall into this category.

The leadership shift to growth from value marks a break from historical patterns. All told, the annual performance of growth stocks surpassed value stocks just twice in the last decade. Also, value stocks normally do much better coming out of a recession, as more economically sensitive stocks like banks and utilities rebound at the earliest signs that the economy is expanding.

"Typically, the bigger the contraction during a recession, the bigger the snapback when the economy turns," says Stephen Wood, chief market strategist of Russell Investments. "That hasn't happened this time."

This recovery has been tepid. The economy is growing about half as fast as it usually does exiting a recession, says Wood. Though the stock market has climbed 70 percent since last March, unemployment remains at 10 percent.

Still it's clear growth stocks were hot in 2009. Growth stocks within the Russell 3000, a broad index covering 98 percent of the U.S. stock market, surged 37 percent last year. Value stocks ended with a more modest 20 percent gain.

That big gap was reminiscent of the late 1990s, when growth had its last big run. Of course that fizzled in early 2000 as the dot-com bust pummeled technology companies.

"What happened in 2009 is not what we should expect going forward," says Jim Swanson, chief market strategist at MFS Investment Management, which manages nearly $188 billion. "We need to look at it as an extraordinary year."

The reality is that certain industries play a pivotal role in driving the performance of growth and value stocks.

Tech stocks are the biggest part of growth, accounting for 30 percent of the value of all that category's stocks in the Russell 3000. Last year those tech stocks finished up an average 59 percent — tops among 11 sectors — boosting growth's overall performance. Two of tech's biggest names put up especially strong results: Shares of Apple and Google more than doubled.

On the value side, financial services stocks are the biggest piece, making up one-quarter of the Russell 3000's value component. While many large banks came back from the brink of failure, their stocks haven't returned to pre-plunge levels. In 2009, financials trailed the broader market despite finishing up 17 percent.

Utility stocks, another value staple, also weighed down the overall performance of the category. They gained just 12 percent last year, less than any other segment of the stock market.

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Ultimately, investors trying to forecast whether growth or value will lead the market should closely watch the economy.

In each of the past four recessions since 1980, growth stocks fared better than value as the economy shrank, a Russell Investments study found.

That's because growth companies' competitive advantages — think of Google's search engine dominance, for example — tend to hold up even if the economy is lousy. Value stocks tend to fall more sharply because many are in industries that are unusually sensitive to economic cycles — think of banks that see loan losses multiply in a bad economy, or energy companies that see demand from industrial customers shrink.

When the economy began expanding coming out of past recessions, value stocks began rising faster than growth stocks, the study found.

That's not the case now, so the current market is breaking with the norms. Still, after value stocks led the market nearly all the past decade, Wood, of Russell Investments, figures growth stocks could be in favor for a long while.

But even if they are, don't rush in. Individual stocks don't neatly follow the trend of their broader category. And, perhaps more importantly, Wood says the performance advantage for either growth or value is likely to be narrow.

"2010," Wood says, "will probably surprise us in how normal it will be."