MSCI Barra
RESEARCH BULLETIN

The Shift From Value to Growth Around the World | October 11, 2007

Introduction

Over the long run globally, value stocks have outperformed growth stocks, a premium that has averaged roughly 300 basis points annually over the last four decades. Since May of this year, growth stocks have exhibited strength over value stocks, as evidenced by the MSCI World Value and Growth Indices. In fact, the growth premium has averaged 11.5 percentage points annualized over the last five months—May, June, July, August, and September. In this article, we put this recent development in historical context and briefly discuss its differences from past periods and its possible drivers.

The Long-Run Value Premium

Over the long run, value stocks have traditionally outperformed growth stocks, as evidenced in the earliest literature (see Fama and French, 1992)[1]. Figures 1A and 1B display the long run Value-Growth spread, i.e. the value premium, as evidenced by the MSCI World Value and Growth Indices since 1978.[2]

Figure 1A

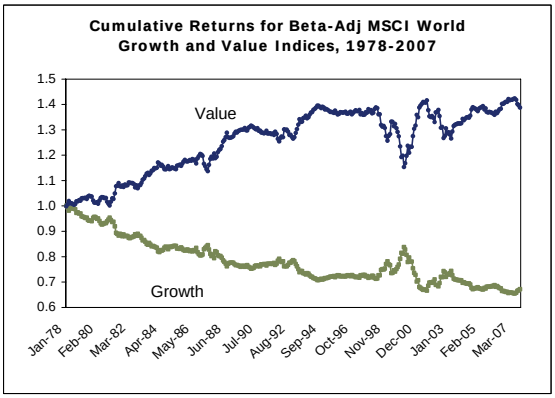
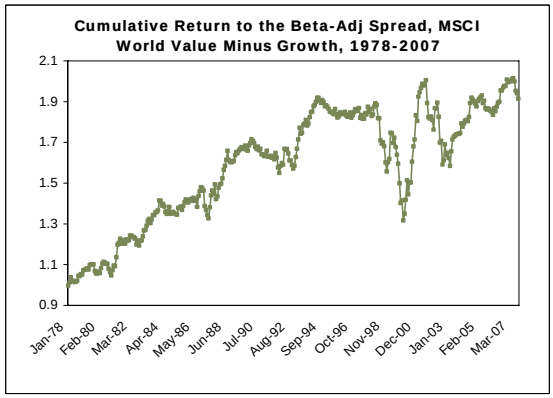


Figure 1B



Despite the long-run value premium, there have been notable periods where growth stocks have outperformed value stocks. The relative attractiveness of growth stocks depends on many factors such as their perceived opportunities for financing and expansion, their borrowing costs, etc., so expected and unexpected interest rate changes, expected economic growth, and market uncertainty have been all been suggested as factors that affect how they perform relative to value stocks. Here we do not examine the impact of macroeconomic variables[3] on the value-growth relationship but rather we focus on understanding their drivers within the asset space.

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[1] The well-known Fama-French three-factor model extended the traditional CAPM to explain excess returns not just with market beta but also with a small-stock and value-stock premium. See Fama, Eugene F. French, Kenneth R. "The Cross-Section of Expected Stock Returns." The Journal of Finance. Vol. XLVII, No. 2. (June 1992).

[2] In these charts, the index returns are beta-adjusted for illustration; we calculate the rolling 3-year monthly betas of the MSCI World Value and Growth Indices to the MSCI World Index and subtract the beta-adjusted market return from the Value and Growth returns.

[3] The relationship between macro variables and asset prices encompasses a large body of literature and is highly dependent on the data used and both frequency and timing assumptions. See MSCI Barra Research Insight, “Macroeconomic Factors in a Fundamental World” (2007) by Melas and Liu for a discussion of these issues.

The Current Growth Premium

Over the last several months, a sizable growth premium has emerged and persisted. Table 1 highlights the size of this premium, while Figures 2A and 2B shows how rapidly this spread has evolved.

Table 1: Average Return (Annualized) to Value and Growth

	MSCI World Value Index	MSCI World Growth Index
January 1975 to September 2007	13.63%	10.55%
January 2006 to September 2007	18.19%	16.32%
May 2007 to September 2007	5.08%	16.63%

Figure 2A

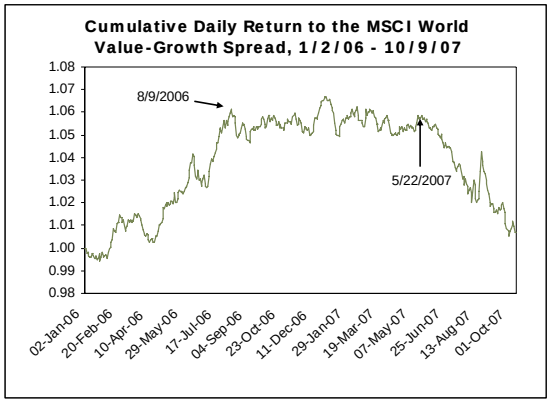
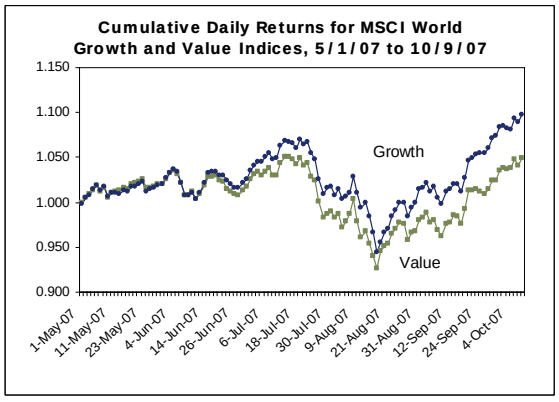


Figure 2B



The current size of the growth premium is not out of context historically. Since 1975, there have been approximately 40 months out of nearly 400 months (10%) where the MSCI World Growth Index has outpaced the MSCI World Value Index by more than 200 basis points, as we saw in July 2007. There have been large retrenchments of the value premium, most notably from the first quarter of 1998 through the beginning of 2000; and again in the second half of 2002. Historically, periods where growth stocks outpace value stocks can persist for some time. The question remains whether this current growth premium will continue to extend on par with the 1998-1999 run or whether it will disappear quickly. In the next section, we examine the sources of return of the MSCI World Value and Growth Indices to uncover what has driven the most recent premium.

Sources of Return

Attributing the returns of an index or portfolio allows us to understand what sources the returns are coming from, be they industries, common style biases, or idiosyncratic risk. Here we decompose the MSCI World Value and Growth Indices, which allows us to have a better understanding of the forces behind the recent growth premium. We decompose the constituent-level MSCI World Value and Growth Indices along the dimensions of the Barra Global Equity Model (GEM) factors.[4]

[4] We use Barra Aegis Performance Analyst to attribute the performance of the two Indices at the constituent-level each month. The model we use is Barra Global Equity Model (GEM).

Table 2 shows the key sources of return for the two Indices using monthly data for (1) August 2000 to September 2007 and (2) May 2007 to September 2007. We compare the MSCI World Value and Growth Indices against a market benchmark, the MSCI World Index. Note that a Bayesian adjustment is used in the risk calculations below, which combines historical realized and predicted risk from the GEM model. This adjustment allows us to use such a short observed history in the latter case.[5]

Table 2: Sources of Return, Overview*

	MSCI World Value Index		MSCI World Growth Index	
Source of Return	**Return (%)**	**Risk (%)**	**Return (%)**	**Risk (%)**
Aug 2000 – Sept 2007				
Total Return	8.22	13.67	1.44	14.46
Active Return	3.29	3.46	-3.49	3.66
May 2007 – Sept 2007				
Total Return	5.31	12.42	18.05	13.13
Active Return	-6.25	2.3	6.49	2.28

* Annualized numbers shown using monthly data.

Table 2 shows that over the longer term, the MSCI World Value Index has had relatively strong performance. In contrast, the MSCI World Growth Index has performed poorly relative to the World Index. In the last several months, not only has this relationship been flipped but the switch in performance has been extreme. Of the active return, we focus on the contribution to return from the systematic or common factors, Barra style and industry factors. This is shown in Table 3.

Table 3: Sources of Return, Systematic Versus Non-Systematic*

	MSCI World Value Index		MSCI World Growth Index	
Source of Return	**Return (%)**	**Risk (%)**	**Return (%)**	**Risk (%)**
Aug 2000 – Sept 2007				
Common Factor Return	3.49	2.45	-3.55	2.58
Asset Selection	0.20	1.61	-0.26	1.70
May 2007 – Sept 2007				
Common Factor Return	-3.19	1.89	3.25	1.87
Asset Selection	-2.61	0.81	2.78	0.8

* Annualized numbers shown using monthly data.

Much of the return differential between the MSCI Value and Growth Indices comes from the style factors in Table 3. This set of four factors is comprised of Value, Success, Variability in Markets, and Size. As expected, the GEM Value factor is the key source of return for this historical value premium as we see in Table 4.

[5] The combination of historical and realized predicted risks follows the formula where T is the number of months available and δ is a fixed number of months (24): $\hat{\sigma} = \sqrt{\frac{\delta}{\delta+T} * \sigma_{predicted} + \frac{T}{\delta+T} * \sigma_{historical}}$

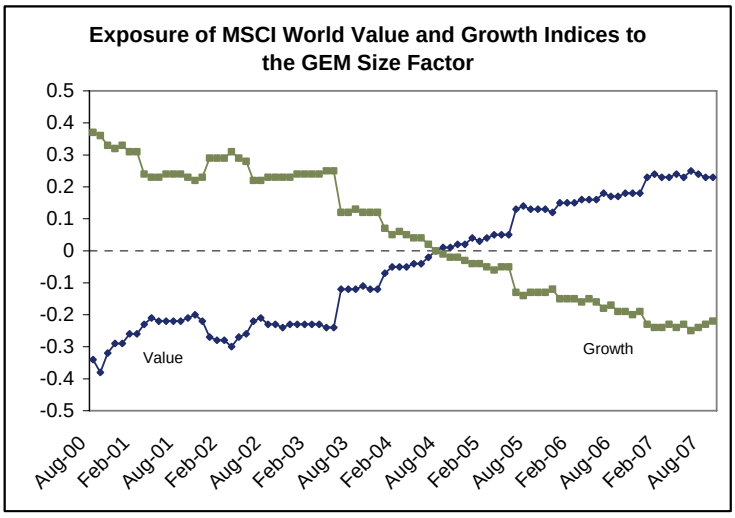
Table 4: Key Style/Sector Sources of Return for MSCI World Value and Growth Indices, May 2007 to September 2007*

	MSCI World Value Index		MSCI World Growth Index	
	Return (%)	Average Exposure	Return (%)	Average Exposure
Value	-2.37	0.59	2.49	-0.58
Success (Momentum)	-0.54	-0.06	0.57	0.06
Variability (Volatility)	-0.48	-0.25	0.53	0.24
Size	1.84	0.24	-2.06	-0.24
Finance	-1.98	13.67	2.15	-13.53
Capital Equipment	-1.03	-6.12	1.12	6.06
Materials	-0.48	-1.2	0.51	1.19

* Annualized numbers shown using annual data.

The main style driver appears to be Value, as we would expect, and to a lesser extent, Size. In fact, the exposure of the MSCI World Value Index to Size has gone from negative to positive over the last seven years even as the MSCI World Growth Index exposure to Size has gone from positive to negative (Figure 3).

Figure 3



With large stocks outperforming small stocks globally (as gauged by the performance of the Size factor), the recent growth premium would in fact have been larger if not for the bias of the Growth Index towards these smaller stocks relative to the Value Index.

Conclusion

Value stocks continue to demand a premium over the long run relative to growth stocks. However, growth stocks exhibit periods where they are in favor over value stocks as we have seen since the middle of this year. We link the recent growth premium to the systematic factors in the Barra Global Equity Model. The Barra Value factor explains a large amount of the spread that has developed between the MSCI World Value and Growth Indices. Other factors such as

industries within the Finance sector, and non-systematic return in a handful of sectors across the US and Asia also appear to have been important.

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