



September 2, 2011

### **Time to Live Large?**

As we scan today's investment horizon, it's hard to miss what appears to be an attractive opportunity to invest in some of the world's largest, most profitable companies at bargain prices. We're talking about large-cap growth companies.

Small-cap growth stocks often lead during the early stages of an economic recovery. However, leadership often shifts to large-cap growth stocks during the latter stages of an economic cycle. While it's difficult to determine what stage the economy is in right now, we expect that the current slow-growth environment may persist for some time. In this uncertain environment, large-cap growth stocks look like good relative values.

Many large-cap stocks, especially those of multi-national companies, will benefit more from faster economic growth outside of the U.S., particularly in emerging markets. Most small companies don't have the global reach to benefit from this trend.

### **Defining "Growth" and "Value"**

It's easy to get confused about what constitutes a growth stock, or for that matter, a growth fund, as the definition has evolved over the years. But in general, we consider a growth stock one where a company is growing earnings faster than the overall market.

Many growth stocks do not pay dividends. Instead, they often reinvest almost all of their profits back into the business. However, as some growth companies have built up huge cash hoards, shareholders have demanded they return some of that money in the form of dividends (think Microsoft or Intel).

Value stocks, on the other hand, are companies whose shares trade either below their inherent worth or lower than the market average. Value investors are shopping for bargains, and as a result they tend to place significant emphasis on the price (or valuation) of a stock. Because growth investors focus on a company's potential, they place less emphasis on the current price of the stock and are more willing to pay above-average valuations for attractive growth opportunities. Whereas value stocks can be referred to as "cheap" or "discounted," growth stocks have tended to trade at a valuation "premium" to the over-all market. In today's market, however, that is no longer the case.

### **Opportunities in Today's Market**

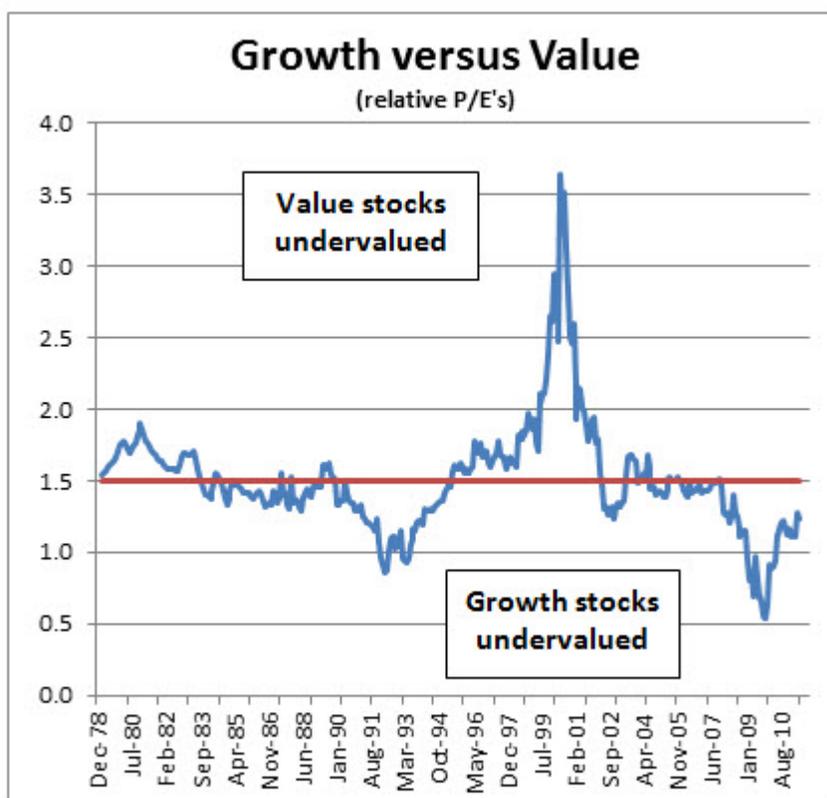
Despite the market's recovery from the lows of March 2009, price-to-earnings

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(P/E) ratios (a measure of the amount investors pay for each dollar of earnings) on large-cap growth stocks are well below their long-term average, especially when compared to value stocks. In fact, P/E ratios on growth stocks would have to expand by almost 20% just to get back to their average valuations relative to value stocks.

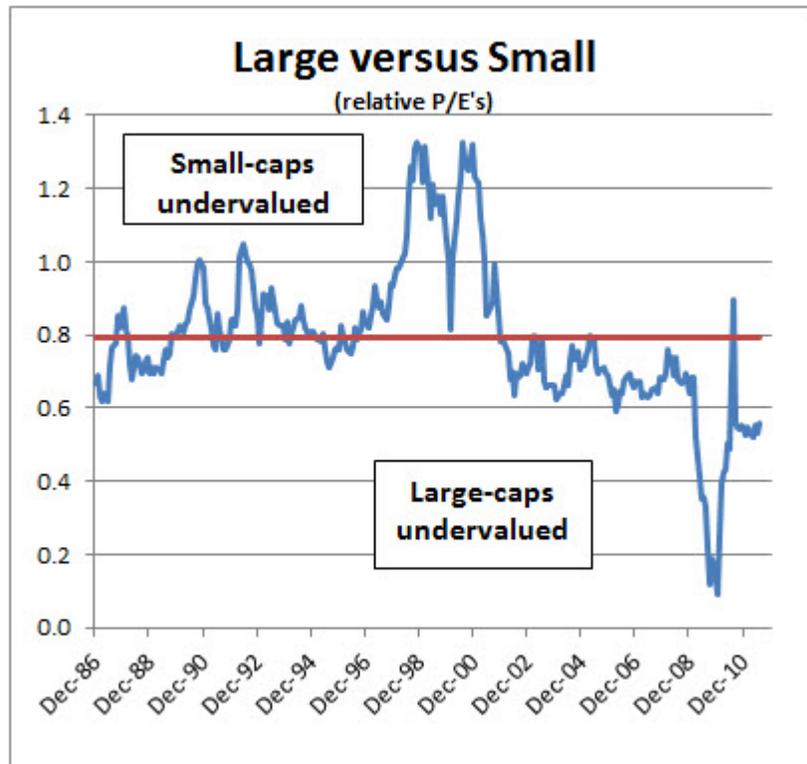
The chart below, which is based on the growth and value subsets of the Russell 3000 Index, provides some perspective on the relative values in the growth and value stock universe. It shows the relative P/E ratio between the Russell 3000 Growth and Russell 3000 Value indexes from the beginning of 1979 through July 2011, which we calculated by dividing the P/E ratio of the growth index by that of the value index. The red line is the historical average (1.51), while the blue line shows how the relative P/E ratio has varied from month to month. When the value of the blue line is above that of the red, the relative value of "value" stocks is higher than that of "growth" stocks. When the blue line is below the red, as has been the case since the end of 2007, growth stocks are priced more attractively than value stocks.



Source: Adviser Investments, Russell Investments.

Note: Chart data from 3/31/79 through 7/31/11.

Looking at a similar chart comparing large-cap stocks to small-cap stocks (with large-caps represented by the Russell Top 200 Index and small-caps represented by the Russell 2000 Index) we find a similar pattern of undervaluation (see below). According to the Russell data, investors are currently paying about 14.6 times earnings for the largest stocks, while they're paying 26.2 times earnings for small stocks. On average, large stocks have typically sold for more than 22 times earnings when small stocks were this richly valued, as the chart below shows.



Source: Adviser Investments, Russell Investments.

Note: Red line is the average relative price-to-earnings (P/E) ratio between the Russell Top 200 and the Russell 2000 Indexes, while the blue line shows the month-to-month relative P/E ratio. Relative P/E ratio is calculated by dividing the P/E ratio of the Russell Top 200 Index by the P/E ratio of the Russell 2000 Index. Chart data from 12/31/86 through 7/31/11.

### Attractive Large-Cap Growth Funds

While profit growth really defines growth stocks, it's a different story for growth funds. Growth fund managers (as defined by style-maps or their prospectus--objectives can vary widely under the "growth fund" label) may be looking for companies where profits are currently growing at breakneck pace, or for companies whose assets are so undervalued that market recognition of that value may generate strong price appreciation. Either way, above-average growth is what matters.

When we evaluate a growth fund, we look for the ability to power a portfolio by producing long-term gains that can be banked five, 10, 20, or even 40 years into the future. Often, those gains come with lower current income, which means greater tax efficiency for investors with taxable accounts.

Between Fidelity and Vanguard, as well as certain other fund families, we've identified and invested alongside some of the best large-cap growth managers running funds today.

Within Fidelity's fund universe, we include Will Danoff's Contrafund or Matthew Fruhan's Mega Cap Stock in certain client portfolios. Danoff has run Contrafund since 1990 with a broad contrarian mandate--choosing companies that go against the grain or are underappreciated by investors. While he has the freedom to choose among growth and value stocks large and small, Danoff has historically stocked the portfolio with large-cap growth names. At Mega Cap Stock, Fruhan invests in the largest, best-known

companies in the U.S., mainly picking companies found in either the S&P 100 or Russell Top 200 indexes.

Within the Vanguard family of funds, we've been long-time believers in the PRIMECAP Management team, which runs the PRIMECAP and PRIMECAP Core funds in the large-cap growth space. Unfortunately, if you don't already own these funds, they are closed to new investors. However, PRIMECAP Odyssey Growth, a near clone of PRIMECAP, and PRIMECAP Odyssey Stock, launched around the same time as PRIMECAP Core and run in the same style, are still open. The PRIMECAP team follows a growth-at-a-reasonable-price philosophy, meaning that they are likely finding great values in growth stocks these days.

A Vanguard option that remains open to new investors is Don Kilbride's Dividend Growth, which invests in companies that have shown a commitment to growing their dividends. Kilbride's strict investment discipline has produced a concentrated, large-cap portfolio that's generated market-beating returns since he took charge in 2006. Unlike the other growth funds we've spotlighted, Dividend Growth investors benefit from both the potential for capital appreciation as well as a steady stream of income (the fund pays out distributions semiannually).

The pendulum between growth and value, and small-cap and large-cap is constantly on the move. In today's environment, we think conditions favor large-cap growth stocks, and have included them in our clients' portfolios by investing in some of the funds mentioned above. While we believe in a diversified approach across multiple capitalization ranges and styles when it comes to portfolio construction, it's gratifying to know that key components of our clients' portfolios are in great position to achieve long-term growth, especially in light of the recent uncertainty in the markets.

### **About Adviser Investments**

Adviser Investments and its subsidiaries operate as an independent, professional money management firm specializing in Fidelity and Vanguard mutual funds. With 2,400 clients and over \$2 billion under management, Adviser Investments is one of the nation's largest mutual fund research and money management firms. Our staff of 50 investment professionals focuses on helping individual investors, trusts, foundations, and institutions meet their investment goals. Our minimum account size is \$350,000.

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