

## VIEW FROM THE US

# Rare opportunity to sample big-caps

The market herd moved on to pastures new this past year, leaving value seekers many large treats to graze on, says Whitney Tilson

When it comes to owning stocks of the best-known businesses in the world, value investors usually feel like children looking through the window of the candy store, unable to afford the treats inside because they refuse to pay the prices such high-quality franchises typically bear.

But a rare opportunity appeared over the past year for value investors to sample the treats inside the store.

As recently as mid-July, the S&P 500 index and the Dow Jones Industrial Average, both heavily weighted in large-cap growth stocks, were roughly flat for the year, and this category was the worst performing over the previous one, three and five years.

Such underperformance is hardly surprising, given how overvalued blue-chip growth stocks had become during the bubble in the late 1990s. By early 2000, companies such as Home Depot, Wal-Mart, Dell and Microsoft were trading at absurd multiples, with price/earnings ratios well above 50.

Since then, while earnings for companies such as these have grown, the stocks are down because multiples contracted dramatically as the market herd moved on to small-caps, real estate and commodities.

As contrarians who like to buy quality on the cheap, we began investing in a range of blue-chip stocks last year and accumulated positions in Berkshire Hathaway, McDonald's, Microsoft, Wal-Mart, Anheuser-Busch, Wendy's, Costco, Tyco, Foot Locker, Dell and Heinz, all of which we still own.

This strategy has particularly started to pay off in the

latest market rally, to the point where our mutual fund, the Tilson Focus fund (TILFX), was the top performer of 833 funds in its Multicap Core category over the 12 months to September 30, according to Lipper.

Have such blue-chip "growth" stocks had their run? Alan Abelson, the Baron's curmudgeon, thinks so. "Mutual funds and their more adventurous, far more addicted to debt and often more feckless younger kin, hedge funds, have piled into the big-caps because the consensus has opined that the big-caps are the place to be," he wrote recently. "This has proved a self-fulfilling analysis since their very piling in has been very much one of the reasons the big-caps have been the place to be. How long this ring-around-the-rosy, Wall Street-style, can go on before it all falls down is anybody's guess. Ours is: not very long."

We respectfully disagree. The S&P 500 is trading at a modest 18 times trailing earnings, relative to 35 for the Nasdaq and a more ridiculous 36 for the Russell 2000. Particularly in a late-cycle period of moderating growth, large, high-quality businesses should trade at a premium, not a discount to tech and small companies. In addition, the cycles between large-caps versus small-caps, and growth versus value, tend to last for many years. Rich Pzena of Pzena Asset Management has identified four distinct periods since the beginning of 1969 in which the S&P 500 (ie "growth") stocks dominated and four in which buying low price-to-book (ie "value") stocks did. (Value stocks were defined as the

200 stocks among the largest 1,000 that had the lowest price/book ratios.)

These data suggest some interesting things. First, buying low price-to-book stocks has produced superior returns over extended periods of time but there have also been periods of significant underperformance. Sec-

ond, the average time in which growth stocks dominated was 37 months, whereas when value stocks returned to favour, they remained in favour for an average of 76 months. Interestingly, 76 months from the beginning of the latest value cycle in March 2000 took us to the middle of this year,

which is when large-cap growth stocks started to outperform and traditional low price-to-book stocks started to underperform.

Are growth stocks due to outperform for another two or three years? I don't know and, as a bottoms-up stock picker, I don't really care. But value investors such as

me continue to see more "value" today in stocks that have traditionally been characterised as "growth".

Whitney Tilson is a money manager who co-edits *Value Investor Insight* and co-founded the *Value Investing Congress*.  
feedback@tilsonfunds.com

## Growth vs value

Period	Months	Return (%)		Difference %
		S&P 500	Value stocks	
Jan 1969 – Jun 73	54	19.3	-8.3	-27.6
Jul 73 – Jul 79	73	30.4	206.9	+176.5
Aug 79 – Nov 80	16	45.6	17.4	-28.2
Dec 80 – Nov 88	96	160.7	414.7	+254.0
Dec 88 – Oct 90	23	25.1	-18.2	-41.3
Nov 90 – Aug 95	58	113.2	247.9	+134.7
Sep 95 – Feb 2000	54	163.0	71.8	-91.2
Mar 2000 – May 06	75	2.9	148.1	145.2
Cumulative Annualised (since Jan 1 1960)		11.1	16.8	+5.7

Source: Pzena Asset Management