TAKE 5 VIEWS

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Equity Investor Toolkit

When equity investors purchase shares of a company's stock, they are doing so in the hope that the company's value will increase or that it will generate dividends. But equity investing isn't as simple as just picking stocks. In this issue, we explore the difference between growth and value companies, why a company's market capitalization matters, the benefits and drawbacks of non-U.S. equities, and the difference between active and passive equity investing. We also take a look at some of the most widely used analytical statistics to help investors evaluate equity funds.

1 How can investors tell the difference between growth stocks and value stocks

ClearBridge Investments

Evan Bauman, Portfolio Manager,
ClearBridge Investments

Growth and value have long been considered two ways to invest in the stock market. Growth investors seek companies with strong earnings growth, while value investors look for companies that appear to be undervalued by the marketplace. But how can you tell which is which? Investors tend to group companies into growth vs. value categories based on several different measurements of fundamental characteristics, including their price-to-earnings or P/E ratio, and their PEG ratio, which divides a stock's P/E by its historical rate of earnings growth.

When looking at a stock's price-to-earnings or P/E ratio, which divides a stock's price by its earnings per share, growth investors will look for stocks with higher P/Es than value stocks. That's because growth investors are willing to pay more for the earnings those stocks deliver. And growth stocks are also likely to have faster rates of growth in earnings and/or revenues than value stocks.

On the other hand, value companies usually trade at a price below their historical average P/E. While there is no guarantee the company will recover,

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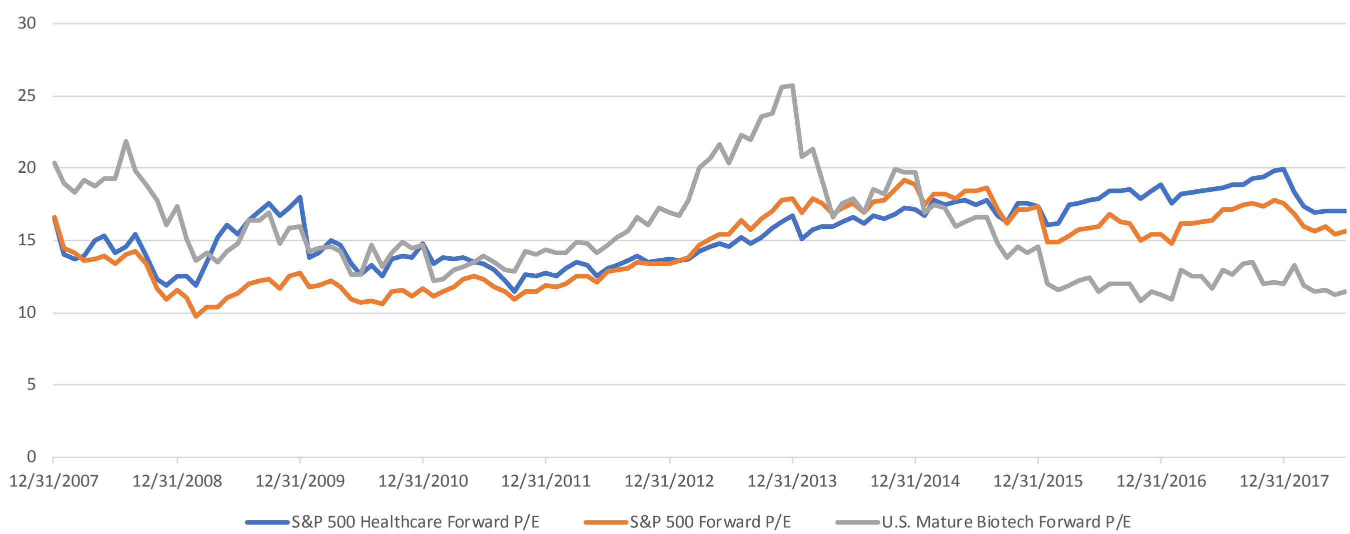
value stocks are starting from a lower level of expectations as the market has a pessimistic view of its prospects. Put another way, a value company may have a lower hurdle to clear to deliver strong performance than a growth stock with much higher performance expectations.

Another measurement to look at is the PEG ratio, which divides a stock's P/E by its historical rate of earnings growth. The PEG can tell you how much you are paying for growth: a high PEG usually means a stock is expensive even if it's growing fast; and a low PEG (under 1) indicates that a stock provides an attractive value for its growth rate.

It is possible for a stock to go back and forth between value and growth. Value vs. growth can be a function of a company's stock price or valuation compared to its history. For example, a stock that starts off as "growth" -- with strong earnings, revenue, and price appreciation -- could run into near-term difficulties that cause its price to decline and/or financial results to become depressed, turning it into a "value" option. Biotechnology companies are a good example of this.

From 2011 through the summer 2015, biotechnology stocks significantly outperformed the broader market, driven by lower branded drug patent expirations, increasing optimism about innovative drug therapies, a more favorable regulatory environment for new drug approvals, and robust prescription-drug pricing power. But political scrutiny over the high prices of certain branded drugs during the 2016 presidential campaign coincided with the end of the rally. Since then, many investors have abandoned biotech stocks in favor of companies with more attractive growth profiles and less political risk, causing biotech P/E ratios to plummet (Exhibit 1). In other words, these stocks enjoyed a growth categorization, but are now seen as a value option instead.

Exhibit 1: Biotech P/E Ratios are at Value Stock Levels



U.S. Mature Biotech is an equal weighted group comprised of Amgen, Biogen, Celgene and Gilead Sciences.
S&P 500 Healthcare is an equal weighted index of 61 health care companies. Source: Bloomberg as of June 30, 2018.

It's possible that biotech stocks could be on the road to recovery and may soon regain their growth characteristics. From an investor's point of view, the performance of biotech stocks simply illustrates how important it is to own a mix of value stocks and growth stocks, as they can provide greater opportunities to participate in the performance of equities. Buying stocks with both value characteristics that can improve and growth characteristics that can continue can be a sound long-term approach for investors.

Why should market capitalization matter to investors?

2

Regina Pitaro, Managing Director,
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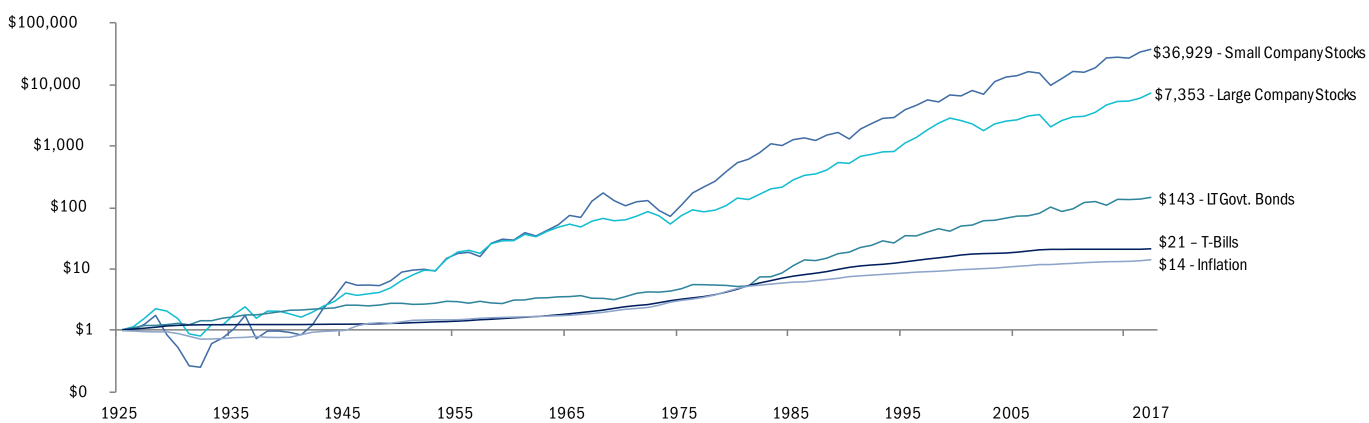
GAMCO ASSET MANAGEMENT

Investors have long considered the attributes and advantages of investing in companies with different market capitalizations as they build portfolios and determine their ideal asset allocation. While definitions vary, Large Cap companies are generally considered those with market capitalizations above $10 billion, Small Cap companies have market capitalizations under $2-$3 billion, and Mid Caps hover in between. Large Cap companies are typically more liquid with higher trading volumes and are usually more widely covered by Wall Street analysts. Over the last 10 years since the Global Financial Crisis, there has been a trend toward passive investing for Large Cap companies, as investors are often able to capture most of the return in this category using an index. On the other hand, Small and Mid Cap companies, which are not followed as frequently by Wall Street analysts, have a potentially greater possibility of price inefficiency, which creates value-based opportunities for active managers.

Market cap performance – short- and long-term

Using the Russell 2000 and Russell 1000 as proxies, Small caps have had a strong start to the year and are outperforming Larger Cap companies in the second quarter and first half of 2018. This is a recent reversal, as Small Caps have underperformed Large Caps over the trailing, 3- and 5-year periods using the same proxies. The picture is quite different however if we take a longer term view. From 1926 through 2017, using Ibbotson Associates' return data as illustrated below, $1 invested in Small Cap company stocks would have grown to $36,929 compared to $7,353 for Large Cap company stocks.[1]

Small Cap Outperfrom Over the Long-term[1]



[1]Hypothetical value of $1 invested at year-end 1925 through 12/31/17, using return data from Ibbotson Associates' 2018 Stocks, Bonds, Bills, and Inflation Yearbook. Assumes reinvestment of income and no transaction costs or taxes. For illustrative purposes only. Past performance is no guarantee of future results.

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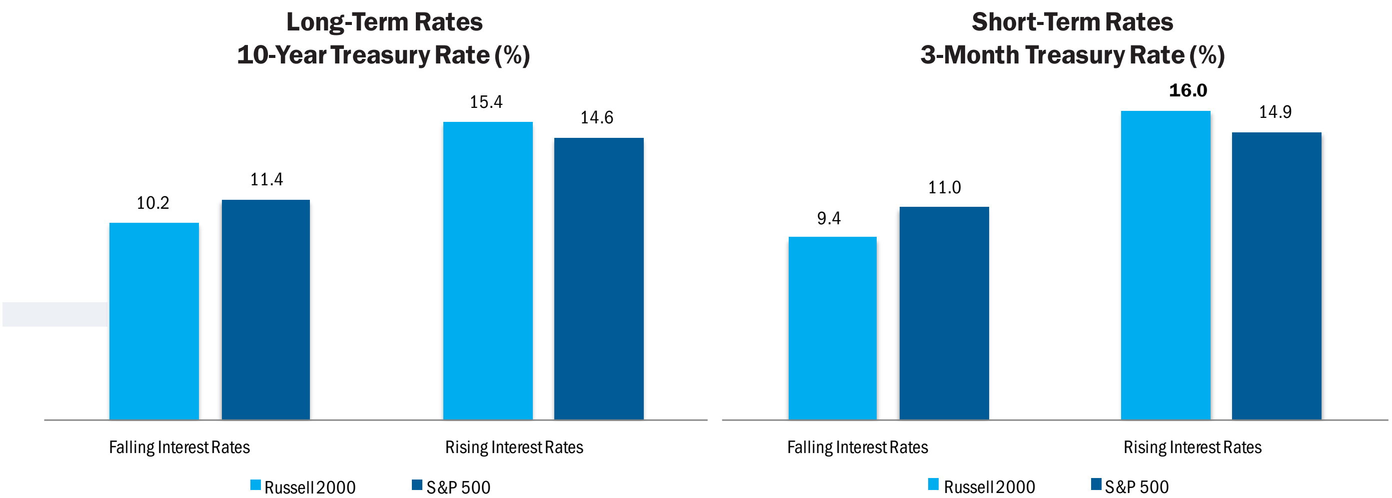
Which market cap looks most attractive going forward?

The current economic and political environment is particularly compelling for smaller companies for several reasons. Small Caps tend to be more domestically focused, with roughly 80% of their revenues in the US, compared to their Large Cap peers which derive about 60% of their revenues in the US. As trade war rhetoric and posturing continues between the US, China and multiple trading partners on multiple fronts, Small Cap companies' domestic focus may provide a cushion from some of the associated market volatility. Smaller cap companies also stand to benefit more from recent tax changes and the softening regulatory environment than larger companies. Smaller companies tend to be full cash tax payers and generally have lower cash reserves and often higher margin projects to allocate to, and thus are more highly levered to the lowering of the corporate tax rate to 21%. The current regulatory environment is also more beneficial to small companies with limited resources.

Additionally, Small Cap companies have tended to perform better in a rising interest rate environment than in a falling interest rate environment as illustrated in the chart below. In rising interest rate environments, higher quality companies have tended to outperform which is also positive for active managers.

Average Annual Performance of Small-Capsand Large-Caps When Treasuries Rates are Rising and Falling



Source: Munder Capital Management "The Small-Cap Investing Environment." Since the inception of the Russell 2000 in 1979 through 2012.

Lastly, small and mid-sized companies will benefit from continuing momentum in deal activity as larger companies use acquisitions to boost their revenues. Cheap financing, unprecedented levels of cash on corporate balance sheets, a lower tax rate and global growth and globalization (which fuels cross border deals) will continue to propel M&A going forward.

3 What are the advantages and disadvantages of non-U.S. equities?

Euan Mackay, Client Portfolio Manager, AXA Investment Managers

Today's consumers embrace globalization in many parts of their lives -- from the cars they drive to the food they eat. But, in investing, a home bias often still prevails. Despite easy access to overseas equities, investors still hold a large proportion of their portfolio in the domestic market. While the recent outperformance of U.S. stocks may mask the benefits of non-U.S. equity investing, looking further afield can open up a world of opportunities.

Investors have a variety of options to broaden their horizons. For example, global equity funds can be a good way to increase diversification while maintaining a large allocation to the U.S. The United States makes up approximately 60% of the MSCI World Index, a common global equity benchmark that includes companies in 23 developed markets around the globe. Its weight in MSCI's All Country World Index (ACWI), which also covers 24 developing countries, is approximately 50%.

Those who wish to separate their U.S. and foreign investments might consider international and emerging markets funds. International strategies, such as those managed against the MSCI EAFE Index (Europe, Australasia and the Far East), invest in developed markets outside the U.S., while emerging market strategies focus on developing markets.

One advantage of global investing is greater choice. This may be especially appealing given that the number of companies listed on U.S. stock exchanges has been falling for several years. The Wilshire 5000 Index – an index designed to capture all actively traded U.S. stocks that took its name from the number of companies it originally contained – now has fewer than 3,500 constituents. Against this backdrop, casting a wider net can add significantly to your opportunity set.

However, not all of the stocks in this broader selection universe will be compelling investments. The S&P 500 Index has outperformed the MSCI EAFE Index by almost 1% per year since 1970. On the other hand, as Ben Carlson noted in a recent post on his blog A Wealth of Common Sense, all of this outperformance has occurred since 2010; between 1970 and 2009, the international index delivered better returns. Given U.S. equities' recent dominance, foreign stocks may now be particularly attractive to valuation-oriented investors. As the chart below shows, price-to-earnings ratios on several international indices are currently lower than in the U.S. Considering that growth expectations for many of these markets are also higher, international equities could offer more than just diversification benefits in the coming years.

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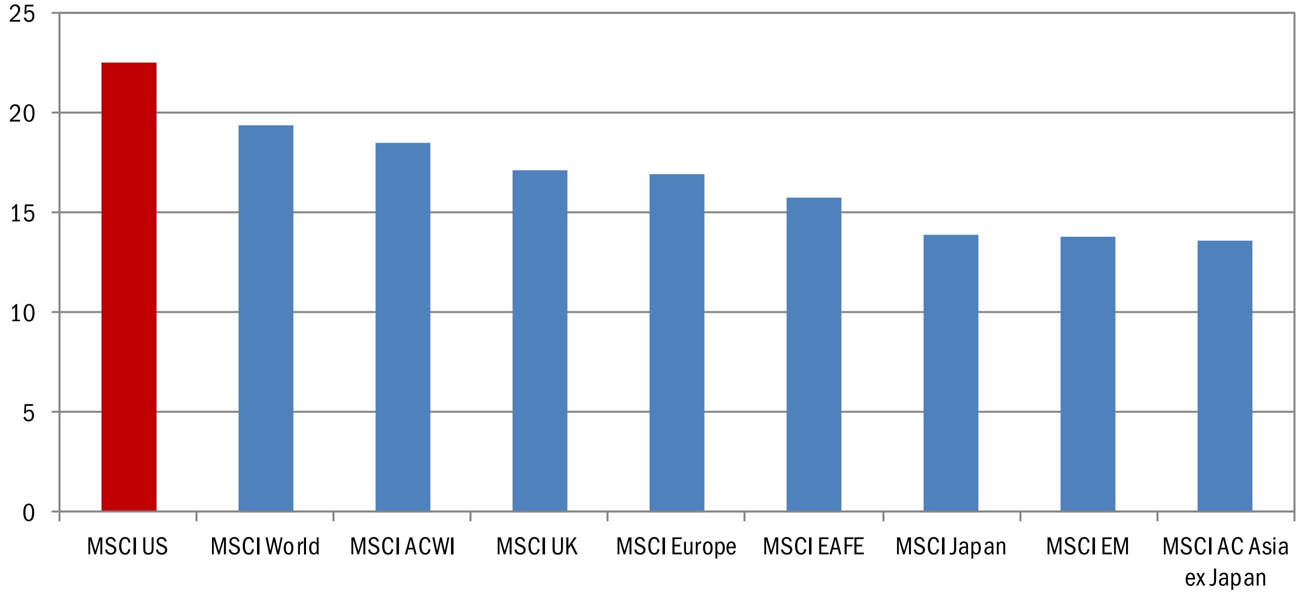
P/E Ratios Around the World



Source: MSCI, data as of 30 June, 2018. P/E ratios based on trailing twelve month earnings

Of course, international investing isn't without risk. For starters, buying non-U.S. stocks typically adds currency risk to a portfolio. This can be an additional source of volatility, on top of the fact that many foreign markets have historically been more volatile even in their local currencies. However, for investors who can manage these risks, the current valuations and growth prospects for non-U.S. equities, as well as the greater choice they provide, suggest investors should consider globalizing their portfolios, like they have the rest of their lives.

4

What's the difference between active and passive equity investing?

Mark Gleason, Director, Multi-Asset Global Business Development, AllianceBernstein, LP

There seems to be no end to the ongoing debate about active and passive investing. Many investors prefer passive strategies, which provide access to "beta," the return of a broad market, such as that represented by the S&P 500 Index, or a market segment, such as that represented by the Commodity Producers Index.

Others prefer active investing, with its added potential to outperform the markets, called "alpha." Many investors choose a combination of these two approaches. The decision ultimately comes down to an individual's goals and objectives, and should include a full understanding of each approach and its pros and cons.

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Active and Passive: A Closer Comparison

The low cost of passive investing is a big advantage. Fees are lower than those of active strategies, allowing inexpensive market participation. When the market does well, so do investors. On the other hand, fully passive strategies are also exposed to all the market's downside in difficult times.

Active management seeks to add value by outperforming basic market exposure. Managers can generate alpha through tactical asset allocation—managing and repositioning their exposures to a collection of passive components as market conditions evolve. They can also use stock selection and other tools in an effort to outperform individual indices. Used effectively, active management may help reduce portfolio losses in down markets.

Of course, investors pay higher fees for this alpha potential—substantially more than passive strategies—and there's no guarantee that a given active manager will outperform passive strategies. In fact, many managers underperform. This makes in-depth research critical in assessing a manager's track record and capabilities.

The Role of the Market Environment

Following the global financial crisis, markets were strong, volatility was low, and the differences between individual stock returns were unusually small. This environment was challenging for active management, and many investors concluded that simply capturing beta through passive investing was a better choice.

These conditions seem to have changed recently, with lower expected returns, higher volatility—including the February 2018 downturn—and increased dispersion among stock returns. Although it's impossible to predict market conditions in advance, the unusual conditions that we've seen since the crisis aren't likely to last, and the needle now seems to be tilting toward active investing.

The Bottom Line

Both investing approaches have benefits for investors, whether it's the inexpensive broad-market access of passive management or the potential of active management to dynamically adjust allocations or employ security selection to beat the market and help defend in downturns. When it comes down to it, both active and passive investing have a place in well-designed portfolios.

5 What analytical statistics can investors use to evaluate equity funds?

J.P.Morgan Asset Management

Jordan Jackson, Market Analyst, J.P. Morgan Asset Management

Modern portfolio theory "MPT" is a widely accepted and influential economic concept that provides a helpful framework for portfolio construction based on the measurement of expected return for a given level of risk. It suggests that through diversification, investors can reduce unsystematic risk and maximize return potential. This theory undergirds today's understanding of portfolio management and uses analytical measurements to build its framework. The MPT incorporates five statistical risk measurements:

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Alpha reflects a strategy's total return above or below a benchmark;

Beta measures a strategy's sensitivity to the market. The beta of the market is 1.00 by definition;

R-squared reflects the percentage of a strategy's movements that can be explained by movements in its benchmark;

Sharpe ratio measures unit of return over the risk-free rate (normally a short-term U.S. treasury rate or cash) per unit of risk and,

Standard deviation measure the volatility of total returns.

All of these measures are intended to help investors determine the risk-reward profile of a potential investment. While each measure has merit in its own right and provides helpful risk and/or return characteristics of a strategy, evaluating a fund using each metric in isolation does not paint a complete picture. Rather, these statistical measures should be used in conjunction with each other, alongside an investor's risk tolerance and return objective in order to adequately guide their investment decisions. Overall, these measurement help investors get a sense of a funds past returns (alpha), systematic and overall risk (beta, standard deviation), similarity to benchmark (r-squared) and risk-adjusted returns (Sharpe ratio).

Over the past decade, the number of vehicles that allow us to access capital markets has dramatically increased. Because of this, investors now have hundreds of investment options -- from pure beta exposure, to sector/style tilts, to more complex factor-based investing funds. In a world where too many options can be overwhelming, these simple, yet useful, statistics can be helpful in comparing and contrasting which strategies would be appropriate for an investor. For example, an investor may be looking for a fund that has exhibited high excess returns or strong alpha over time. However, looking at excess returns alone does not tell us about the amount of additional risk that was taken to achieve those returns. Additionally, an investor will need to consider time horizon, liquidity needs, and risk appetite. Once these are taken into account, that same investor may be willing to forgo that excess return for a less riskier option. Therefore, when comparing funds, it is better to look at measurements like standard deviation and Sharpe ratio, that allow for easy evaluation, to arrive to an investment decision.

When evaluating a fund, an investor may compare it to others in the same style category to determine which is superior. The chart on the following page shows three different U.S. equity funds, all categorized as large cap growth strategies. You can see that each fund portrays a different risk and return profile and using these statistics we can very quickly see how they compare:

- Fund A has the highest annualized return over the period, but it also has the highest standard deviation or volatility of returns.

- Fund B, has the second highest return, but has the lowest standard deviation, thus leading to a best Sharpe ratio.

Therefore, if an investor was just to consider a fund with the best risk-adjusted returns, Fund B would be the best choice.

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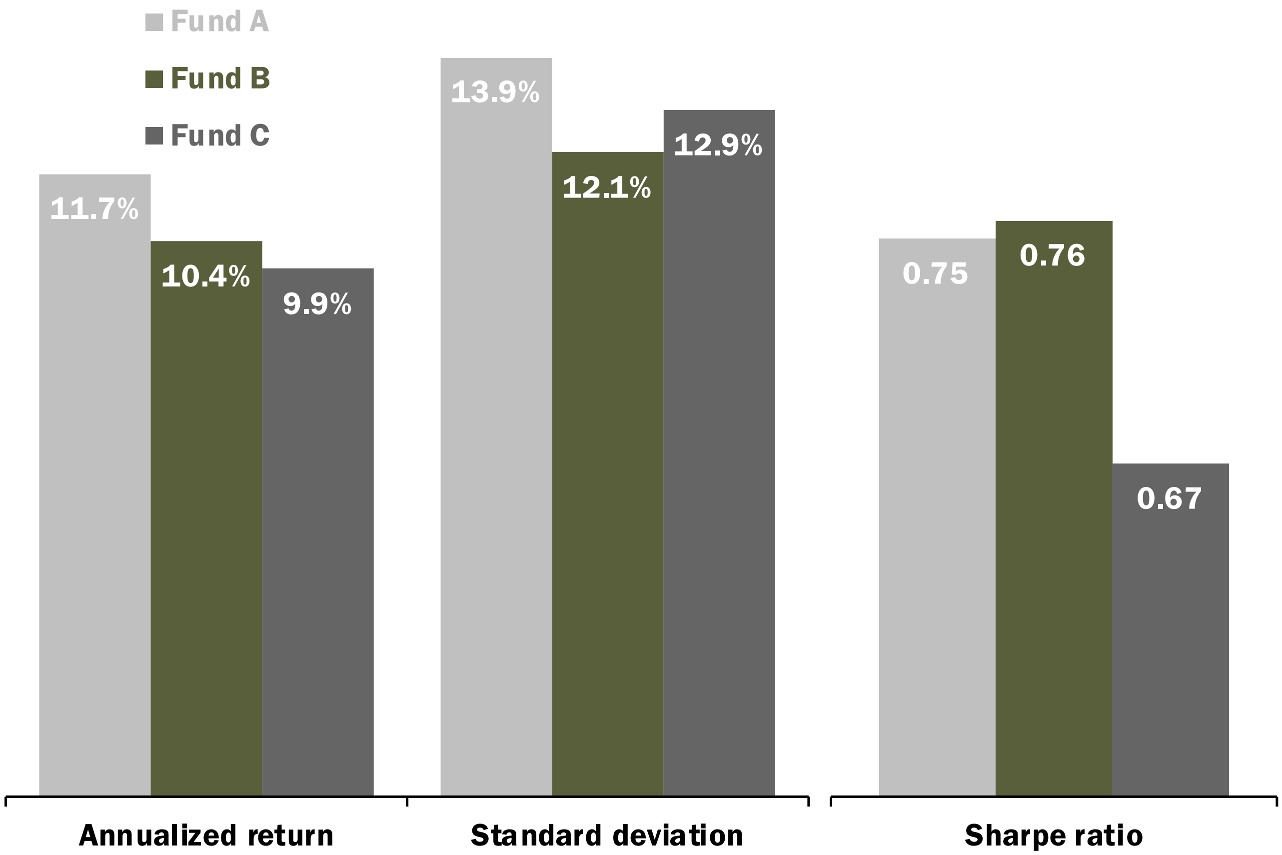
Risk/Returns for Three Equity Funds

10-year holding period



Source: J.P. Morgan Asset Management. This information is for illustrative purposes only and does not reflect actual investment results. Data as of June 30, 2018

These metrics are not the only way to evaluate a fund. Investors may look at other statistics such as information ratio, batting average, up/down capture, correlation, etc. to try and get a more complete picture. However, these measures are useful in both comparing and evaluating equity funds. Furthermore, funds go in and out of favor depending on investor sentiment and where we are in the business cycle. Therefore, as long–run investors, we should focus on statistics over a market cycle with an emphasis on 5- and 10-year numbers over short-term performance which may paint a different picture. Overall, investors should always know what they own, so it is important to consider funds that display consistency and use metrics that allow apples-to-apples comparisons over time to help guide their decision-making process.

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