

## What's With All the Growth Managers?

We've had it wrong. We often write about the seemingly unwavering inclination of investors to chase performance, to buy whatever has gone up the most (and is therefore expensive) and to sell whatever has gone down the most (and is therefore a bargain). It is natural to take the recent past and extrapolate it into the future. In most areas of our lives, this propensity is useful, but in investing, it can lead to disastrous results. Yet, here staring us in the face, is evidence that this penchant for chasing investment performance does not always hold.

In the Morningstar database, there are over 5,000 separate account managers and more than 21,500 mutual funds. Morningstar categorizes equity managers as following a growth style (trying to buy rapidly growing companies, usually in technology, healthcare and related areas) or a value style (trying to buy assets cheap, usually in more mundane, basic industries). For all capitalization sizes of U.S. stocks, and for foreign stocks as well, there are far more growth managers than value managers. Over most historical periods, however, the value managers have performed better than the growth managers have. So why are there relatively few of them?

There appear to be two possibilities. First, perhaps there simply are more "natural" growth managers than value managers. Many gifted investment managers seem born with an innate tendency towards growth or value, much as salmon hatchlings going downstream turn either right or left when they reach the ocean. In our experience, however, genetically determined growth managers seem to be rarer than genetically

determined value managers. While a supply side rationale for the greater number of growth managers is possible, we are skeptical that this provides an adequate explanation.

The second possibility is that there are more growth managers because it is easier to sell investors growth investments, and therefore Wall Street trains more managers in the growth style. This seems much more plausible to us. After all, value stocks are a value for a reason; their price is low because investors perceive a problem with the underlying company. Value companies are at best boring and at worst scary. Investors perceive growth companies, on the other hand, as successful. The stocks are at worst comforting and at best exciting; investors *want* to own them. There are emotional, non-economic reasons to buy growth companies, while the only reason to own a value company's stock is to make money.

***“When people are free to do as they please, they usually imitate each other.” – Eric Hoffer***

The money management business tends to be product oriented rather than service oriented. If investors like a particular kind of product, the industry will create that product in profusion. The Morningstar mutual fund database lists 313 specialty technology funds with five-year records, but only 75 with 10-year records. Many technology funds have been closed or merged away after the bursting of the bubble ~ the industry is able to bury its mistakes in the hope that you will forget. Even ignoring this factor, however, the number of technology funds more than quadrupled between 1996 and 2001. Did the supply of fully-trained, excellent, experienced technology-oriented money managers quadruple in those five years? It seems dubious. The number of utility funds, for example, barely increased during the same period. Wall Street “created” more technology managers than utility managers because of investor demand or, more precisely, because it was relatively easier to sell prospects technology investment products than utility investment products.

While the industry's tendency to create products that are easy to sell is easiest to see in relatively narrowly focused sector funds, we believe it is also generally true for broader growth and value investments. Wall Street can make more money from even mediocre growth funds than value funds if investors have an innate desire to buy growth “product.”

There is still an observable tendency for investors to chase performance. Since value managers have had a hot hand over the past several years, money is flowing into a lot of new value “products.” If our thesis is correct, however, investors will abandon this newfound hankering for value investments relatively soon if adversity strikes; having left their comfort with growth stocks, they are less forgiving and quicker to flee if their value investments encounter difficulty.

One of Sigma's core principles is that any emotion injected into the investment process is likely to lower investment returns. Part of our job is to assess where emotions exist in the financial markets and then try to take the opposite side on behalf of our clients. We have no love affair with either growth or value investments; we try to determine which areas of the market are cheap and take advantage. If this makes sense to you, call us at (503) 419-3938 or check us on the web at [www.sigmainvestment.com](http://www.sigmainvestment.com).