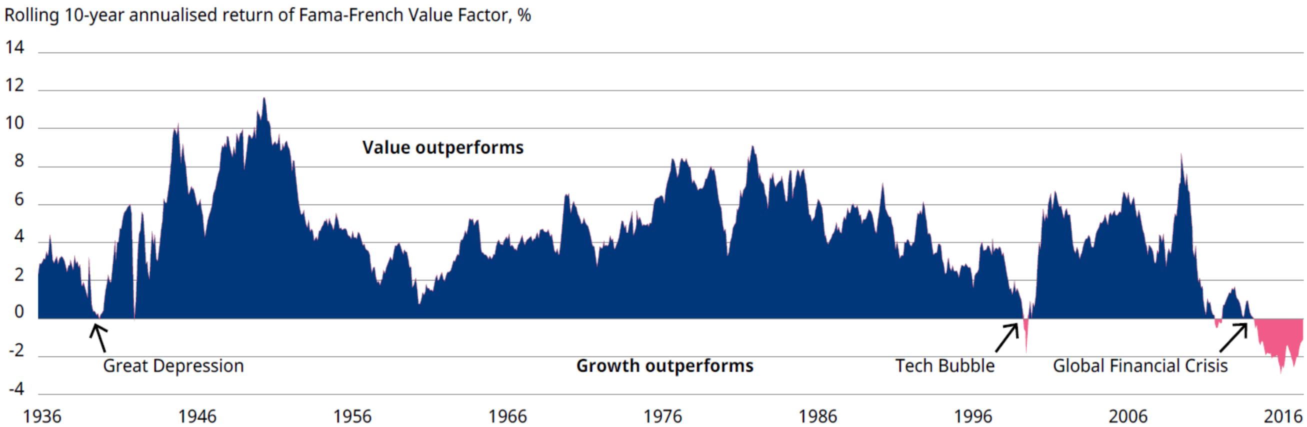
"(Valuation) is not an important or relevant variable to performance. It's making something psychological into something scientific and that is WRONG! The whole world (except the troglodyte value managers) has come to understand that the price-to-earnings discipline...doesn't work any more."

-James Cramer | theStreet.com | 02.11.2000

Figure 1: Value has nearly always outperformed growth - until recently



Source: Schroders

"The debate between so-called 'growth' investors and 'value' investors rages on." While a correct statement in July 2018, these words were penned in one of the Equity Opportunities Group's market updates 18 years ago in June 2000. As was stated then, we have no intention of calling the end of the outperformance of growth stocks, but just as then we'll start with the facts. "Growth" strategies have blown value-oriented strategies out of the water in recent years. While this was a true statement 18 years ago as seen in the chart above during the "tech bubble," value-oriented strategies have underperformed even more dramatically in recent years if measured on a trailing 10 year basis.

We have difficulty with the definitions market participants assign to "growth" and "value" (for example, how can IBM, Best Buy, and Pepsi be in both the Russell 1000 Growth and Russell 1000 Value indexes at the same time?). Yet, these labels have implications for mutual fund flows and look no further than Morningstar's report for May 2018 that saw $6.5 billion in inflows into the "growth" category, the category's largest inflow in a decade. Meanwhile value-oriented funds such as mid cap value saw outflows of $2.5 billion.

Regardless of the labels assigned to these stocks, we recognize that sometimes it is possible to pay too much for good companies and that many "cheap" assets in the stock market are inexpensive because they destroy value. That is why we engage in the same process set forth in the Group's 2000 commentary where we stated that "we seek growing companies at the best available prices, intuitively knowing we get what we pay for."

How do we decide which stocks to prioritize in terms of new purchases? One characteristic we pursue with vigor are "quality" companies. "Quality" can transcend beyond a company's financial statements and "growth" stocks often can appear to have superior fundamentals. But a straightforward assessment of return on equity as a measure of "quality" can provide a basis for comparison. As noted on the chart on the second page, "growth" stocks typically have reported higher returns on equity than value stocks, but increasingly the question is how much of a premium to pay for "higher quality?" With "growth" stock valuations widening to "near extreme" levels per Cornerstone Macro relative to value we are seeking to take advantage of improving fundamentals in selecting "value" stocks.

Russell 1000 Growth ROE (blue) vs. Russell 1000 Value ROE (orange) Indexed to 1994

Source: Bloomberg

As seen above, while "growth" stocks have higher returns on equity, those returns have been flat since 2010. "Value" stocks on the other hand have seen their returns improve since 2015. Just as "growth" stocks had a great relative performance move from 1994-1999, the start of that move came when "growth" names had the best relative profitability at the lowest relative price-to-earnings ratio in history. Currently, "value" stocks trade at one of the lowest relative valuations with improving relative profitability.

Perhaps that is why in the Equity Income, Special Opportunities, SMID Opportunities, Insight and Global Leaders portfolios, new money in the first half of the year was placed in stocks where the average price-to-earnings ratio was below the S&P 500, the average growth rate last year was twice that of the S&P 500 and, consistent with improving fundamentals, the average return on equity for these purchases increased 40% since 2015.

As always, thank you for your interest and trust managing your investments.

Chip Wittmann, CFA®
Executive Director
(757) 417-4901
cwittmann@sterling-capital.com

*The **Chartered Financial Analyst® (CFA)** charter is a graduate-level investment credential awarded by CFA Institute — the largest global association of investment professionals. To earn the CFA charter, candidates must: 1) pass three sequential, six-hour examinations; 2) have at least four years of qualified professional investment experience; 3) join CFA Institute as members; and 4) commit to abide by, and annually reaffirm, their adherence to the CFA Institute Code of Ethics and Standards of Professional Conduct.*