Mind the Valuation Gap

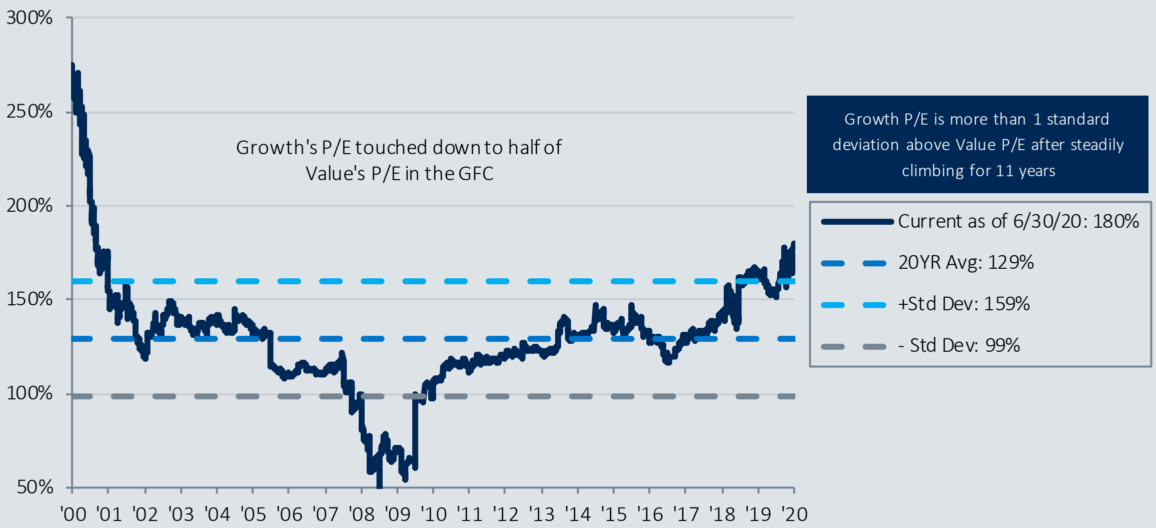
A look at current P/E ratios of growth and value stocks compared to historical averages.

Throughout history, growth and value investment styles have cycled in and out of favor. That ebb and flow has been driven by economic activity, company growth rates, the market outlook and a series of other factors. Investors should pay attention to the valuation gap between growth and value styles and look for attractive opportunities to strengthen portfolios.

Growth Spurt

Growth stock valuations, which were about half of their value counterparts during the 2008 financial crisis, have steadily climbed for the past 11 years. Today, growth trades at a premium not seen since the tech bubble.

Growth premium



Growth premium is defined as the S&P 500 Growth P/E as a percentage of the S&P 500 Value P/E.
Source: Bloomberg

The valuation gap between growth and value has widened considerably. The S&P 500 Growth Index is trading at an 80% premium to the S&P 500 Value Index compared to an average premium of 29% over the past 20 years. This growth premium is even more pronounced in the Russell 1000 and Russell Mid Cap Indexes. When looking at trailing P/E ratios, the Russell 1000 Growth Index is trading at an 110% premium to the Russell 1000 Value Index and has averaged a 38% premium over the past 20 years. The Russell Mid Cap Growth Index is trading at a 210% premium to the Russell Mid Cap Value and has averaged 70% over the past 20 years.

A Small Discount

Value stocks are trading at a discount to their growth counterparts, with small-cap value offering the largest discount.

Current P/E as a percentage of the 20-year average P/E for Russell indexes

	Value	Blend	Growth
Large	113%	129%	156%
Mid	102%	122%	166%
Small	66%	199%	n/a

**Trailing P/Es*

* Trailing earnings for the Russell 2000 Growth Index turned negative on 6/29/20. The P/E figure is not available due to negative earnings.
Source: Bloomberg

Small-cap value stocks are trading at the highest discount. Right now, value indexes are trading at significant discounts to their blend and growth counterparts when comparing current index P/E ratios to their 20-year average trailing P/E ratios as of June 30, 2020. According to this metric, small-cap value stocks are offering the largest discount, followed by mid-cap value and large-cap value. Small-cap growth stocks are the most overpriced.

Mind the gap and look for opportunities to rebalance. When style valuations approach bubble territory, active managers rebalance their portfolios to take advantage of attractive prices in beaten-up stocks and mitigate the downside risk of mean reversion in styles that are in favor. Similarly, investors can evaluate their asset allocation mix to uncover areas that might be too richly valued and worth rebalancing.

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