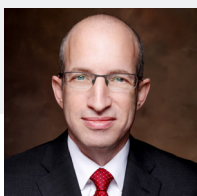




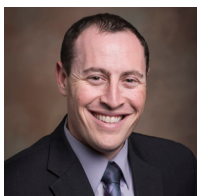
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U.S. Equities **TACTICAL ASSET ALLOCATION: THINKING ABOUT GROWTH VERSUS VALUE**

EXECUTIVE SUMMARY

- Growth and value cycles tend to persist for long periods of time, and the growth style of equity investing has outperformed the value style since the 2008 global financial crisis—its longest outperformance streak on record.
- Relative valuations, sector composition, and macroeconomic factors such as interest rates, inflation, and growth historically have been the primary drivers of relative performance for the two styles.
- Recent market developments such as valuation convergence, higher short-term interest rates in the U.S., and deregulation of the financials sector could cause an inflection point in the growth/value cycle.
- Investors potentially can prepare for this outcome by holding portfolios that not only strike a balance between value and growth but are also actively managed to adapt to new regimes.

In theory, the value style of equity investing should outperform the growth style over the long term because the former approach favors stocks selling at prices that potentially are below their intrinsic values. Given a sufficiently long investment horizon, prices eventually should converge to fair value.

A behavioral explanation for the historical value premium is that investors tend to over-extrapolate past returns into the future. Investors tend to be too negative about stocks that have performed badly in the past and too positive about stocks that have performed strongly. Value, therefore, potentially works because investors tend to be too pessimistic about cheap stocks and too optimistic about expensive stocks.

This is the theory. In practice, however, value has underperformed growth since 2007, the longest growth cycle on record. Have the tides shifted? Is it the end of a 100-year-long value cycle? To answer these questions, we need to understand the factors driving the relative performance of growth and value.

WHEN VALUE BECAME MORE EXPENSIVE THAN GROWTH

Like other equity assets, value and growth stocks historically have gone through valuation cycles. Figure 1, shows that growth stocks typically have had higher price/earnings (P/E) ratios than value stocks, which is not surprising given that one definition of a value stock is a relatively low P/E. However, in 2008 the P/E of the Russell 1000 Value Index surpassed that of the Russell 1000 Growth Index.

In our view, investors should prepare for a potential shift in relative style performance by ensuring their portfolios are appropriately balanced between value and growth.

The switch in relative valuations may have been one of the catalysts that launched the current growth cycle. However, in 2010 the Russell 1000 Value Index P/E fell back below the Russell 1000 Growth Index P/E. So, while valuation might have helped trigger a growth cycle, it doesn't seem to explain its persistence.

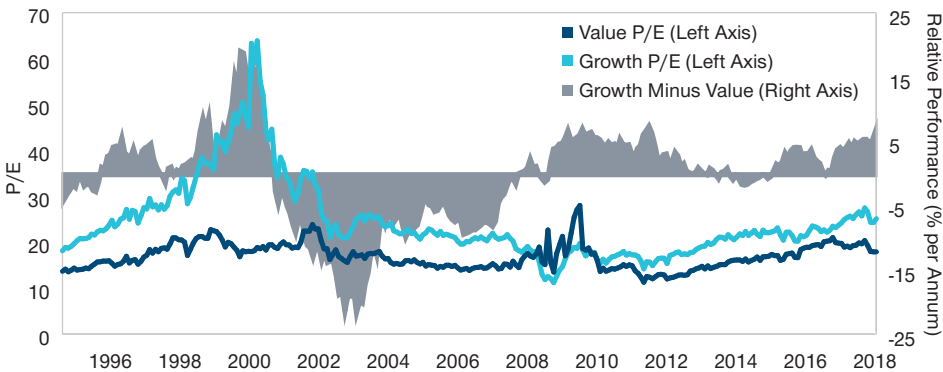
SECTORS: TECHNOLOGY AND FINANCIALS

From 2008 through early 2018, a select group of large-cap companies with dominant technology platforms not only succeeded but exceeded expectations. These companies are sometimes referred to as the FAANG stocks—Facebook, Apple, Amazon, Netflix, and Google. Over the same time period, the financials sector broadly performed in line with the general stock market. Low interest rates and a flat yield curve, coupled with tighter regulation and intense competition, dented the profitability of banks and financial services firms in general.

These sector trends appear to have played an important role in relative style performance. Looking at the sector composition of value and growth, the Russell 1000 Value Index is overweight in financials while

FIGURE 1: Growth and Value P/Es and Relative Style Performance

Russell 1000 Growth Minus Russell 1000 Value
Rolling 36-Month Annualized Returns Through 31 May 2018



Past performance is not a reliable indicator of future performance.

Sources: FTSE Russell/Bloomberg Index Services, Inc.; all data analysis by T. Rowe Price. Bloomberg Index Services Ltd. Copyright © 2018, Bloomberg Index Services Ltd. Used with permission.

FIGURE 2: Sector Composition of Russell Style Indexes

As of 31 Mar 2018

Sector	Russell 1000 Value	Russell 1000 Growth	Difference	Russell 2000 Value	Russell 2000 Growth	Difference
Financial Services	31.9%	11.2%	20.7%	41.4%	10.4%	31.0%
Health Care	13.6	12.3	1.3	6.6	25.0	-18.4
Energy	10.8	0.8	10.0	6.3	1.1	5.2
Technology	8.7	32.1	-23.4	7.5	20.6	-13.1
Utilities	8.7	0.9	7.8	6.6	1.8	4.8
Consumer Discretionary	8.3	19.7	-11.4	11.7	15.3	-3.6
Producer Durables	7.8	13.6	-5.8	12.1	15.6	-3.5
Consumer Staples	7.0	5.5	1.5	1.8	2.2	-0.4
Materials & Processing	3.2	3.9	-0.7	6.0	8.0	-2.0

Source: FTSE Russell.

technology has a heavy weight in the Russell 1000 Growth Index (Figure 2).

As Figure 3 shows, relative sector performance—as measured by returns

for the S&P technology sector minus returns for the S&P financials sector—has broadly tracked the relative performance of the Russell 1000 Growth Index versus the Russell 1000 Value Index. In other

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words, the outperformance of tech and the market-average performance of financials since 2008 appear to explain much of the current growth cycle.

INTEREST RATES, INFLATION, AND ECONOMIC GROWTH

Value stocks typically have higher dividend yields than growth stocks because distributing cash to shareholders is often a more efficient use of capital for low-growth companies. As a result, the expected cash flows of growth stocks typically are further in the future compared with value stocks. In other words, growth stocks generally can be expected to have longer duration than value stocks. This means growth stocks are normally more sensitive to changes in interest rates than value stocks.

Since 2008, due to the relatively slow pace of economic growth, the prolonged economic recovery, and quantitative easing by the Federal Reserve, growth stocks in general have benefited from low inflation and low interest rates. These factors also may have contributed to the length of the current growth cycle.

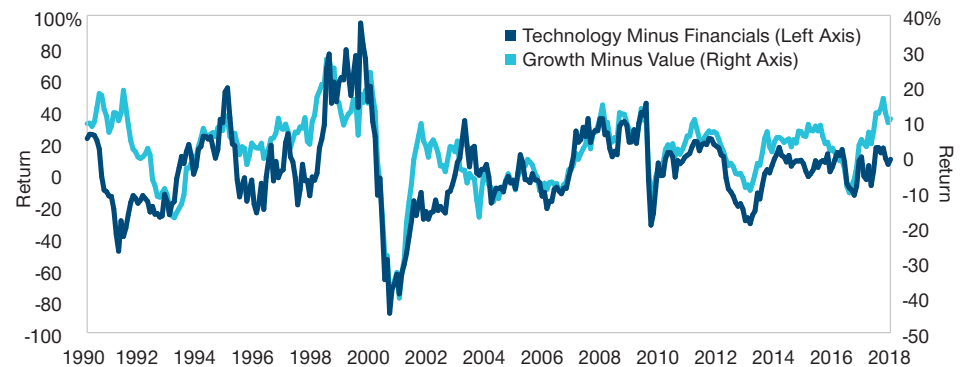
CONCLUSION

Starting with the global financial crisis in 2008, a unique combination of low rates, strong technology performance, the slow pace of economic growth, and valuations that initially favored growth stocks created a perfect storm of conditions supporting the growth style (Figure 4).

The big question now is whether these conditions will continue to hold. Rates in the U.S. have been moving higher; tech potentially might lose momentum due to relatively rich valuations and additional regulation; financials could

FIGURE 3: Performance of Technology Less Financials, and Growth Less Value

S&P Technology Sector Minus S&P Financials Sector; Russell 1000 Growth Minus Russell 1000 Value
Rolling 12-Month Returns Through 31 May 2018

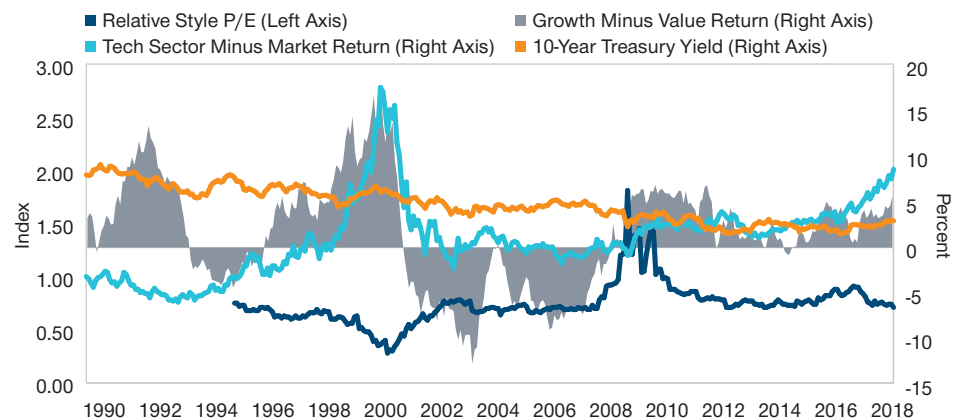


Past performance is not a reliable indicator of future performance.

Sources: S&P and FTSE Russell/Bloomberg Index Services, Inc.; all data analysis by T. Rowe Price.

FIGURE 4: Treasury Yields, Style P/Es, Relative Technology Returns, and Relative Style Returns*

Rolling 36-Month Returns Through 31 May 2018



Past performance is not a reliable indicator of future performance.

Sources: S&P and FTSE Russell/Bloomberg Index Services, Inc.; all data analysis by T. Rowe Price.

*Treasury yield = constant-maturity 10-year Treasury yield; style P/Es = Russell 1000 Growth and Russell 1000 Value Indexes; relative technology returns = S&P technology sector minus S&P 500 Index.

fare better due to rising yields and deregulation; and valuations no longer favor growth. Any of these factors could produce a comeback for value.

In our view, investors should prepare for a potential shift in relative style

performance by ensuring their portfolios are appropriately balanced between value and growth. Actively managed strategies, based on in-depth fundamental research, potentially can adjust to market inflections far better than momentum-driven strategies.

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