

Key Definition

Sharpe Ratio

Named after its creator Prof. William F. Sharpe, the Sharpe Ratio measures risk-adjusted returns and is defined as the return of a portfolio in excess of the risk-free rate divided by the portfolio's volatility. A higher Sharpe Ratio is preferable, in that it is indicative of a higher risk-adjusted return.

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Is There a Value Premium in the U.S. Equity Market?

By Adam J. Smith, CFA, CAIA

In order to outperform the broad U.S. equity market, most institutional investors focus primarily on hiring active managers to outperform a narrow part of the market, such as large-cap growth or small-cap value, while maintaining an equal allocation between growth stocks and value stocks. In addition to active management, however, institutions should also consider taking advantage of a structural bias that exists in the U.S. equity market: the outperformance of value stocks relative to growth stocks over longer periods (the value premium).

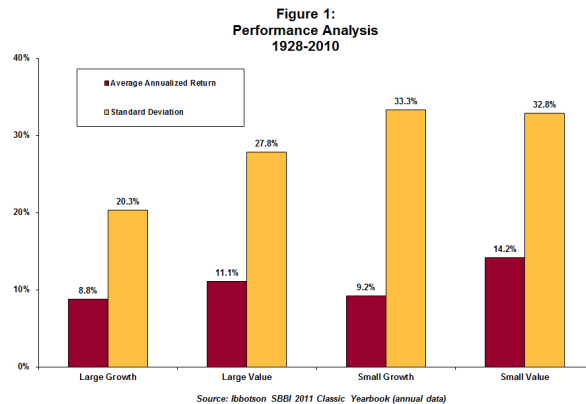
The evidence of a value premium can be found by analyzing the returns of various style indexes. For example, Ibbotson Associates publishes the Fama-French data series of annual returns for U.S. stocks going back to 1928 based on the following four size/style segments: large-cap growth, large-cap value, small-cap growth and small-cap value. Based on this data series through 2010, value stocks outperformed growth stocks by 2.3

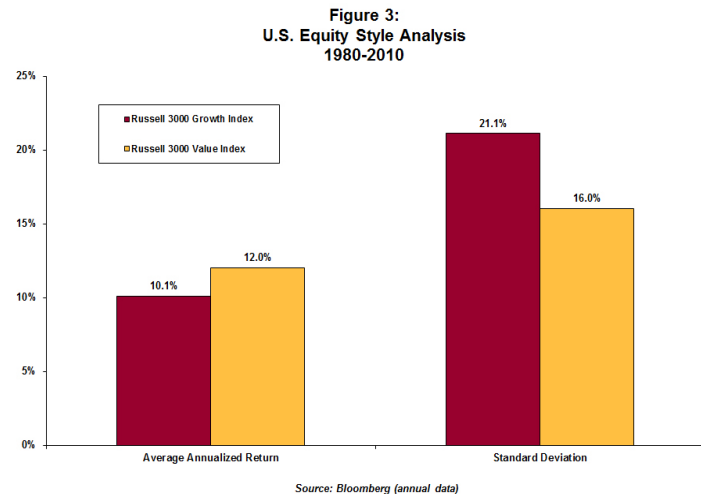
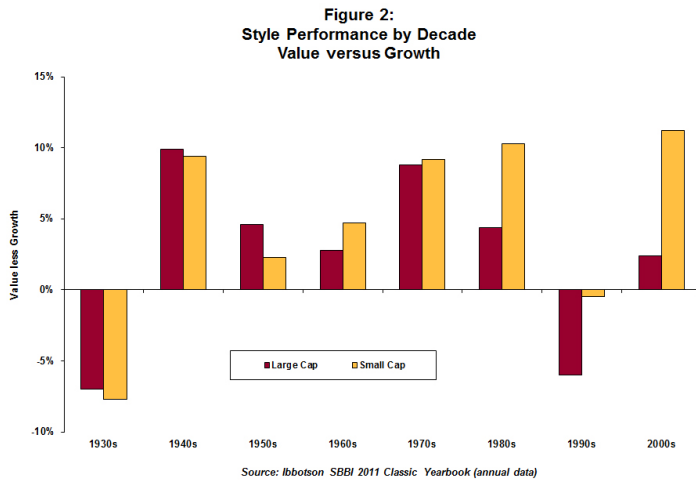
percentage points per year in the large-cap segment and 5.0 percentage points per year within the small-cap segment of the market. (See Figure 1.) Therefore, the Ibbotson data provide evidence of a value premium in the U.S. equity market over the long term.

In addition to generating higher returns, institutions should also be concerned about the level of volatility that comes with doing so. Given the positive relationship between return and risk, higher returns are typically associated with higher risk; however,

the Ibbotson data show that this is not necessarily the case with regards to style-specific returns. While this premise did hold for large-cap stocks, it did not prove to be true for small-cap stocks. (See Figure 1.) For example, for the period 1928-2010, small-cap-value stocks realized slightly less volatility than small-cap-growth stocks (32.8% to 33.3%), despite outperformance of 5 percentage points per year.

Another way to analyze the returns
(Continued on back)





of each size/style segment with respect to its volatility is by using the Sharpe Ratio, which measures risk-adjusted returns by taking the return in excess of the risk-free rate and dividing it by the volatility of returns. As a result, a higher Sharpe Ratio is preferable, in that it is indicative of a higher risk-adjusted return. Over the period 1928-2010, the Sharpe Ratio was higher for both large cap value stocks (0.27 to 0.25) as well as small-cap-value stocks (0.32 to 0.17), each relative to their growth counterparts. Therefore, not only have value stocks historically generated higher returns than growth stocks, but they have also generated higher risk-adjusted returns.

Although this analysis demonstrates the outperformance of value stocks relative to growth stocks over a long period, institutions must also consider the consistency of such outperformance. For example, building a portfolio to take advantage of this structural bias would prove less effective if the bias was not persistent. An analysis of returns by decade, however, shows that the value premium has persisted over time. Over the eight decades from the 1930s to the 2000s, including 2010, value outperformed growth during six of the decades in each of the large cap and small cap segments of the market. (See Figure 2.) The two decades where growth outperformed value were in the 1930s and the 1990s. Coincidentally, these two decades included a significant stock market decline that occurred during an economic depression (1930s) and a stock market bubble driven largely by the technology sector (1990s). During the other decades, however, value consistently outperformed growth, with the value premium reaching more than 5 percentage points per year during some decades. Therefore, the value premium is a structural bias that has persisted in the U.S. equity market over a long period of time.

While the Ibbotson data cover virtually the entire U.S. equity market, there are no investable indexes currently available that track the market in this way. As a result, it is instructive to conduct a similar analysis using currently available indexes in which institutions can invest to verify the existence of a value premium. Two appropriate indexes for such an analysis are the Russell 3000 Growth Index and the Russell 3000 Value Index, both of which are investable and include stocks regardless of market capitalization (small-, mid- and large-cap stocks). Using annual returns for the period 1980-2010, which cover the entire history of each index, the Russell 3000 Value Index outperformed the Russell 3000 Growth Index by 1.9 percentage points per year. (See Figure 3.) In addition, value stocks had less volatility than growth (16.0% to 21.1%), which resulted in a higher Sharpe Ratio (0.42 to 0.23). Therefore, the value premium also exists in widely used indexes in which institutions can invest.

Based on this evidence, institutions should consider structuring their portfolio to take advantage of this value premium; however, they should not completely exclude growth stocks from their portfolio. Rather, institutions should consider favoring value stocks within their U.S.-equity allocation by building an overweight exposure relative to growth. This overweight allocation to value stocks can be achieved in one of two ways: either by increasing the allocation to a manager with a value philosophy (active) or increasing the allocation to an index fund that is comprised of value stocks (passive). Either strategy, however, should ultimately result in the same outcome: increased performance relative to the broad U.S. equity market over longer periods.