Research Newsletter #6
Dated: August 15, 2002

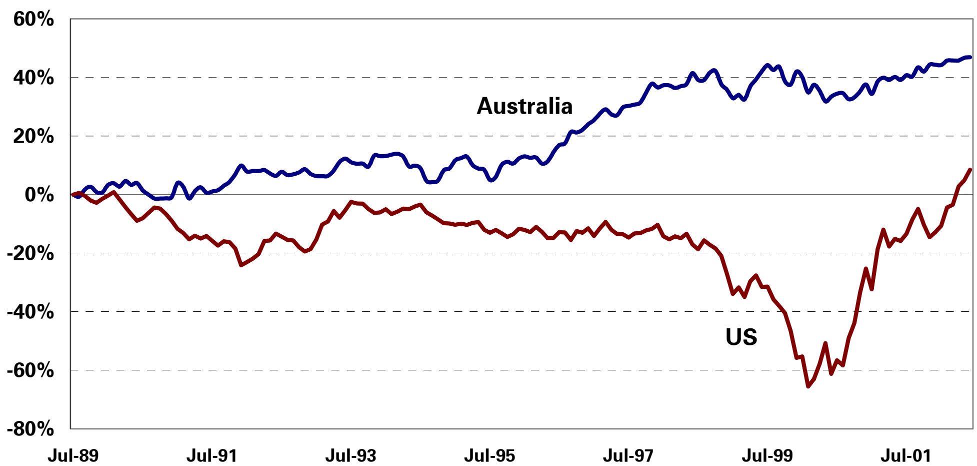
Value & Growth – Are There Problems? (Part 1)

Following US practice, there has been a move in Australia to configure domestic equity managers on the basis of value and growth investment styles. However the Australian situation is different from the US, and the style segmentation of Australian equities can create problems for Australian investors. In coming to this view we focus on three issues:

(1) Differences in the Performance of Value and Growth

The chart below looks at the cumulative difference between value and growth returns, based on Salomon Smith Barney style indices, for both Australia and the US. A positive reading on the chart says that value has outperformed growth on a cumulative basis. A positive slope says that value is beating growth at that point.

Value - Growth Cumulative Index Returns



Source: Salamon Smith Barney, WestAM

- In the US, neither style appears to dominate while in Australia value has outperformed growth by 3.6%p.a. Style divergence in the US is also much more dramatic.
- Australia lacks many of the growth industries that have such a big impact on the US economy and this difference in industry composition appears to explain the different behaviour of value/growth in the two countries.
- The different behaviour of value/growth in Australia suggests that adopting the US practice of using a growth manager to balance the style effect of a value manager could lead to underperformance.

WestAM (Australia)
ABN 42 094 191 689
Level 32, 60 Margaret Street
Sydney N.S.W. 2000
Telephone 61-2-9777 8088
Facsimile 61-2-9777 8080

(2) The Narrowness of the Australian Market

The US market is very much larger than the Australian market, and lends itself to segmentation. This is not the case in Australia.

The US market is large and efficient and it is difficult for a US manager to be competitive by addressing the broad market as the required research effort is overwhelming. In response, managers in the US focus on segments of the market where they have a perceived competitive advantage and the research task is manageable. The scarcity of active managers in the US who address the broad market is driven predominantly by the difficulty that such managers have in adding value.
In Australia the investment universe numbers in the hundreds, compared to the thousands for the US. So, unlike in the US, it is feasible for Australian managers to address the whole market. In the US, a manager can specialise by style and still address a large universe of stocks. In Australia, when the investment universe is segmented by style, the situation becomes very limiting.

The table below highlights some important differences between the US and Australian sharemarkets.

	US	Australia
Market Capitalisation (30/6/02)	US$10,100b	US$394b
Annual Market Turnover	101%	68%
Broad cap index coverage*	1500	200
Definitive Value Stocks	956	56
Definitive Growth Stocks	931	55

Sources: ASX, NYSE, S&P, Salomon Smith Barney
**S&P/ASX200 in Australia covers 90% of market capitalisation, S&P Super Composite 1500 in the US, covers approximately 87% of market capitalisation*

Broker Salomon Smith Barney applies a sophisticated stock classification system to the world's equity markets to identify typical value and growth stocks. In contrast to the US market where they find over 900 clearly identifiable securities for each style basket, the unambiguous stocks number just over 50 for each classification in the Australian market. Only around half of those securities are constituents of the large cap S&P/ASX 100 index. This means that large cap style managers face a very small investment universe in which to exploit stock selection.

The annual liquidity of the Australian market is much lower at 68% compared to 101% for the US. This means that large Australian managers need to be wary of concentrating portfolios as positions become harder to manage. The logical response to maintain portfolio flexibility is diversification of active stock positions, but this is problematic where style restricts the investment universe. Hence in the Australian market it is difficult for managers to grow, remain true to style, and add value relative to that style.

Wide swings in performance and confusion about style can make it awkward to manage a style based manager configuration.

(3) Holding Managers to Account

High performance volatility, small peer groups and a lack of appropriate style indexes make it difficult to assess the performance of style-based managers. We will discuss this point in more detail in our next Research Newsletter.