"Style Bubbles": Observations in the Current Market

April 2007

Albert Einstein used "thought experiments" to develop his ideas on various topics in physics. Interestingly, the same technique can also be used to consider what might be happening in the financial markets today. For example, imagine an individual who is encased within a large, roomy, crystal clear and pliable sphere, in other words, a bubble. Should that bubble begin to expand uniformly, the observer inside may have a difficult time recognizing the growth of the bubble. However, given a different point of view, an outside observer may easily notice the growth of the bubble sphere. Anyone who has ever blown up balloons at a birthday party can attest to sensing that, at some given point, a balloon will burst with any additional air.

So what does all this have to do with the equity markets? It is possible that one can argue that we are presently in a "bubble" period with respect to equity styles. Some investors may find themselves "inside" the bubble, and thus do not have the perspective to realize that an asset bubble is expanding around them.

Recall what is meant by equity styles. Typically equities can be categorized by breaking them down using capitalization size (large, small, and mid for example) and by book value (high book to price would imply a value stock, and low book to price a growth stock). A simple grid can be constructed to visualize the concept as shown below:

Large Value	**Large Growth**
Mid Value	**Mid Growth**
Small Value	**Small Growth**

= **Total Domestic Equity Portfolio**

Yet, how much to allocate to each style can be challenging as various styles will tend to fall into and out of favor in a random manner over time. In other words, investors may find that a given style is outperforming another at any particular point in the normal market cycle. Clearly, an investment manager who is instructed to remain within a given "style box" may find that achieving performance is difficult if the designated style is out of favor in the market. Conversely, a manager who is managing assets in a style that is currently in favor may find that the performance is comparatively easy to come by.

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However, such a situation flows to the heart of the bubble argument. The reason is that such relative outperformance may skew an allocation to a certain style as the one style outperforms over time. Should an "asset bubble" develop, an investor may be assuming a style risk that they may not have anticipated.

What does this have to do with the present market environment? Interestingly, the perspective of history may provide investors with the "outside observer" needed to help determine if the market is exhibiting any unusual characteristics. For example, consider the past relative performance of the S&P/Barra Growth and Value Indices. Since they were created in 1975, the performance of each can be seen here:

Relative Performance of the S&P/Barra Growth and Value Indices

Year	S&P 500/Barra Growth	S&P 500/Barra Value	Favored Style
2006*	11.01%	20.80%	Value
2005	3.46%	6.33%	Value
2004	6.13%	15.71%	Value
2003	25.66%	31.79%	Value
2002	-23.59%	-20.85%	Value
2001	-12.73%	-11.71%	Value
2000	-22.08%	6.08%	Value
1999	28.25%	12.73%	Growth
1998	42.16%	14.67%	Growth
1997	36.53%	29.98%	Growth
1996	23.97%	21.99%	Growth
1995	38.12%	36.99%	Growth
1994	3.13%	-0.64%	Growth
1993	1.68%	18.60%	Value
1992	5.07%	10.53%	Value
1991	38.37%	22.56%	Growth
1990	0.20%	-6.85%	Growth
1989	36.40%	26.13%	Growth
1988	11.95%	21.67%	Value
1987	6.50%	3.68%	Growth
1986	14.50%	21.67%	Value
1985	33.31%	29.68%	Growth
1984	2.33%	10.52%	Value
1983	16.24%	28.89%	Value
1982	22.03%	21.04%	Growth
1981	-9.81%	0.02%	Value
1980	39.40%	23.59%	Growth
1979	15.72%	21.16%	Value
1978	6.78%	6.16%	Growth
1977	-11.82%	-2.57%	Value
1976	13.84%	34.93%	Value
1975	31.72%	43.38%	Value

Growth now overdue?

Value was overdue

* YTD returns through 12/31/06 using S&P 500/Citigroup

Taken from sources believed to be reliable. Past performance is no assurance of future results.

For the nineteen years from 1975 through 1993, neither the large growth nor the large value style had more than three consecutive years of relative outperformance. Interestingly, now it is rather easy to see the emergence of the growth bubble of the late 1990s, and the subsequent rise of the value bias in the present market cycle. If the current performance trend between the large growth and large value continues in 2006, it would represent an unprecedented seventh consecutive year of value dominance.

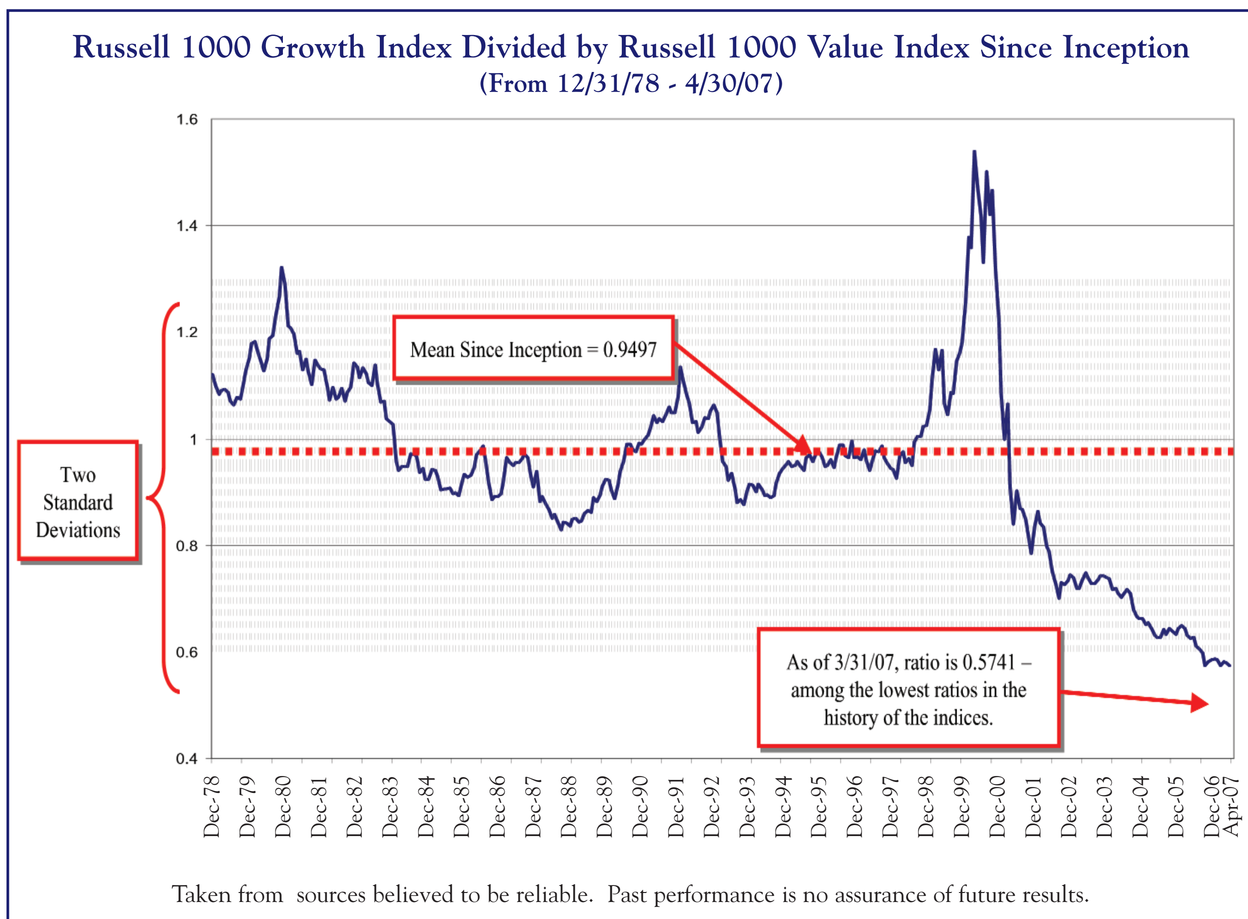
To gain yet another perspective of where we are in the present market cycle, consider the creation of a simple

ratio using the prices of the Russell 1000 Growth and Russell 1000 Value indices, including dividends. By dividing the aforementioned growth index by its value cousin, it is possible to plot the result to see which style might be more prominent.

$$\frac{\text{Russell 1000 Growth (numerator)}}{\text{Russell 1000 Value (denominator)}}$$

If the two numbers are equal, then the ratio result will be 1. Recall from simple arithmetic that as the numerator gets larger (in this case the numerator is the large growth style) relative to the value denominator, the plotted result will begin to get larger. Obviously the opposite is also true, as the denominator (large value) increases relative to the large growth numerator, the result will get smaller.

So, over the entire history of the two indexes, what does the plot reveal?



It is pretty easy to pick out the aforementioned growth bubble of the late 1990s as evidenced by the sharp upward spike; but note the current value trend falling below the red dotted average line. The duration and depth of the value bias is unique and considerable.

Thus, it can be argued that we may be in an unusual point in time with respect to the large growth and value styles. A historical snapshot provides an interesting perspective that perhaps a bubble presently exists with

respect to bias toward the large value style. It is possible that when the bias moves back toward the growth style, investors who are significantly overweighted in the large value sector could find themselves exposed to an unanticipated risk, namely, style risk.

While it is difficult, if not impossible, to predict when such anomalous trends may change course, investors would be well served to be cognizant of the current environment. Although an observer inside the bubble may be unaware of its expansion, the outside observer can more easily recognize and adapt to such anomalies.

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