Style Investing

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Defining Growth and Value

¬ Each month we monitor approximately forty different stock selection strategies.
¬ Two of the forty strategies are “pure” growth and “pure” value portfolios.
¬ The “pure” growth portfolio is the fifty stocks in the S&P 500 with the highest five-year projected EPS growth rates.
¬ The “pure” value portfolio is the fifty stocks in the S&P 500 with the highest earnings yield.
¬ The term “pure” is used because the portfolios are those stocks in the S&P 500 that are made up of the companies that show the most extreme values of the particular characteristic.
“Pure” Growth and Value Portfolios

When Growth outperforms, Value tends to underperform and vice versa.

Source: Merrill Lynch Quantitative Strategy
Relative Performance of S&P/Barra Growth and Value Indices

Source: Merrill Lynch Quantitative Strategy
Relative Performance of MLQS Growth and Value Indices

Relative Performance of the Growth Mutual Fund Index versus the Value Mutual Fund Index

Source: Merrill Lynch Quantitative Strategy
Growth Managers

→ Growth managers are typically defined as high expectations managers who prefer to search for investments among stocks that have a proven superior track record of earnings growth.

→ Growth stock investors usually pay a high premium to hold such stocks because the market realizes the superior qualities of the company.

→ The assumption behind growth stock investing is that the market will continue to reward the superior grower.
Value Managers

→ Value managers are typically defined as low-expectations managers because they tend to search for investments among stocks that are out of favor.

→ The assumption behind value investing is that the consensus views a company overly pessimistically, and that the stock’s valuation will improve once the consensus realizes its mistake.

→ Value managers, therefore, usually search for stocks that sell below the worth of a company’s assets or below the value of its future growth prospects.
Good and Bad Managers

Growth: CONTRARIAN SELLERS

Value: CONTRARIAN BUYERS
Defining Quality

→ We use the S&P Common Stock Rankings to define quality.
→ S&P ranks approximately 1500 companies based on their stability in earnings and dividends growth over the last ten years.
→ A company with extremely stable earnings and dividends growth would be rated an A+ whereas a company in bankruptcy or reorganization would be rated a D.
→ The rankings are A+, A, A-, B+, B, B- and C/D.
Relative Performance by Quality

Relative Performance MLQS "A+" vs. "C&D"

Indices are based on S&P Common Stock Ratings.

Similar to Growth and Value, High vs. Low Quality goes through cycles of out- and under-performance.

Source: Merrill Lynch Quantitative Strategy
Relative Performance by Size

Relative Performance of S&P 500 and Russell 2000

Source: Merrill Lynch Quantitative Strategy
The Importance of Profits

The scarcity or abundance of earnings growth drives style rotation.
# The Tech Bubble Distorts Growth versus Value Investing

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
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<tbody>
<tr>
<td>&quot;Pure&quot; Growth</td>
<td>-22.4%</td>
<td>-33.2%</td>
</tr>
<tr>
<td>&quot;Pure&quot; Value</td>
<td>20.7%</td>
<td>24.5%</td>
</tr>
<tr>
<td>MLQS Growth</td>
<td>-12.7%</td>
<td>-15.8%</td>
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<tr>
<td>MLQS Value</td>
<td>-4.2%</td>
<td>-1.7%</td>
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<tr>
<td>A+ Index</td>
<td>22.4%</td>
<td>2.4%</td>
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<tr>
<td>C/D Index</td>
<td>0.1%</td>
<td>3.8%</td>
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High Quality Value?

Proportion of High Quality Stocks in S&P/Barra Growth & Value Indices

S&P/Barra Growth
- Composition as of 6/30/00: 50%
- Composition as of 12/31/01: 60%

S&P/Barra Value
- Composition as of 6/30/00: -58%
- Composition as of 12/31/01: 54%

Source: Merrill Lynch Quantitative Strategy
Sector Concentration of S&P/Barra Growth Index

S&P Barra Growth Index By Sector
(December 2001)

Technology: 23%
Healthcare: 21%
Consumer Discretionary: 18%
Consumer Staples: 15%
Industrials: 12%
Financials: 7%
Other: 4%
Change in Composition of SGX

Change in Composition of S&P/Barra Growth Index

Composition as of 6/30/00
Composition as of 12/31/01

Technology Healthcare Consumer Staples Consumer Discretionary Industrials Financials Other
Sector Concentration of S&P/Barra Value Index

S&P/Barra Value Index By Sector

- Discretionary: 18%
- Financials: 16%
- Industrials: 14%
- Technology: 13%
- Materials: 11%
- Utilities: 11%
- Energy: 7%
- Healthcare: 4%
- Telecom: 3%
- Staples: 3%
- Financials: 16%
- Industrials: 14%
- Technology: 13%
Proportion of Sector in S&P/Barra Growth Index

(Data as of 12/31/01)

- Staples: 64.7%
- Healthcare: 66.7%
- Technology: 43.6%
- Industrials: 25.0%
- Discretionary: 29.5%
- Telecom: 15.4%
- Financials: 13.9%
- Energy: 13.9%
- Materials: 7.5%
- Utilities: 0.3%
- Healthcare: 0.3%
## Style Allocation Benchmarks (2/28/02)

<table>
<thead>
<tr>
<th></th>
<th>USPC Equity Allocation</th>
<th>Large Cap Growth</th>
<th>Large Cap Value</th>
<th>Small Cap Growth</th>
<th>Small Cap Value</th>
<th>International</th>
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<tbody>
<tr>
<td>Capital Preservation</td>
<td>15%</td>
<td>5%</td>
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<tr>
<td>Current Income</td>
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<td>5%</td>
<td>25%</td>
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<tr>
<td>Income &amp; Growth</td>
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<td>15%</td>
<td>20%</td>
<td>5%</td>
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<tr>
<td>Long-Term Growth</td>
<td>65%</td>
<td>15%</td>
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<tr>
<td>Aggressive Growth</td>
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<td>10%</td>
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<tr>
<td>U.S. Strategy Asset Allocation</td>
<td>50%</td>
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<td>15%</td>
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<td>10%</td>
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