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Of Good Risk and Bad Risk

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WHAT portion of the stock mutual funds in your 401(k) plan should be invested in so-called value funds, as opposed to those that hold growth stocks?

For years, the nearly unanimous recommendation from academia was to invest all of the equity allocation in value funds and nothing in growth funds. But the best approach, according to a powerful strand of recent research, is to divide a long-term portfolio just about equally between the two types.

Growth and value refer generally to whether a stock is in or out of favor. Value stocks are those that, for whatever reason, are being overlooked or even shunned by investors, and for this reason have relatively low ratios of price to earnings or price to book value. By contrast, growth stocks tend to be current Wall Street darlings. Their popularity leads them to trade at relatively high valuation ratios.

It is widely known that value has outperformed growth over the very long term. In fact, according to Ibbotson Associates, the race isn't even close: over the nearly four decades from the start of 1969 through the end of last year, value stocks outperformed growth stocks by an average of 2.5 percentage points a year. Even better, according to Ibbotson, the typical value stock over those 38 years was 15 percent less risky than the typical growth stock.

Given the impressive case for value investing, it seems hard to argue that long-term investors should still make heavy allocations to growth funds. But there is a strong argument to be made for growth funds, and its theoretical basis traces to a study that appeared in the December 2004 issue of *The American Economic Review*, entitled "Bad Beta, Good Beta." Its authors were John Y. Campbell, an economics professor at Harvard, and Tuomo Vuolteenaho, who at the time was also an economics professor at Harvard but is now a partner at Arrowstreet Capital, a money management firm based in Boston. Professor Campbell is also a partner at the firm.

The key to their argument is the need to differentiate between two types of risk. While a short-term investor is equally worried about each type, a longer-term investor is primarily interested in just one of them. The researchers found that, though growth stocks have more total risk than value stocks, they have less of the kind that is of most concern to long-term investors.

The first of the two kinds of risk is discount rate risk -- which in some ways can be viewed as the risk that interest rates will rise. Growth stocks are particularly vulnerable to it, because their current valuations depend so much on the discounted value of their future earnings. The second kind of risk is that of economic trouble, or even catastrophe -- what the researchers call cash-flow risk. They found that value stocks are more vulnerable than growth stocks to this type of risk.

The researchers argue that most investors with very long time horizons -- a decade or more -- will be less interested in discount rate risk because it tends to be largely self-correcting. A growth stock whose price comes down because of higher interest rates will recover most of that loss when those rates decline again. By contrast, the researchers found that cash-flow risks tend to be much more enduring. Needless to say, a company that goes out of business will never recover.

PROFESSOR CAMPBELL and Mr. Vuolteenaho offer this analogy: Risk is like cholesterol in that both have a "bad" variety and a "good" variety. Doctors are not particularly alarmed by a high total cholesterol level, if the bulk of it is the good variety. Similarly, the researchers argue, long-term investors shouldn't be concerned about growth stocks' apparently high levels of risk, because the bulk of it is the "good" variety, the discount rate kind.

The analogy isn't perfect, of course. For the short-term investor, both kinds of risk are equally bad. That's because stocks over short periods don't have a chance to recover from any losses generated by higher interest rates. It's only over longer periods that the investor becomes more concerned with cash-flow risk than discount-rate risk.

What does all of this mean for the choice of stock mutual funds in a retirement portfolio? An answer is provided by a study that has circulated for several months as an academic working paper. Titled "Optimal Value and Growth Tilts in Long-Horizon Portfolios," it is by Luis M. Viceira, a finance professor at Harvard Business School, and **Jakub W. Jurek**, a Ph.D. candidate there. A version is at <http://papers.ssrn.com/sol3/papers.cfm?abstract-id=796207>.

Building on the research by Professor Campbell and Mr. Vuolteenaho, and assuming that the future will be like the past, Professor Viceira and Mr. Jurek calculated which allocations to growth and value funds will produce the greatest future returns, relative to the amount of risk incurred. They concluded that an investor whose time horizon is relatively short -- just a year or two -- should place almost all of his equity allocation in value funds. But unless he is eager to take on risk, an investor with a very long time horizon -- more than a decade, for example -- should invest as much as half of his equity allocation in growth funds.

The study by Professor Viceira and Mr. Jurek also illustrates the need to rethink the relationship between the short and long terms in the stock market. For years, many financial planners have made the implicit assumption that the long term can be viewed as a succession of short terms. The new study shows that this assumption is not always correct.

Chart: "How Much Growth, and How Much Value?" The longer the time horizon of a conservative investor's equity portfolio, the greater the proportion that should be allocated to growth funds, a new study has found. Chart shows Recommended allocations within a conservative investor's equity portfolio. Growth funds from 1,5,10, and 20 years. Growth funds and Value funds.

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