

Does Valuation Matter for Growth Stocks?

It has been a little over 20 years since the peak of the Tech Bubble. It has also been 20 years since we've seen the more expensive part of the market demand such a premium valuation. For the purposes of this market update, we analyzed Russell 2000 Growth stocks by taking profitable companies in the Index and grouping them into buckets based upon how cheap or expensive they are according to their price to earnings ratio on earnings estimates for the next fiscal year. We repeated this exercise for each year end from December 31, 2000 through last month end, November 30, 2020. A condensed version of the results is presented in Table 1.

TABLE 1: CHEAPEST TO MOST EXPENSIVE BUCKETS
P/E OF STOCKS IN THE RUSSELL 2000 GROWTH INDEX

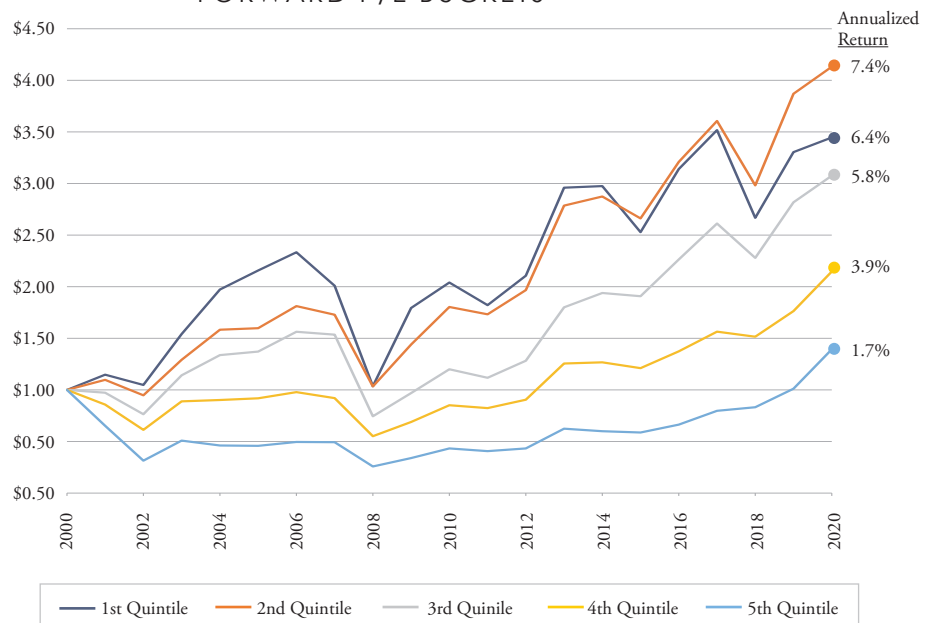
	1st Quintile	2nd Quintile	3rd Quintile	4th Quintile	5th Quintile
Dec-00	6.6	11.5	16.8	25.9	75.6
Dec-02	8.1	11.9	15.5	21.5	51.1
Dec-04	12.1	16.8	20.5	25.6	47.4
Dec-06	12.0	15.9	19.1	24.7	44.6
Dec-08	5.6	9.4	13.1	18.0	39.0
Dec-10	9.6	13.4	16.4	20.8	42.0
Dec-12	8.6	12.5	15.1	19.5	40.2
Dec-14	10.6	14.6	17.8	22.1	38.3
Dec-16	11.0	15.6	19.1	24.1	45.8
Dec-18	6.7	10.7	14.1	20.0	42.4
Nov-20	9.5	15.9	21.2	31.0	103.0
PERCENT CHANGE, SINCE DEC-16	-14%	2%	11%	29%	125%

Data as of 11/30/2020
Sources: Renaissance Research, Bloomberg

The first quintile in this table represents the cheapest stocks in the Index, while the fifth quintile represents the most expensive stocks. As the table illustrates, the most expensive bucket has experienced an expansion of its forward P/E multiple by 125% since December 2016. While the fourth quintile has also gotten more expensive recently, the first three quintiles as a group have not changed on average.

Expensive stocks have had a good run recently, as evidenced by the expansion in their P/E multiples. However, even with fast growing companies, it does matter what one pays for the investment in calculation of the eventual gain or loss achieved on the investment. In Chart 1, we show the growth of a \$1 over the last twenty years for an investment in each of these five buckets of the Russell 2000 Growth Index.

CHART 1: GROWTH OF A DOLLAR
RUSSELL 2000 GROWTH INDEX GROUPED BY FORWARD P/E BUCKETS



Data from 12/31/2000–11/30/2020
Sources: Renaissance Research, Bloomberg

The most expensive bucket provided paltry returns for investors over a 20-year period—1.7% annualized to be precise. The fourth quintile did not do much better, generating an annualized return of 3.9%. During this time frame, the second quintile actually performed the best, with each of the first three quintiles performing better than the Index as a whole.

As investors, we are attracted to companies with fat gross profit margins and outsized revenue growth, but we are also sensitive to what we have to pay for these stocks. Usually, we find the price required by the market is too high for the companies in the fifth bucket. This has become decidedly so in the past year.

DISCLOSURES

This Market Update reflects the thoughts of Renaissance as of December 29, 2020. This information has been provided by Renaissance Investment Management. All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. This is not to be construed as an offer to buy or sell any financial instruments and should not be relied upon as the sole factor in an investment making decision, nor should it be considered a recommendation. The views and opinions expressed are those of the Portfolio Manager at the time of publication and are subject to change. There is no guarantee that these views will come to pass. As with all investments, there are associated inherent risks. Please obtain and review all financial material carefully before investing.

PERFORMANCE

If Renaissance or benchmark performance is shown, it represents historically achieved results, and is no guarantee of future performance. Future investments may be made under materially different economic conditions, in different securities and using different investment strategies and these differences may have a significant effect on the results portrayed. Each of these material market or economic conditions may or may not be repeated. Therefore, there may be sharp differences between the benchmark or Renaissance performance shown and the actual performance results achieved by any particular client. Benchmark results are shown for comparison purposes only. The benchmark presented represents unmanaged portfolios whose characteristics differ from the composite portfolios; however, they tend to represent the investment environment existing during the time periods shown. The benchmark cannot be invested in directly. The returns of the benchmark do not include any transaction costs, management fees or other costs. The holdings of the client portfolios in our composites may differ significantly from the securities that comprise the benchmark shown. The benchmark has been selected to represent what Renaissance believes is an appropriate benchmark with which to compare the composite performance.

The value of an investment may fall as well as rise. Please note that different types of investments involve varying degrees of risk and there can be no assurance that any specific investment will either be suitable or profitable for a client or prospective client's investment portfolio. Investor principal is not guaranteed and investors may not receive the full amount of their investment at the time of sale if asset values have fallen. No assurance can be given that an investor will not lose invested capital. Consultants supplied with these performance results are advised to use this data in accordance with SEC guidelines. The actual performance achieved by a client portfolio may be affected by a variety of factors, including the initial balance of the account, the timing and amount of any additions to or withdrawals from the portfolio, changes made to the account to reflect the specific investment needs or preferences of the client, durations and timing of participation as a RIM client, and a client portfolio's risk tolerance, investment objectives, and investment time horizon. All investments carry a certain degree of risk, including the loss of principal and are not guaranteed by the U.S. government.

RUSSELL DATA

FTSE Russell is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell[®] is a trademark of FTSE Russell. This presentation may contain confidential information and unauthorized use, disclosure, copying, dissemination or redistribution is strictly prohibited. This is a presentation of Renaissance Investment Management. FTSE Russell is not responsible for the formatting or configuration of this material or for any inaccuracy in Renaissance's presentation thereof.

REFERENCED INDICES

(Indices are unmanaged and are not available for direct investment.)

Russell 2000 Growth Index—The Russell 2000 Growth Index is composed of the smallest 2,000 of the 3,000 largest U.S. companies based on total market capitalization with higher price-to-book ratios and higher forecast growth values.