Shifting Market Leadership—Russell 2000 Growth Index

For the past three years, leadership in small cap growth stocks has come from the most expensive stocks (as measured by price to earnings ratio on expected earnings in fiscal year two) and from the stocks of companies with negative earnings. Looking at the returns in Table 1, it is clear why momentum-oriented investors have become so enamored with the most expensive stocks and negative earners, with the tenth decile up 124% since September 30th of 2017 and with negative earners up 73%. The cheapest stocks barely budged during the same time frame.

TABLE 1

TOTAL RETURN FOR RUSSELL 2000 GROWTH STOCKS GROUPED BY P/E DECILES[1]

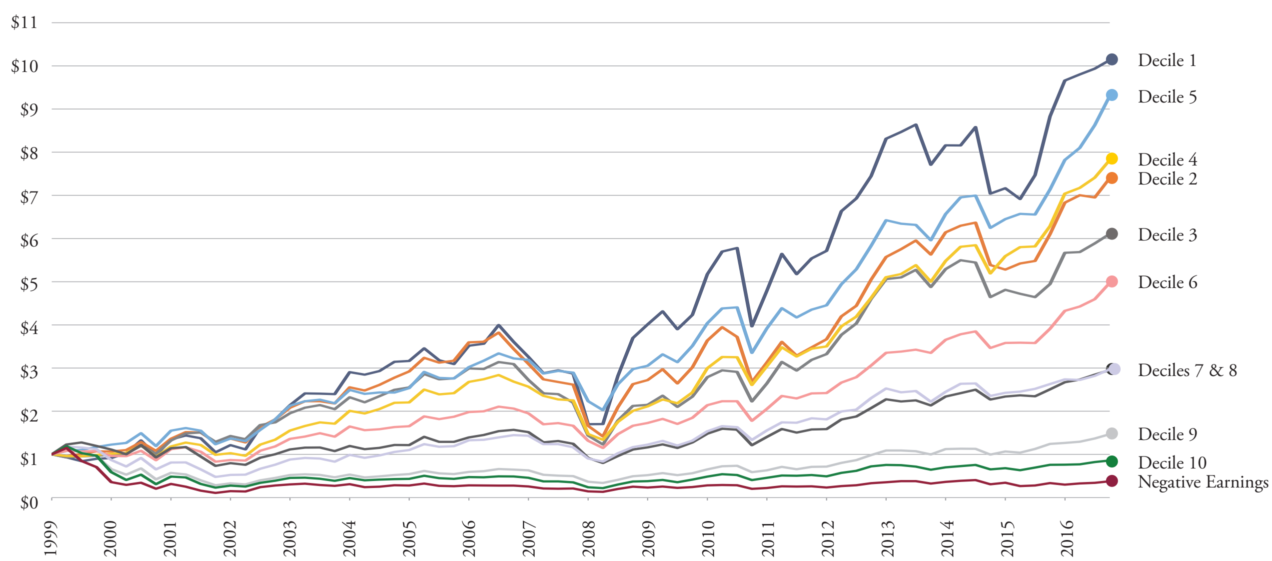
	10/1/2017–12/31/2020
Cheapest	2%
2nd Decile	22%
3rd Decile	37%
4th Decile	16%
5th Decile	13%
6th Decile	32%
7th Decile	50%
8th Decile	58%
9th Decile	66%
Most Expensive	124%
Negative Earnings	73%

[1] Please refer to the disclosure entitled "Construction of P/E by Decile" in the Disclosures Section.
Source: FactSet

However, this period is an anomaly. At the end of 2020, the P/E ratios of each bucket of stocks looked similar to those at the end of 1999 at the peak of the Technology Bubble. We took a look back at how the P/E buckets performed for the period from December 31, 1999 through September 30, 2017. Chart 1 provides a visual depiction of the growth of a $1 invested in each P/E decile. As the chart illustrates, the first five deciles (the cheapest five) provided healthy returns for investors. The tenth decile and negative earners provided negative returns for the entire 17¾ year period. Let that sink in… one would have lost money for almost two decades. At the nadir, an investment in the most expensive bucket would have been down a cumulative 78% in early 2009. An investment in the negative earners would have been down 87% during the same period.

CHART 1

GROWTH OF $1—RUSSELL 2000 GROWTH STOCKS BY P/E DECILE[1]



Data from 12/31/1999–9/30/2017.
[1] Please refer to the disclosure entitled "Construction of P/E by Decile" in the Disclosures Section.
Source: FactSet

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Table 2 outlines the cumulative returns for each of the two periods and year-to-date 2021. In our view, the tide has turned. Even with the recent pullback in expensive stocks, they remain as expensive as they were at year-end 2020, with the tenth decile sporting an average price-to-earnings ratio on fiscal year two estimated earnings of 200 times. This is more than three times the historical norm for this bucket as measured from the end of 2002 through 2018, which suggests that there is no reasonable bottom from which an investor in these stocks can rely.

The portfolio management team for the Renaissance Small Cap Growth Strategy has consistently sold the most expensive winners over the past year. Today, the average P/E of the portfolio is 23.4x versus 53.4x for the rest of our universe (as of the close on March 5). Using a more normalized calculation of P/E by throwing out the 5% outliers from our portfolio and the rest of the universe, our portfolio still looks very attractive on valuation with a P/E of 22.9x versus 31.8x for the rest of the universe. This is the first time in many years that we have felt compelled to tilt decidedly toward value for our clients. With the economy set to re-open in the U.S. and projected strong GDP growth, the backdrop for higher quality, more mature companies with reasonable stock valuations looks like a great place to focus investment dollars to us.

We are not suggesting that history will repeat itself, but we certainly do believe it will rhyme.

TABLE 2

RUSSELL 2000 GROWTH STOCKS GROUPED BY P/E DECILES[1]

	TOTAL RETURN 12/31/1999–9/30/2017	TOTAL RETURN 9/30/2017–12/31/2020	TOTAL RETURN 2021 YTD AS OF 3/5/2021	AVERAGE P/E AS OF 3/5/2021	RENAISSANCE PORTFOLIO EXPOSURE AS OF 3/5/2021[2]
Cheapest	913%	2%	18%	7.6x	11%
2nd Decile	640%	22%	20%	12.2x	9%
3rd Decile	511%	37%	17%	15.3x	6%
4th Decile	682%	16%	11%	17.7x	15%
5th Decile	830%	13%	11%	19.9x	13%
6th Decile	398%	32%	14%	23.1x	13%
7th Decile	196%	50%	6%	27.6x	7%
8th Decile	197%	58%	12%	34.5x	17%
9th Decile	47%	66%	4%	51.2x	9%
Most Expensive	-14%	124%	5%	200.0x	0%
Negative Earnings	-62%	73%	9%	NMF[3]	0%

[1] Please refer to the disclosure entitled "Construction of P/E by Decile" in the Disclosures Section.
[2] Renaissance Small Cap Growth Portfolio weights based on a representative account.
[3] Not meaningful figure.
Source: FactSet

DISCLOSURES

This Market Update reflects the thoughts of Renaissance as of March 5, 2021. 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.

CONSTRUCTION OF P/E BY DECILE

Each P/E decile represents the universe of profitable companies in the Russell 2000 Growth Index as of 12/31/1999 broken down into ten buckets of companies with an equal number of companies in each bucket. The companies were placed in their respective buckets based upon their price-to-earnings ratio on estimated earnings-per-share for fiscal year two. Returns for the stocks were then calculated for the subsequent calendar quarter. The deciles were then recalculated the next quarter-end and each quarter thereafter through 12/31/2020. The average P/E as of 3/5/2021 was calculated in a similar fashion using data as of the market close on March 5th. For each decile, the average P/E was calculated using a trigonometric mean, throwing out 10% of the outliers.

Continued

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REFERENCED INDEX

(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.