

# Explaining equity: What's happening with this year's returns?

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*The divergence between growth and value stocks is one of the biggest stories of 2018, and equity income investors find themselves on the wrong side of it. Why?*

In the first half of 2018, the Russell 1000 Growth Index was up over 7%, and the core Russell 1000 Index was up almost 3%. Meanwhile, the Russell 1000 Value Index lagged with a -1.7% return. **Quality equity income stocks tend to be found somewhere between value and core stocks.** Growth companies are less likely to pay a dividend because they're reinvesting in themselves with the goal of growing faster than the overall market, while really deep value companies don't have cash available to fund a dividend. The result? Quality equity income investors find themselves with returns closer to the core and value indices. And they're left wondering why.

## It's a growth-at-any-price market

In the current market, growth is winning, and the amount investors pay for growth is less of a concern. One way to look at this dynamic is to understand the underlying factors that have driven equity markets across all sectors and styles. Growth factors have outperformed, and valuation factors have underperformed. This has created a growth-at-any-price market, where valuation doesn't seem to matter. And expectations for growth matter more.

Growth factors measure a company's growth trajectory and include price momentum, sales growth and predicted earnings-per-share growth. Valuation factors use financial statements to indicate if a stock is selling at a price that reflects a company's worth; these types of factors include book-to-price, sales-to-price and earnings-to-price ratios.

## No factor is spared — even free-cash-flow yield.

The Columbia Threadneedle dividend income team focuses on free-cash-flow yield — it identifies companies that are generating free cash flow and trading cheaply. This means a company can adequately fund its dividend and [won't need to dip into other cash or cut its dividend](#).



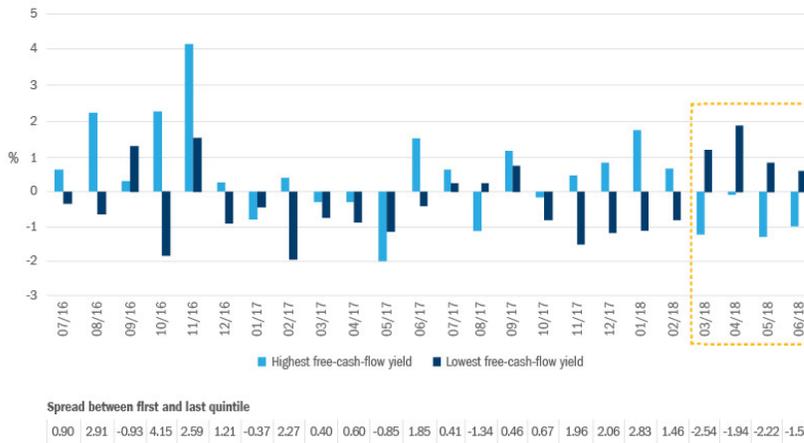
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However, free cash flow is currently included in the long list of value-oriented factors that have underperformed on a short-term basis. If you look at the difference in returns between the highest free-cash-low companies and the lowest, you'll see how this factor has underperformed in the last few months in the current growth market. Valuations don't seem to matter as much as growth momentum does.

▶ **Companies with the highest free-cash-flow yield have been underperforming**

Average excess return for highest and lowest free-cash-flow companies compared to the Russell 1000 Index



Source: Columbia Threadneedle Investments as of 06/30/18. Highest and lowest represent the top and bottom quintile of

We still think that having high-quality income stocks matters, despite the periods of time when the market doesn't reward it. Remember: As the economy slows, which eventually all economies do, having cash flow on hand to pay a dividend and fund operations is incredibly important. Even though the market may not be rewarding companies for having free cash flow right now, it's important to focus on high-quality companies for reliable income from equity investments.

**Bottom line**

The divergence between growth and value stocks is one of the biggest stories of 2018. And right now, quality equity income investors are finding themselves on the wrong side of it. We're in a growth-at-any-cost market, and valuations seem to be a distant concern. Companies aren't currently being rewarded for having good valuation metrics such as free-cash flow yield, but when the trend reverses, having cash flow to pay dividends will become increasingly important.

The Russell 1000 Index tracks the performance of 1000 of the largest U.S. companies, based on market capitalization. The Russell 1000 Growth Index measures the performance of those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.



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