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Rebalancing Act: Rethinking Growth Versus Value

Heading into 2025, a handful of mega-cap tech companies had tilted the U.S. public equity markets meaningfully into growth territory. Recent gyrations have revealed the potential risk in such positioning, and offered yet more evidence for why we believe it is time to rebalance portfolios by increasing value exposure.

In this paper, we address the ongoing growth tilt across both public and private equity (PE) portfolios, as well as the potential risk if further impressive gains prove more elusive than expected.

In line with our new-year outlook, "Solving for 2025", we believe tech earnings growth will likely moderate from here and that, while volatility may continue, broadening economic growth should benefit more cyclical sectors and value stocks.

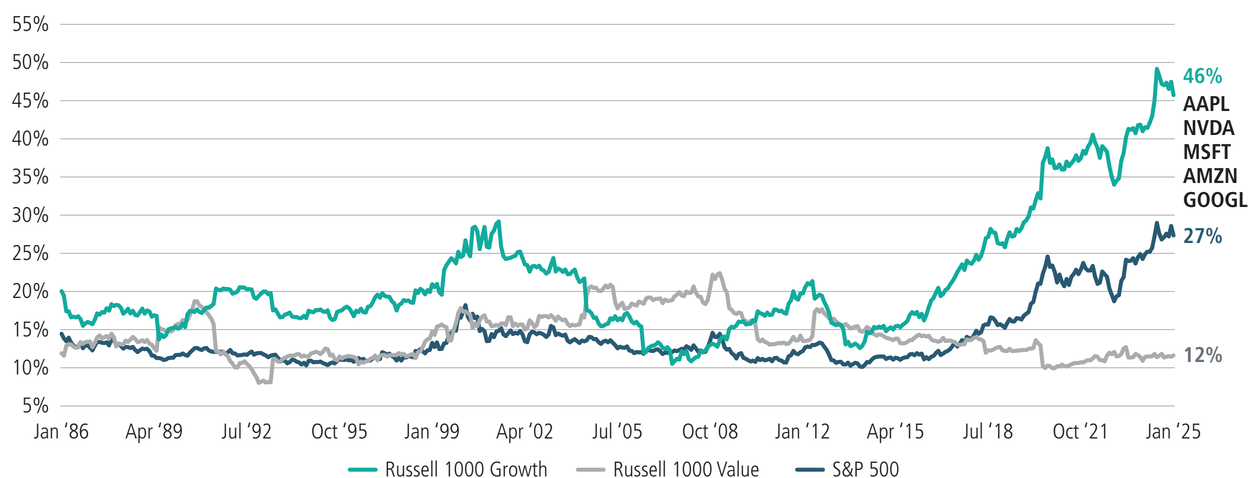
Public Equities: Excessive Concentration, Heady Valuations and Style Drift

Nearly 75 years after Nobel Prize winner Harry Markowitz established the foundations of modern portfolio theory, diversification remains a cornerstone of sound portfolio construction. Yet thanks to a persistent bull run by a handful of mega-cap companies, we believe many public equity portfolios now have a greater exposure to "growthier" pockets of the economy than many investors may truly appreciate.

Excessive Concentration

If support for value seems almost quaint given the mega-caps' recent dominance, consider the chart in figure 1: As of January 31, 2025, five companies—Amazon, Apple, Google, Microsoft and Nvidia (call them the Mag 5)—represented *more than a quarter* of the S&P 500 Index and *nearly half* of the Russell 1000 Growth Index.

FIGURE 1: THE S&P 500 AND RUSSELL 1000 GROWTH INDICES HAVE SIGNIFICANTLY OVERLAPPED



Source: Bloomberg, data as of January 31, 2025. For illustrative purposes only.

These observations suggest to us that passive investors seeking broad equity exposure have effectively pinned their hopes on a handful of high-growth, U.S. mega-cap companies.

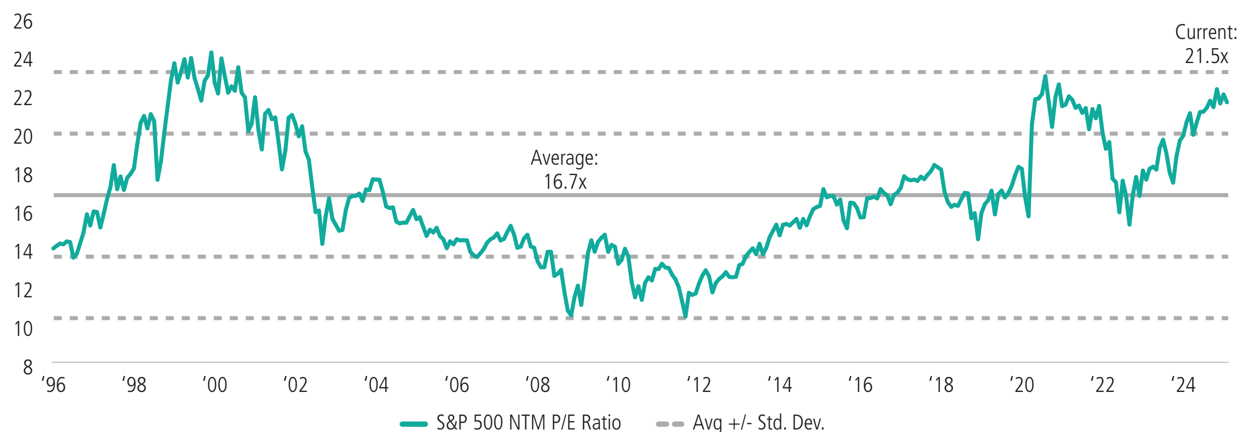
Furthermore, we believe investors who have additional direct growth exposure (perhaps through a growth-oriented index fund) are likely getting an *extra* helping of those very same names, potentially amplifying the overall risk of their broader equity portfolio.

Heady Valuations

While market concentration captures one aspect of the market's tilt into growth territory, rich equity valuations, in our view, illustrate another.

As shown in figure 2, the S&P 500 Index now trades at a forward price-to-earnings (P/E) multiple of nearly 21.9, a near-three-decade peak. That's not to say we think the broader market is rich, but rather that the Mag 5's lofty valuations have hoisted the index's market-cap-weighted multiple higher than the other 495 constituents. Indeed, at the end of February, the Mag 5 traded at an aggressive 27.2 times forward earnings, implying to us that this vaunted group will have to maintain their heady growth streak to justify those valuations.

FIGURE 2: THE S&P 500 INDEX'S FORWARD P/E IS TOUCHING NEAR-HISTORIC HIGHS



Source: Neuberger Berman and FactSet, data as of February 28, 2025. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed.

Note: The solid grey horizontal line is the average P/E for the next 12 months (16.7x), and each of the dotted lines above and below correspond to 1 standard deviation from the average. As shown, the market is now nearly 2 standard deviations from its 30-yr average of 16.7x; put another way, over that period the forward P/E has been higher just 7% of the time.

When combined with significant market concentration, we believe valuations based on aggressive growth targets have the potential to threaten future risk-adjusted returns within public equity portfolios.

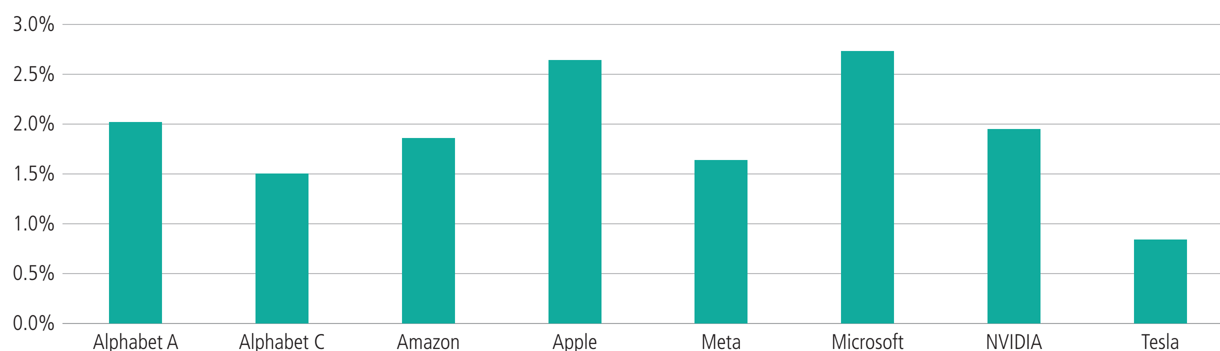
Style Drift

Investors seeking to maintain optimal diversification face yet another challenge: style drift. We find that many so-called "value" managers have gone at least partially off-script by piggybacking on mega-cap names to enhance returns.

As shown in figure 3, more than half (170) of the 300 open-end funds[1] within Morningstar's "value" designation hold at least one of the Mag 7 in their portfolios—even though none of those high-fliers are included in the Russell 1000 Value Index.

FIGURE 3: MANY LARGE-CAP VALUE MANAGERS HAVE LEANED ON THE MAG 7 TO BOOST RETURNS

Average Overweight Position by Stock Among Large-Cap Value Funds (bps)



Source: Morningstar, data as of December 31, 2024. For illustrative purposes only.

Note: This chart includes funds in the Large Cap Value (LCV) Morningstar category that own one of the Magnificent 7 stocks. Not all LCV funds own these names.

In our view, stretching for growth within value portfolios may thwart optimal diversification and ultimately threaten overall risk-adjusted returns.

[1] Calculated using a respective fund's oldest share class.

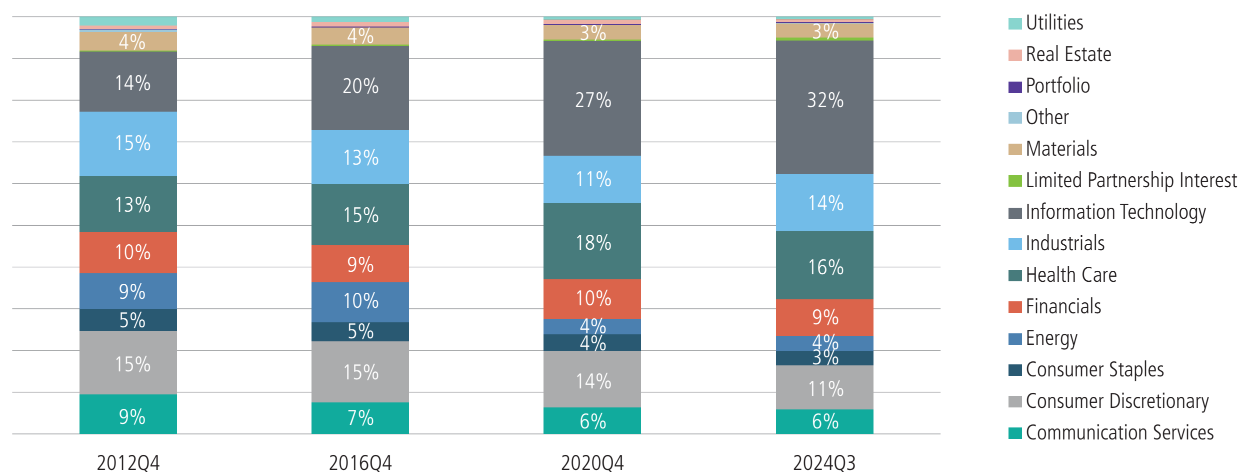
Private Equity: Popular Targets Skew Toward Growth

Similar to public equities, we've also seen a significant tilt toward growth in private portfolios, subtly increasing investors' overall growth exposure.

One way to capture that shift, in our view, is to compare the change in sector exposures within PE portfolios over time, noting that some sectors tend to have growthier complexions than others.

As shown figure 4, companies in the growthy Information Technology sector now account for an estimated 32% of PE portfolios, up from just 14% in 2012. Meanwhile, exposure to comparatively staid sectors—such as Energy, Consumer Discretionary and Consumer Staples—has declined.

FIGURE 4: PRIVATE EQUITY PORTFOLIOS HAVE LEANED TOWARD GROWTHIER SECTORS OVER TIME



Source: Neuberger Berman and Cambridge Associates, data as of February 12, 2025. For illustrative purposes only.
Note: Investments tracked for Venture Capital, Growth Equity, Buyout, Mezzanine and Private Equity Energy funds only.

Despite PE's gradual growthy tilt, we still believe PE can offer attractive performance and diversification within broader investment portfolios. And while tariff policy negotiations remain fluid, we think PE may offer some welcome insulation from a potentially tougher U.S. regime given the industry's exposure to sectors and industries where innovation and intellectual capital—rather than tangible imports—are the primary drivers of value. (For more on this theme, see: Tariffs Are Here: What Does That Mean for Private Equity?)

Key Macro Drivers: Nominal U.S. Growth and Strengthening Capex

In addition to risk-management considerations, we believe there are underlying macroeconomic drivers that argue for rebalancing toward value from growth.

Nominal Economic Growth
In 2024, a challenging combination of weakening nominal U.S. economic growth and rising real 10-year bond yields hampered the broader equity market as investors discounted softer future corporate profits at higher rates; meanwhile, U.S. mega-cap tech companies continued to rack up impressive earnings gains, extending their bull run.

But the U.S. growth story has improved coming into 2025, supported—as my colleagues Jeff Blazek and Erik Knutzen recently observed—by consumer confidence, declining unemployment and rising wages. Meanwhile, global central banks remain coordinated in easing monetary policy to stimulate their economies, providing the most market-friendly backdrop outside of recessions that we've seen in three decades (for more on this, see our 1Q2025 Equity Market Outlook). That improving growth outlook has led to a broadening of performance beyond megacap tech, and may continue to bode well for value stocks, in our view.

Strengthening Capex

While sagging global industrial activity has favored growth-oriented and large-cap stocks in recent years,[2] fresh data suggest to us that manufacturing may pick up in 2025, providing a potential tailwind for value stocks, which tend to be more sensitive to the traditional industrial economy.

We believe improving corporate capex—a major component of industrial production—has the potential to sustain a manufacturing rebound: Historically, capex has lagged earnings growth and business confidence by about nine months;[3] however, both have recently moved higher, a potentially positive sign for future capex outlays. Indeed, Goldman Sachs forecasts capex growth to accelerate in 2025 and grow 2.6 times faster than U.S. GDP.[4]

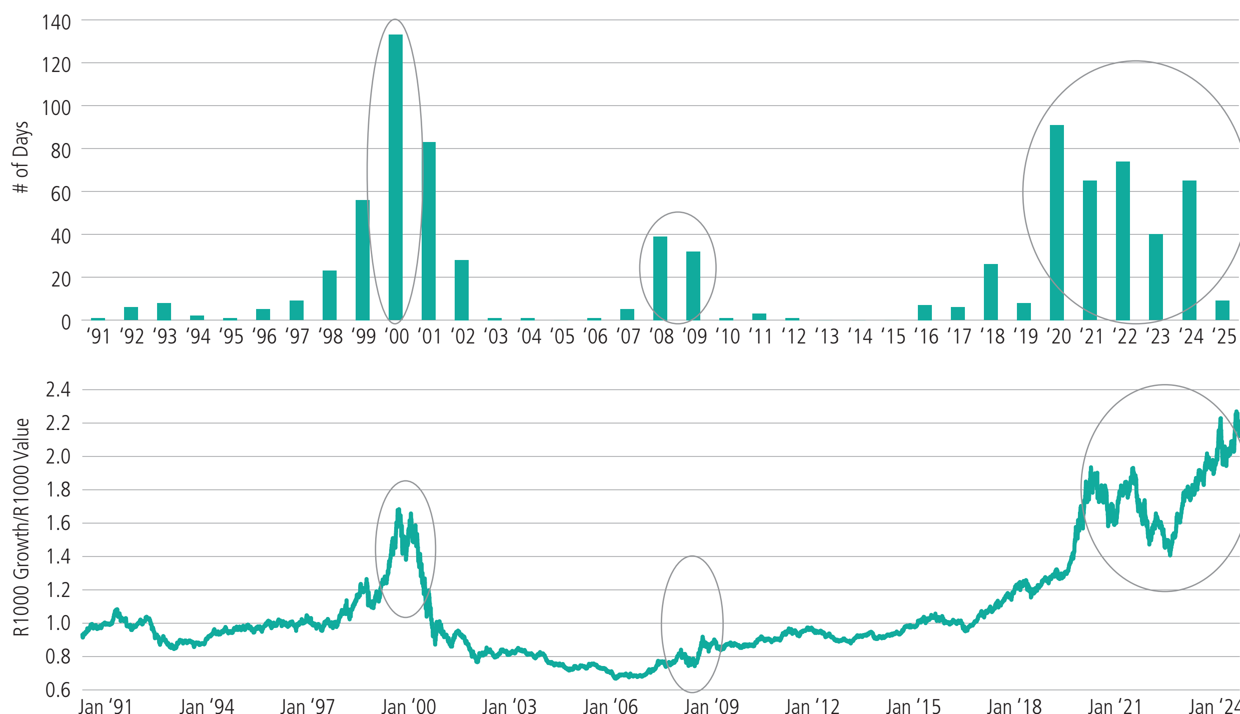
Relative Returns: Increasing Volatility Could Favor a Resurgence in Value

While we acknowledge that a number of factors could help sustain the persistent mega-cap tech run (more on those below), we believe warning signals of a leadership change away from growth have begun to flash.

One useful signal, in our view, is the *volatility in relative performance between growth and value indices*. We find history suggests that rising daily disparities between these benchmarks can herald shifts in market leadership.

Consider the daily performance spreads between the Russell 1000 Growth Index and the Russell 1000 Value Index going back to 1991 (see figure 5). We find that an increase in the number of days when the spread exceeded 1% tended to coincide with significant shifts in market leadership.

FIGURE 5: RISING VOLATILITY IN RELATIVE DAILY RETURNS CAN SIGNAL CHANGES IN MARKET LEADERSHIP



Source: Bloomberg, data as of January 31, 2025. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. **Past performance is not indicative of future results.**

[2] Neuberger Berman and FactSet, data as of November 30, 2024.

[3] Ibid.

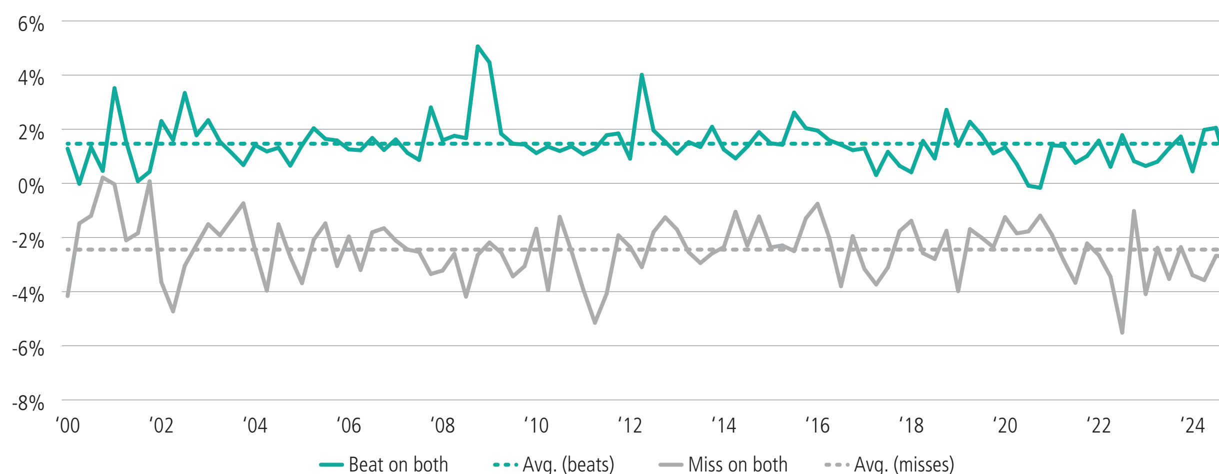
[4] Goldman Sacs, Neuberger Berman, FactSet and Bloomberg; data as of November 11, 2024.

As shown in the chart, relative daily volatility spiked during the late 1990s, at the height of the dotcom boom, triggering an extended period in which value outperformed growth. Those tables turned heading into the 2008 Global Financial Crisis, when a spike in performance spreads heralded a historic bull run for growth stocks. Now, as daily spreads have jumped in the wake of the megacaps' post-Covid growth spurt, we believe the market could be signaling yet another switch in leadership back toward value.

Another signal that growth may be fully priced, in our view, is that investors appear less impressed by above-consensus earnings announcements—and more disappointed when companies undershoot Wall Street's expectations—than they have been in the past.

Figure 6 plots the one-day relative performance of stocks in the S&P 500 Index that beat and missed Wall Street's quarterly sales and earnings expectations since 2000. For example, in the first quarter of 2009, stocks that beat both estimates outperformed the benchmark by an average of 5% the next day; however, as shown in the chart, that outperformance gap has trended down in recent years and now hugs the 1% long-term average.

FIGURE 6: MUTED CHEERS FOR BEATING EXPECTATIONS MIGHT SUGGEST GROWTH IS FULLY PRICED



Source: BofA U.S. Equity & Quant Strategy, FactSet. Data as of December 31, 2024. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. **Past performance is not indicative of future results.**

Meanwhile, companies that missed both quarterly sales and earnings expectations have increasingly trailed their long-term relative underperformance of -2%, suggesting perhaps that investors are growing incrementally impatient with companies that can't hit their growth targets.

The Case for Value in 2025: Persistent Headwinds, Potential Outperformance

Despite the market's increasing leverage to growth, we recognize that a new value regime may continue to face delays:

- First, big tech companies are not tulip bulbs: Unlike those tiny blooms, we believe the tech giants continue to sport powerful business models, healthy free cash flows and deep resources to invest in growth initiatives and help maintain their market leadership.
- Second, we acknowledge that the potential for greater deregulation and a more moderate antitrust regime under a second Trump administration could put additional wind behind the megacaps in the near term. At the same time, we also believe a strong deregulatory thrust may help value stocks even more: For example, improved permitting provisions should support the energy, materials and industrials sectors, where value names tend to congregate.

- Third, and not least, substantial capital flows into market-cap-weighted equity index funds continue to support mega-cap valuations, in our view. As these popular passive vehicles mechanically invest in line with current market-cap weightings, irrespective of the true financial performance of the individual companies within a given index, we believe concentrations and valuations of leading stocks could continue to rise, further ratcheting overall equity market risk.

While the U.S. megacaps may find a way to extend their remarkable run, we believe tech earnings growth will likely moderate from here and that broadening economic growth should benefit cyclical sectors like financials, industrials and energy, and value stocks more generally.

Furthermore, we fear the market's significant tilt toward growth could reverse—quickly and hard—should the rosy earnings projections implied by current valuations begin to crack. *In light of this potential risk, we believe equity investors may be wise to increase their exposure to value stocks in 2025.*

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Index Definitions

The S&P 500 Index consists of 500 U.S. stocks chosen for market size, liquidity and industry group representation. It is a market value-weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value.

The Russell 1000® Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium term (2-year) growth and higher sales per share historical growth (5 years).

The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with relatively lower price-to-book ratios, lower I/B/E/S forecast medium term (2-year) growth and lower sales per share historical growth (5 years).

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