

How the Russell Value Index Transformed Exxon Mobil into a Growth Stock

The Russell indexes are reconstituted every year near the end of June. This year's reconstitution brought forth a major surprise. Prior to the June reconstitution, Exxon Mobil (XOM), America's largest corporation by market capitalization and profits, accounted for 4.02% of the Russell 1000 Value Index and 24% of the index's energy exposure. After the reconstitution, XOM's weight dropped to 0.44% of the Russell 1000 Value Index. Amazingly, it now has a weight of 5.0% in the Russell 1000 Growth Index, and represents a full 50% of the Growth energy sector! Has XOM become a growth stock? How could such a dramatic change occur overnight?

Russell's approach is simple and objective. However, investors need to understand that it can lead to unexpected results. Let's look at how the indexes are constructed. In assigning stocks to its Growth and Value indexes, Russell Investments uses two criteria: the stock's adjusted book-to-price (B/P) ratio and the I/B/E/S forecast mean long-term earnings growth rate (IBESLT). Stocks in the Russell 1000 Index are ranked by these metrics and the rankings are combined (50/50) to produce a composite value score (CVS). Stocks with lower P/B ratio and lower IBESLT receive higher CVS and are considered value stocks, and stocks with lower CVS are assigned to the Russell 1000 Growth Index. Stocks with CVS in the middle range are considered to have both growth and value characteristics, and are weighted proportionately in the growth and value indexes.

The reason behind XOM's shift to the growth category is a substantial jump in IBESLT (from 4.3% to 15.9%). This increase in the estimated long-term growth rate more than offset the decline in the P/B ratio from 3.2x to 2.5x, which would be indicative of a move towards value.

Russell's heavy reliance on IBESLT as a value/growth indicator is a concern when there are very few analysts who provide long-term growth forecasts for individual companies. In the case of XOM, which is one of the most widely-followed large-cap stocks, only 4 analysts had published long-term growth estimates as of June 2010. In May of 2009, only two such estimates were available. In fact, the average number of long-term growth rate estimates for stocks in the Russell 1000 Index (per I/B/E/S) currently stands at only four (342 stocks had fewer than three estimates). With so few estimates available, the consensus growth rate is subject to distortions by outliers and may not be representative of the company's true growth potential.

Russell attempts to mitigate this lack of long-term growth estimates by using the average forecasted growth rate for the company's industry. For instance, if the stock has only one growth estimate available, an industry average is given a 2/3 weight when calculating IBESLT. For securities with long-term estimates from only two analysts, the industry average will be given a 1/3 weight. If an industry has fewer than five members, the substitution reverts to the subsector, and so forth to the sector level.

This methodology can simply compound the error of using the same unreliable estimates and may lead to circular calculations. Going back to the XOM example, assuming Russell uses the integrated energy industry to supplement individual company growth forecasts, this would include six companies (XOM, CVX, COP, MRO, MUR and HES); two of these companies have four long-term growth estimates available, one company has three estimates, two companies have two estimates and one company has only one. Consensus long-term growth forecasts for these companies vary from 6.3% to 17.8%.

Investors need to understand that the term “long-term growth rate” differs among analysts. While some consider this to be a company’s rate of growth through the cycle (i.e. a timeframe that includes a cyclical trough and a cyclical peak), others look only at the next two to three years, a period which may include a cyclical upswing but not the subsequent downswing. This makes estimated long-term growth rates highly volatile for economically sensitive stocks. In XOM’s case, the consensus long-term growth rate went from 7% in May of 2009 to -2.8% (!) in December of 2009 and then back to 15.1% in May of 2010. Most investors would agree that XOM’s secular growth prospects have not changed that dramatically over the twelve month period.

Why is all of this important? The issues described above can lead to unwarranted volatility in stock and sector weightings within the Russell 1000 Value Index. Furthermore, it brings into question the index’s capacity to represent a universe of large-cap value stocks. Considering the amount of money managed according to the Russell indexes, it is hard to believe that one analyst’s interpretation of long-term growth has the potential to shift so many funds without investors or fiduciaries understanding why.

Sources: Russell Global Indexes Construction and Methodology, May 2010; Growth rate and valuation calculations from FactSet and I/B/E/S

| GICS Sector | Russell 1000 Value | |
|------------------------|--------------------|----------------|
| | Current Weight | Percent Change |
| Energy | 10.75% | -6.67% |
| Consumer Discretionary | 7.51% | -3.49% |
| Industrials | 9.11% | -1.66% |
| Materials | 3.04% | -1.04% |
| Telecommunication | 4.75% | -0.34% |
| Utilities | 7.06% | 0.45% |
| Information Technology | 5.83% | 0.75% |
| Financials | 28.56% | 2.42% |
| Health Care | 12.89% | 4.64% |

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