

The false contradiction of value versus growth

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Given the substantial outperformance of 'growth' stocks over the past decade – and 2019 in particular – there is currently a robust debate around whether it's time to switch to a more 'value' oriented portfolio. In my view, this is an over-simplification of the issue, given that it reduces both concepts to quantitative 'factors' driving markets. In reality, growth and valuation are two sides of the same coin when selecting stocks for long-term investment.

To take a step back, 'value' investing is broadly defined as trying to determine the intrinsic value of a future stream of cash flows, and paying less than that value to acquire rights to that stream of cash flows – buying \$1.00 for \$0.80, in essence. In contrast, 'growth' investing is generally defined by what it is not: 'value' investing. I think this interpretation lacks nuance. I have yet to encounter the value investor who doesn't believe the future growth potential of a business they own is not reflected in the current stock price, nor a growth investor who would not prefer to pay less than intrinsic value for future potential growth.

I suspect the issue lies with how the major indices define these terms, using the shorthand of multiples or reported historical growth rates as a tool for classifying a business into 'value' or 'growth' buckets, instead of delving into the economics or prospects of a company. Many 'value' indices are constructed by selecting a basket of stocks that trade at low price-to-earnings or price-to-book ratios. This approach assumes the stock price relative to historical financial information is a proxy for value, where real world experience would suggest the fundamentals of a company are much more reliable indicators. The same goes for 'growth' indices, which look to historical growth trends and extrapolates this to a short-term forward EPS growth rate. All this information has the drawback of being backwards looking, relying on the current price and historical numbers (which, if you believe in efficient markets, should already be reflected in the price).

No less than the Oracle of Omaha agrees, writing in the 1992 letter to Berkshire Hathaway shareholders:

[...] most analysts feel they must choose between two approaches customarily thought to be in opposition: "value" and "growth." Indeed, many investment professionals see any mixing of the two terms as a form of intellectual cross-dressing.

We view that as fuzzy thinking (in which, it must be confessed, I myself engaged some years ago). In our opinion, the two approaches are joined at the hip: growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive. In addition, we think the very term "value investing" is redundant. What is "investing" if it is not the act of seeking value at least sufficient to justify the amount paid? Consciously paying more for a stock than its calculated value - in the hope that it can soon be sold for a still-higher price - should be labelled speculation [...].

Whether appropriate or not, the term "value investing" is widely used. Typically, it connotes the purchase of stocks having attributes such as a low ratio of price to book value, a low price-earnings ratio, or a high dividend yield. Unfortunately, such characteristics, even if they appear in combination, are far from determinative as to whether an investor is indeed buying something for what it is worth and is therefore truly operating on the principle of obtaining value in their investments. Correspondingly, opposite characteristics - a high ratio of price to book value, a high price-earnings ratio, and a low dividend yield - are in no way inconsistent with a "value" purchase. Similarly, business growth, per se, tells us little about value. It's true that growth often has a positive impact on value, sometimes one of spectacular proportions. But such an effect is far from certain. [...]

Growth benefits investors only when the business in point can invest at incremental returns that are enticing - in other words, only when each dollar used to finance the growth creates over a dollar of long-term market value.

The last sentence is critical: all else equal, one wants to own businesses that can deploy capital at rates of return that exceed the cost of capital on a sustainable basis. Owning this type of business over the long term – as if you were business owner, and not a speculator – is the path to compounding wealth.

At present, the traditional indicators of 'value' seems to be concentrated the financials, materials, energy and industrials sectors. There are of course exceptions, but in general, many of the businesses in these sectors are generally price-takers and are reliant on external drivers to provide growth, and therefore struggle to consistently generate the excess returns on capital Buffett refers to above. With this in mind, I do not think that switching into 'value'-friendly price takers to capture a short-term factor rotation is not a sustainable way to generate superior investment performance.

I believe Phillip Fisher gave investors a solid framework to assess when to sell a stock in Common Stocks and Uncommon Profits, first published in 1958. He recommended selling only under three circumstances: a) when you were wrong about the facts and your investment thesis is invalidated; b) when the facts have changed and the business can no longer generate the returns you bought it for, or c) when there are better opportunities to be had elsewhere and there is a lack of cash to invest in them. He was abundantly clear on not selling out in fear of a market correction, which are part and parcel of equity investing.

Consider the chart below, which shows the split-adjusted share price of Amazon.com from IPO (May 1997) to present on a weekly basis. Each one of the areas indicated by a red circle represents a price decline of 30% or more, peak to trough. (In some cases, that was closer to 60% – and that excludes the dot-com sell-off in 2000, which saw a whopping 94% drop in the price).



Admittedly, some sell-offs have been more sudden than others – the 4th quarter 2018 global markets sell-off was particularly violent – but increased volatility is the price you pay when discount rates are as low as they are.

Picking Amazon comes with a huge amount of hindsight and survivorship bias, but the point remains the same: there were ample opportunities to fully cash out in 2000, 2003 to 2006, 2008, 2011, 2014 or late 2018. Only by remaining invested for the long term was the compounding effect allowed to gain traction. By that token, a truly long-term investment horizon means portfolio turnover is kept to a minimum.

Does this mean valuations don't matter? No. Given the run in January, we have chosen to follow Fisher's rule number three, and have redeployed capital from names which we considered as trading above our assessment of fair value into other portfolio holdings. However, this does not mean we are selling the more fully-priced stocks out of the portfolio in their entirety, nor that we are about to buy an optically cheap 'value' stock that does not have a compelling long-term investment rationale and a proven ability to generate excess returns on capital sustainably.

Can markets experience a correction over the near-term? Given the strong run we've had since October, almost certainly. That doesn't mean it's time to head for the hills, though. If anything, it means sticking to a process and owning quality businesses. The alternatives – owning 'value' to benefit from a factor rotation, or trying to time the market by trading in and out of stocks – just don't add much value to performance in the long term.

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