The Investment Derby: Value vs. Growth

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"And they are out of the starting gates. High Price to Earnings is out front, trailing just behind are High Earnings Growth and High Price to Sales. In the middle of the pack we have High Price to Book, Low Price to Earnings, and High Dividend Yield. Rounding out the field we have Low Price to Book and High Return on Equity. Now heading into the final stretch it's…"

The manner in which the financial press focuses on the themes and news of the day often makes investing like watching a horse race. The focus is squarely on which stock is up or down, by how much, it's performance relative to its peers, or the market in general. The biggest movers capture the headlines, often without any real long-term significance. In this way, the lexicon of the media becomes strikingly similar to that of the casinos or race tracks. In our opinion that is not long term investing. In many of our client letters (for example see: April Staying in Touch Letter) we suggested ignoring short-term fluctuations and focusing instead on the long term outlook for your portfolios. The short-term becomes background noise while the real data smoothes out long-term returns. If a stock drops 4% in a day due to market volatility, does that imply that the company has permanently lost 4% of their sales and earnings? Did profit margins suddenly decline by 4% that day? In most cases, the answer is probably not. Suppose the next day the market is up and the stock goes up as well. Did the company therefore gain back the missing sales, earnings, and profit margins? Were they ever really missing? When investing over long term horizons, the daily, weekly, or even quarterly noise really does not affect the intrinsic value of a company. The point obviously is that while the short term vacillations of the market will impact the daily value of your portfolio (and perhaps your anxiety levels), it is only the efficacy of your long term investment strategy that will determine your success.

In his famous book, "Margin of Safety", Seth Klarman, one of the most famous value investors today, discusses the choice investors must make regarding long-term investing vs. following the short-term news and market fluctuations. He wrote, "Ultimately investors must choose sides. One side – the wrong choice – is a seemingly effortless path that offers the comfort of consensus. This course involves succumbing to the forces that guide most market participants, emotional responses dictated by greed and fear and a short term orientation emanating from the relative-performance derby. Investors following this road increasingly think of stocks like sowbellies, as commodities to be bought and sold. This ultimately requires investors to spend their time guessing what other market participants may do and then trying to do it first. The problem is that the exciting

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possibility of high near term returns from playing the stocks-as pieces-of-paper-that-you-trade game blinds investors to its foolishness."[1]

The two major valuation types of equity investments, growth and value, could be the names of two horses in our fictitious race, but are actually important fundamental metrics which are used to accurately (one hopes) price stocks. Growth investing seeks capital appreciation by investing in stocks of faster growing companies. Some of the more common fundamental metrics which growth stock investors utilize to identify good candidates include high earnings growth, high price to sales, high price to book, and high return on equity. Growth investors recognize that they are often paying high prices for these stocks. They obviously anticipate even larger and longer growth trends so that the stocks will continue to perform well over time.

Value investing is almost opposite in its approach. Value investors are trying to identify stocks that are trading at a discount to the intrinsic worth of the company. They expect that the market will ultimately reprice the security to better reflect the true value of the company. Value investors utilize fundamental metrics such as low price to book, low price to earnings, and high dividend yield to identify stock selections.

Klarman highlights the differences in the two approaches when he states, "The focus of most investors differs from that of value investors. Most investors are primarily oriented toward return, how much they can make, and pay little attention to risk, how much they can lose. Value investors, by contrast, have as a primary goal the preservation of their capital. It follows that value investors seek a margin of safety, allowing room for imprecision, bad luck, or analytical error in order to avoid sizable losses over time. A margin of safety is necessary because valuation is an imprecise art, the future is unpredictable, and investors are human and do make mistakes."[2]

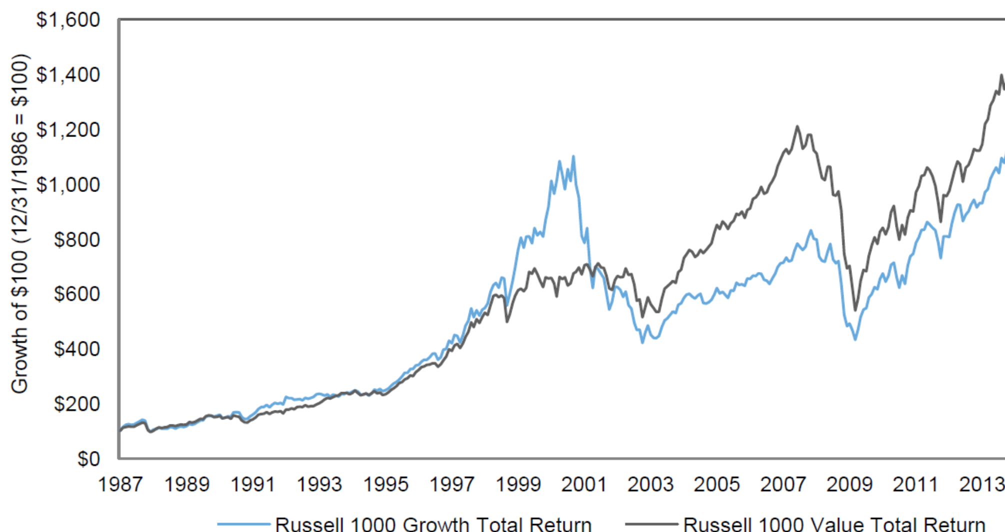
Which style has demonstrated better long-term results? In a paper published by Russell Investments, David Koenig, CFA observed that growth and value performance tends to move in cycles over time. He does point out that there has been a tendency for value stocks to outperform growth stocks over time, as is seen in the following chart for the period from 1987-2013.[3]

[1] **Margin of Safety, Risk-Averse Value Investing Strategies for the Thoughtful Investor ,by Seth A. Klarman, Harper Business, 1991, page xviii**

[2] **Margin of Safety, Risk-Averse Value Investing Strategies for the Thoughtful Investor ,by Seth A. Klarman, Harper Business, 1991, page xix**

[3] **Value? Growth? Or Both? By David A. Koenig, CFA,FRM, Investment Strategist, Russell Investments, Index Insights, April 2014,page 4**

Figure 2: Value has historically outperformed growth over the long term…



Source: Russell Indexes, as of Dec. 31, 2013. Index performance is for illustrative purposes only. One cannot invest directly in an index. Past performance is not a guarantee of future results.

In terms of annualized total return for the 27 year period, the growth index returned 9.78% while the value index returned 10.6%.[4]

Morningstar looked at research conducted by Fama and French over longer timeframes. The Fama-French data series encompasses results from 1927 -2014 and looked at value vs. growth by market capitalization. Here the story is similar, with large cap growth showing annualized returns of 9.1%, versus 11.3% for large cap value. Small cap growth averaged 9.4%, while small cap value averaged 14.1%.[5]

Historically, investing with a value bias has outperformed growth over long time periods. That is not to say that growth should be ignored. As shown in the chart, there are clearly times when growth outperforms value. During the dot com bubble from the mid 1990's through 2001, growth outperformed value, and in today's market, growth has once again outperformed value. The entire energy sector (value) has vastly underperformed the overall market due to the significant move down in oil prices. Value investors will now look at this area and invest in top rated companies for the long term. When these stocks will be re-priced upwards is anyone's guess. In the interim, they will provide reasonably safe income streams in the form of

[4] Value? Growth? Or Both? By David A. Koenig, CFA,FRM, Investment Strategist, Russell Investments, Index Insights, page 7

[5] Ibbotson SBBI 2015 Classic Yearbook: Market Results for Stocks, Bonds, Bills, and Inflation 1926-2012, Chapter 8, Page 119

dividends. The stocks may underperform for a lengthy timeframe, but you are being paid to wait.

Josh Peters, CFA wrote about this in Morningstar's The Dividend Investor in July 2015. He was also looking at the Fama–French data and concluded the following about high paying dividend stocks: "Invested at the average return of the U.S. stock market, a dollar at the end of 1927 became $3,013 by the end of 2014 — an average annualized return of 9.6% a year. Stocks whose yields fell in the top 30% of all dividend payers returned 11.1% a year in the same period. Compounded over 87 years, the extra 1.5 percentage points per year more than tripled the ending result ($9,569). By contrast, stocks that paid no dividends at all returned only 8.5% a year, leading to an ending value of $1,181 — merely one-eighth of the value the high-yielders produced."[6]

The answer to the question of value vs. growth, in terms of long-term performance, is that value has had the edge over growth. Because historical returns cannot be extrapolated, and there are periods when growth outperforms, broader asset allocation strategies should have exposure to both styles, though we favor value investing. For income-oriented investors, today's record low interest rate environment virtually mandates that dividend paying (value) stocks be included in portfolios. As it turns out, in the long term, it may also be the best way to win the investment derby.

[6] Morningstar, Dividend Investor, by Josh Peters, CFA, July 2015 Vol. 11 No. 6, page 3

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