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Value versus Growth Investing

Standard Definitions

Value Investing is thought to be the purchase of "cheap stocks." The idea, of course, is to purchase stocks below their "intrinsic value" and wait for that value to be recognized by other investors. Value investors speak of a "margin of safety" when making investments, or the gap between the price of the investment and its underlying value. To achieve the investment objective, value investors require the market price of the company to be "well below" the company's intrinsic value; ideally the discount will be no less than 33% of the intrinsic value. A challenge with this investment approach is the difficulty in determining true intrinsic value with precision. To be successful, the value investor must factor in a margin of safety large enough to offset the inherent uncertainty in the calculation of the stock's true worth. In addition, the value investor must ask what will cause other investors to finally recognize the "intrinsic value" of the stock, particularly when they passed on the investment opportunity originally.

Growth Investing is thought to be the purchase of fast and/or consistently growing companies, almost independent of the industry in which they compete. The idea is to buy the stocks of companies with sustainable growth and then let the company's value (stock price) increase as the company grows in the future. A challenge with this investment approach is that it assumes that the stock price and company's growth are directly linked, which is true only under specific circumstances and certainly not in all cases. To be successful, the growth stock investor must make accurate estimates of growth rates and overall profitability well into the future. In addition, the growth stock investor must assess whether the company can continue to exceed investor expectations with its future financial performance.

Warren Buffett was quoted in the 2000 Berkshire Hathaway Annual Report on the subject as follows:

> Common yardsticks such as dividend yield, the ratio of price to earnings or to book value, and even growth rates have *nothing* to do with valuation except to the extent they provide clues to the amount and timing of cash flows into and from the business. Indeed, growth can destroy value if it requires cash inputs in the early years of a project or enterprise that exceed the discounted value of the cash that those assets will generate in later years. Market commentators and investment managers who glibly refer to "growth"

> and "value" styles as contrasting approaches to investment are displaying their ignorance, not their sophistication. Growth is simply a component—usually a plus, sometimes a minus—in the value equation.

And once before in the 1992 Berkshire Hathaway Annual Report:

> In answering this question, 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 this 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 that 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?
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> 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, 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 his investment. 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.
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> 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. In the case of a low-return business requiring incremental funds, growth hurts investors.

John Burr Williams set forth in his seminal work, The Theory of Investment Value, published in 1938, the following equation for value:

> The value of any stock, bond or business today is determined by the cash inflows and outflows -- discounted at an appropriate interest rate -- that can be expected to occur during the remaining life of the asset.

As Mr. Williams comments, "growth" is merely a component of the value equation, while "value" is not a determinant of value.
Despite the brilliance of these two seminal thinkers on investing, we answer the value versus growth question as follows:

Value investors tend to buy stocks with low expectations with the belief that these expectations are "too low" and the factors causing the stock to be "undervalue" are only temporary in nature. Value investors believe expectations will increase in time because the current, but temporary, "conditions" will pass. Low expectations tend to correlate with "value" indicators such as low price-to-book ratios, low price-earnings ratios and high dividend yields. These metrics are merely coincidental indicators, however; the key to the investment opportunity is the low expectations for the stock.

Growth investors tend to buy stocks with high expectations, but with the bet that the expectations are also "too low" and will increase in time. Although expectations may already be high, growth investors believe expectations will increase as the company continues to produce better than expected financial results. Keep in mind that for most growth stocks, expectations already assume a high degree of future growth and high expectations tend to correlate with high price-to-book ratios, high price-earnings ratios and low dividend yields. These metrics are merely coincidental indicators and not a measure of investment fitness. Once again, the key to the investment opportunity is the "low" expectations for the stock.

In both cases the investor is betting that expectations are "too low" and will increase with the passage of time. Therefore, investing in either low expectations stocks (value) or high expectations (growth) is essentially the same bet. As such, we conclude that "value investing" and "growth investing" are exactly the same exercise, just bets on different sets of expectations.

Further thoughts:

"Value" stocks tend to have expectations of depressed cash flows or short CAPs; the investment payoff comes from the acceleration in cash flows (versus expectations) and/or a lengthening of its CAP. Value oriented stocks may also suffer from neglect (a potentially good thing) which may lead to an inefficiently priced security. Interestingly, neglect may be a consequence as well as a cause of low expectations. Value investors tend to focus on asset values when calculating intrinsic value. The implied hope/belief of the investor is that some catalyst will come along and allow the "market" to realize this hidden value. As such, traditional value investors are unwilling to forecast future earnings/cash flow growth in order to justify their measure of intrinsic value and do not want to rely on these growth forecasts when making investment decisions. Value investing usually requires two investment decisions: when to buy and when to sell; selling comes once the stock reflects "realistic expectations."

"Growth" stocks tend to have expectations for fast growing cash flows and long CAPs, and most times the underlying company operates with a high ROIC. Growth investors want a high unit growth rate to drive revenue growth and, ultimately, cash flows. Growth investors are betting that the company will create more value in the future than is implied by market expectations. The investment payoff comes from higher than expected cash flow growth, static to lengthening CAPs, or a higher return on invested capital (again, versus expectations). Growth oriented stocks may suffer from group-think or mania (a potentially bad thing) which may lead to a security being over-priced. One of the key paradoxes of growth investing is that investor expectations should adjust to upside surprises in the company's financial performance.

Therefore, for a growth stock to continue to increase, the underlying fundamentals must constantly, and continuously, exceed expectations. This is not a trivial accomplishment to maintain.

What about Risk?

Although both value and growth investing are fundamentally a bet on low expectations, value investors tend to be more sensitive to risk than growth investors. Furthermore, value investors tend to be very sensitive to capital preservation and, as a consequence, many value investors aim to deliver absolute returns. As such, value investors are reluctant to bet on the future as they believe it is challenging to forecast accurately and, in general, are unwilling to pay much for future promises. On the other hand, growth investors tend to be very sensitive to changes in growth rates and aim to deliver superior relative performance. As such, growth investors constantly bet on their “superior” estimates of future growth rates and profitability of individual companies and are relatively quick to abandon companies that fail to deliver consistent financial performance.

Bonus Question:

If value and growth investing are essentially the same exercise, what is the opposite of value investing?

First Principles

All assets

$$\text{Value of asset} = \text{PV(Cash flows)}$$

where PV = present value

For companies the equation is

$$\text{value} = \text{PV} \frac{\text{(cash flows from that company)}}{R}$$

where R = risk adjusted discount rate

expanding of equation, adding a duration component for the cash flows

$$\text{value} = \frac{\text{PV(cash flows, CAP)}}{R}$$

where CAP = competitive advantage period

for stocks, we need to access consensus expectations, rather than a single estimate

$$\text{stock price} = \text{Expectations} \left(\frac{\text{PV(cash flows, CAP)}}{R}\right)$$

Therefore,

$$\text{changes in stock price} = \text{changes in expectations} \left(\frac{\text{PV(cash flows, CAP)}}{R}\right)$$

which translates into

changes in stock price = changes in expectations of cash flows, and/or
= changes in expectations of CAP, and/or
= changes in expectations of R

where R = f(risk, interest rates)