Light Reading

Value vs growth investing – a distinction without a difference

R. B. Matthews and Doug McCutcheon

The person most responsible for China's extraordinary economic growth over the past 50 years is Deng Xiaoping, who led that country from 1978 to 1989. His most famous quotation was a homespun comment about a distinction without a material difference. "No matter if it is a white cat or a black cat; if it can catch mice, it is a good cat."

The investment world is rife with this type of unhelpful distinction. One of the oldest has lately had a lot of play – the distinction between value investing and growth investing.

Value investors are typically described as those who invest in companies priced inexpensively relative to their profits and assets. Growth investors are seen as those who buy fast-growing companies with less concern about the price – presumably based on their belief that the companies' growth will skate them onside.

For stocks, this contrast has been codified in indexes such as the Russell Value Index and the Russell Growth Index. Although different organizations define growth and value in somewhat different terms, all rely upon statistical metrics such as price-to-earnings (P/E), price-to-book-value (P/B) and growth in revenue and profits.

You don't have to think about this for very long before you realize that a company that qualifies as a value investment in one year may increase its growth in the next, potentially commanding a far higher price and becoming a growth investment.

This questionable distinction likely arose because financial academics, trained in mathematics, want to measure hard data, not apply judgment. Statistical measures, such as a P/E ratio and the percentage growth in earnings per share, qualify.

This way of thinking has gained currency in part because it allows investment firms to spin it for marketing purposes – creating new investment vehicles to differentiate themselves and gather assets. If a portion of a pension fund is currently managed by a value investor, then surely some of the fund should also be given to a growth investor to smooth out the returns. Or, given how well growth stocks have performed for the past 11 years, don't you think it's about time that value stocks will start to outperform?

In reality, while the contrast between value and growth may be useful for sales purposes, when it comes to improving investment returns, it is an unhelpful distinction.

To understand why, let's go back to basics. All intelligent investing involves trying to buy an asset, be it a farm, an apartment building or a business, for a price less than its economic value. So, all rational investing is, in effect, value investing.

What is the economic value of an asset? It is simply the value of the cash that you can extract from the asset over time (excluding what you may be able to sell it for).

In the case of a business, the economic value is the future earnings, discounted back to the present. The only way to come up with an approximation of that value is to estimate those future earnings, including the rate at which they are likely to grow. As you would expect, the estimate of future growth is done, in part, by examining past growth. A business that has grown its profits at 10 per cent annually is likely to grow its future profits faster than a business that has historically grown its profits at 2 per cent annually. As Warren Buffett has said, “growth is always a component in the calculation of value.”

Here’s an example. Assume Facebook Inc. has grown its normalized earnings at more than 40 per cent a year for the past five years and is trading at 27 times what it has earned over the past 12 months (that is, it has a P/E ratio of 27). Statistically, it is a growth stock. However, an investor, who has studied the company’s economics and the sector (including regulatory risk), and formed a view of the ability of management, may conclude that it is likely to continue to grow its earnings at an attractive rate over the long run. She might conclude that today’s price represents good value. To again quote the Oracle of Omaha, value and growth “are joined at the hip.”

Determining what price to pay for a given company requires far more than simply looking at metrics based on historical data and categorizing it as a value investment or a growth investment.

Whether you are in the market for cats or companies, focus on what matters – not largely meaningless distinctions.

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