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Asset Management

The Great Debate: Value vs. Growth

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Summary:

• The rivalry between growth and value stocks has built up over the past few decades in the investing community.

• Historically, Value wins – from 1926-2008, value outperformed growth. Professors Eugene Fama and Ken French attributed this outperformance to the riskiness of value stocks. Another, more behavioral, explanation might be that investors simply overpay for growth.

• Recently, Growth wins – Since 2008, growth has substantially outperformed value. Some attribute growth's outperformance to the ultra low interest rate environment we've been living in. Others believe that technological disruption has caused a permanent shift in markets, and traditional valuation metrics are no longer valid.

• Ultimately, there is no right or wrong answer as to which style is better. In fact, they are not mutually exclusive as some appear to believe. Labels can be misleading, as they tend to be overly simplistic and often do not tell the whole story.

Value vs. Growth

Value investing is when you buy a stock which is undervalued relative to its fundamentals, with the expectation that the price will increase to its true intrinsic value. Growth investing is when you purchase a stock with high prices relative to its fundamentals, with the expectation that the company's fundamentals will grow rapidly. In other words, value investing seeks to find the diamonds in the rough, whereas growth investing tries to find the crystals before they become diamonds. It's fair to say that growth and value form a dichotomy in the investing community.

Which has performed best in the past?

Professors Eugene Fama and Ken French, from Chicago's Booth School of Business, published a paper in 1992 on asset pricing called the "The Cross Section of Expected Stock Returns". In their paper, they observe that over time, and in aggregate, value stocks outperform growth stocks.

The historical evidence from 1926 to 2008 clearly supports this idea: value stocks outperformed growth stocks—and by a decently wide margin. The compound annual growth rate of the portfolio of value stocks was 12.80% as compared to the growth stock portfolio which earned 9%. Fama and French conclude that the reason for this outperformance can be attributed to the riskiness of the investments.

Modern Portfolio Theory states that assets which have systematically higher risks have to be rewarded with systematically higher returns to compensate investors for taking on that risk. Fama and French assume that value stocks outperform growth stocks in the long run because value stocks are stocks of companies that are systematically "riskier" than growth stocks (e.g. because they are close to default or because they are operating in an inherently more risky industry).

Another, more behavioral, explanation for this outperformance might be that in the past, investors simply overpaid for growth. It's easy to get caught up in the excitement of a company and to overpay for its stock. In 2000, everyone knew that the internet was going to grow quickly. If you believed in that growth, you probably believed that internet companies, like Cisco (which makes routers and switches) would also grow quickly. And, if you believed in that growth thesis, you were absolutely right. Cisco's revenues grew four fold to $49bn (300%), with profits quintupling to $11bn. However, if you bought the stock in 2000, your investment would currently be down close to 50%. Why? Because you overpaid for growth.

On the other hand, undervalued companies may not be as exciting and people tend to underpay for them. Benjamin Graham explained this concept by stating that "in the short run, the market is like a voting machine--tallying up which firms are popular and unpopular. But in the long run, the market is like a weighing machine--assessing the substance of a company."

Although value has outperformed growth in the past, growth has been outperforming value over the past decade. The recent history of such outperformance is even more astonishing. From 2017-2021, growth outperformed value by approximately 9% per year.

Some attribute growth's outperformance to the ultra low interest rate environment we've been living in while others believe that technological disruption has caused a permanent shift in markets. The world is different than it was when Fama and French wrote their paper. You can argue that their model uses old metrics for new markets. Software companies with high profit margins didn't exist then. Intangible assets (which are not factored into Fama and French's work) have a much larger impact in today's economy. In reality, the only constant in life today is change. So, it is possible that some of these theories, formulas, frameworks and rules of thumb that we have been following are no longer valid. On the other hand, "this time is different" is the biggest faux pas in investing.

While some people faithfully follow value or growth, you can apply aspects of both styles. They are not mutually exclusive as some appear to believe. Warren Buffet famously said "growth and value are tied at the hip". Growth is a characteristic of a business. Value is a judgment about what a business is worth.

When people commit to one style, it can lead to owning companies that are really not worth owning. For example, companies that look cheap might be cheap for a reason (i.e. a "value trap"). On the other hand, it's often not a great idea to buy a company's stock because it has an exciting narrative when it has poor business fundamentals and incredibly high expectations. At Cidel, we view ourselves as long-term investors in businesses. Rather than focusing on one particular style, our investment team strives to buy high quality companies at a reasonable price that will compound our clients' capital over the long term.