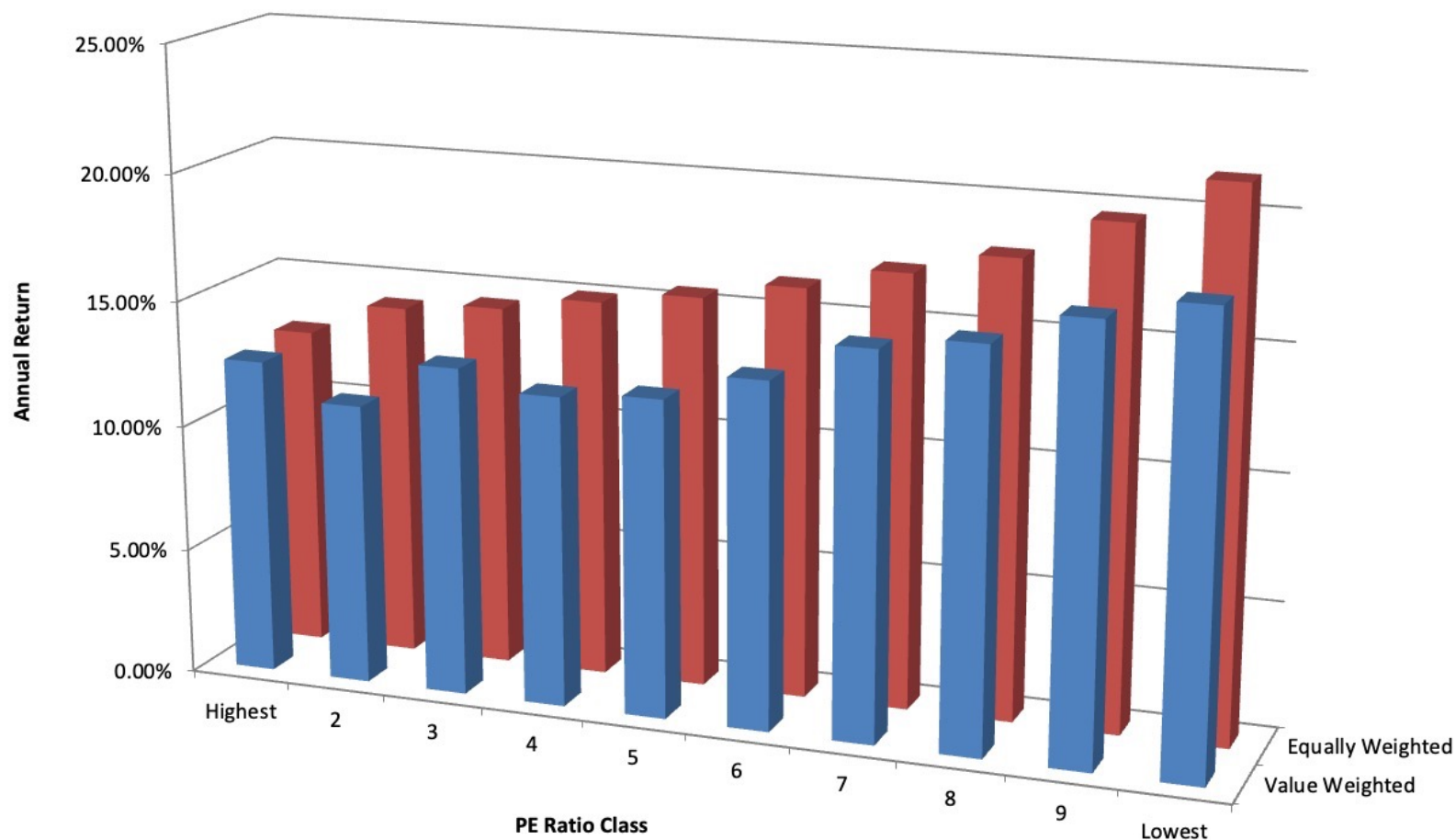


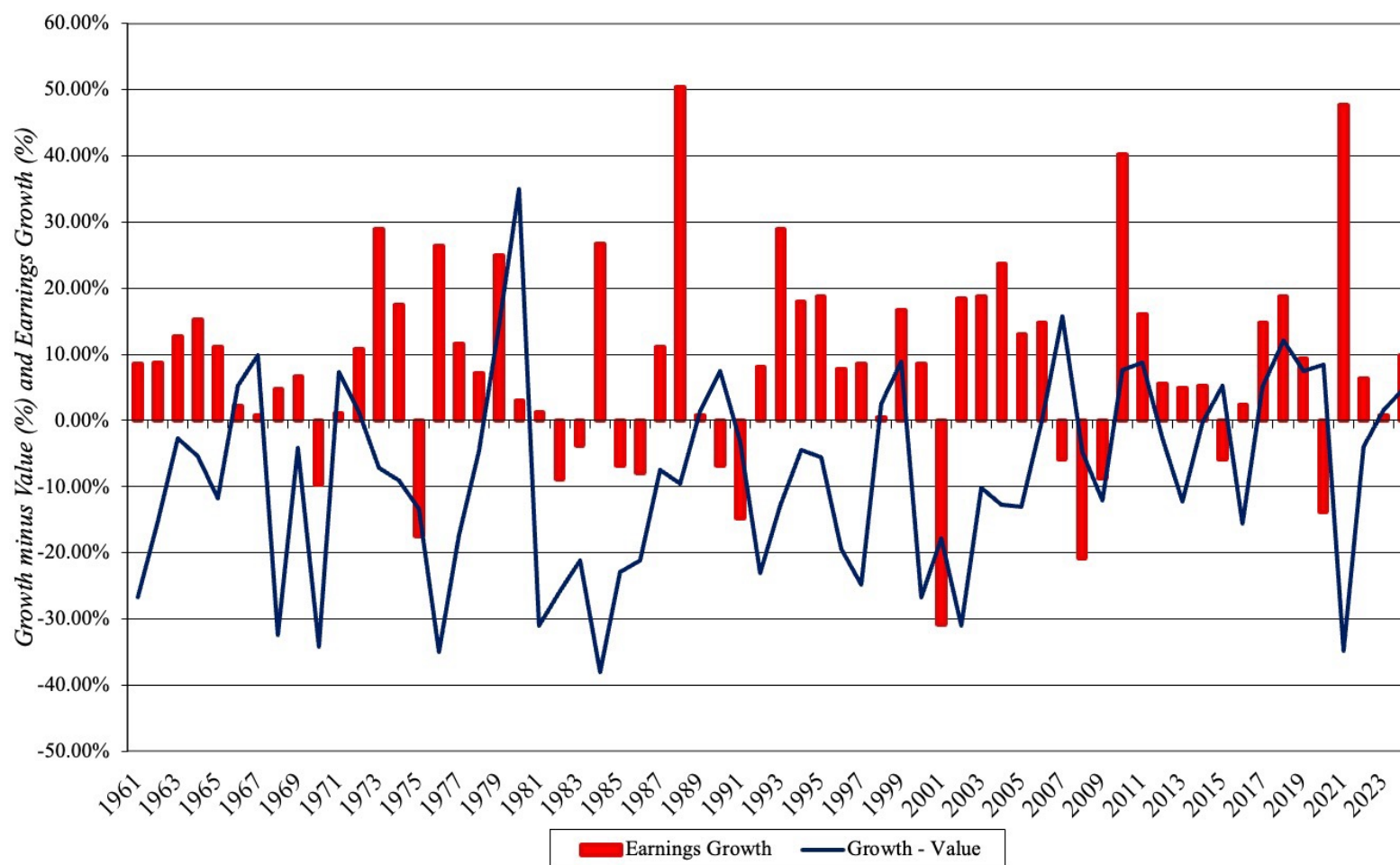
GROWTH INVESTING: AGAINST THE TIDE OF HISTORY

Against the odds!

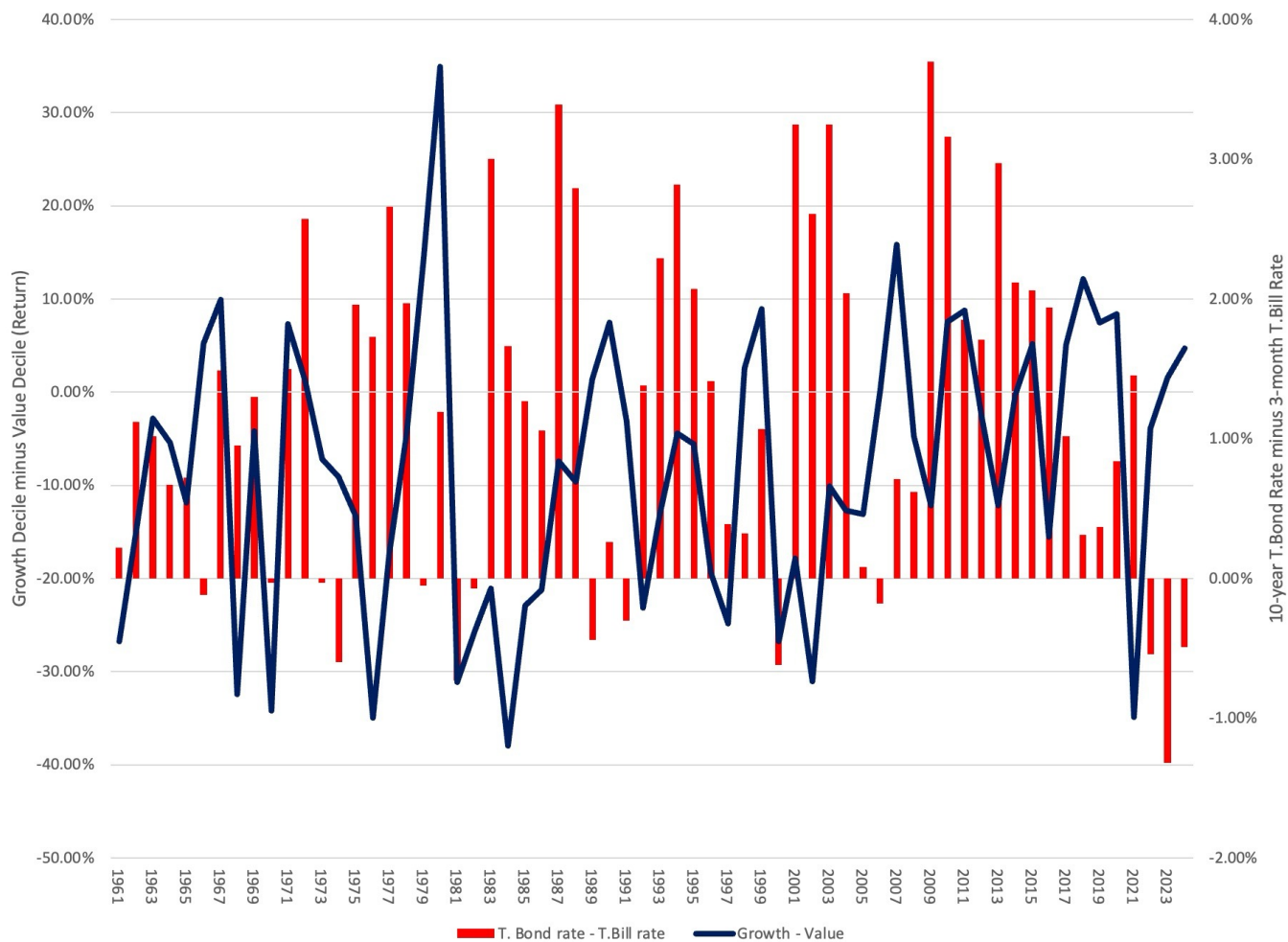
IN PASSIVE INVESTING, HISTORY HAS PICKED A WINNER...



BUT THERE ARE PERIODS WHEN GROWTH OUTPERFORMS VALUE ..



ESPECIALLY WHEN THE YIELD CURVE IS FLAT OR DOWNWARD SLOPING..



AND MAY BE WANING..

PE Ratio	1952-2018	1969-2018	1999-2018
Lowest PE	17.96%	15.08%	11.66%
2	17.21%	14.30%	10.91%
3	16.05%	13.90%	10.36%
4	14.73%	13.85%	8.98%
5	13.99%	12.25%	7.82%
6	12.27%	11.57%	8.34%
7	11.70%	11.34%	7.35%
8	12.03%	12.04%	9.02%
9	10.23%	10.21%	7.44%
Highest PE	11.82%	10.98%	9.98%
Lowest vs Highest	6.14%	4.10%	1.68%

ACTIVE GROWTH INVESTING SEEMS TO BEAT ACTIVE VALUE INVESTING...

- When measured against their respective indices, **active growth investors seem to beat growth indices** more often than active value investors beat value indices.
- In his paper on mutual funds in 1995, Malkiel provides evidence on this phenomenon. He notes that between 1981 and 1995, **the average actively managed value fund outperformed the average actively managed growth fund by only 16 basis points a year, while the value index outperformed a growth index by 47 basis points a year.**
- He attributes the 31 basis point difference to the **contribution of active growth managers, relative to value managers.**

RECONCILING THE CONTRADICTION...

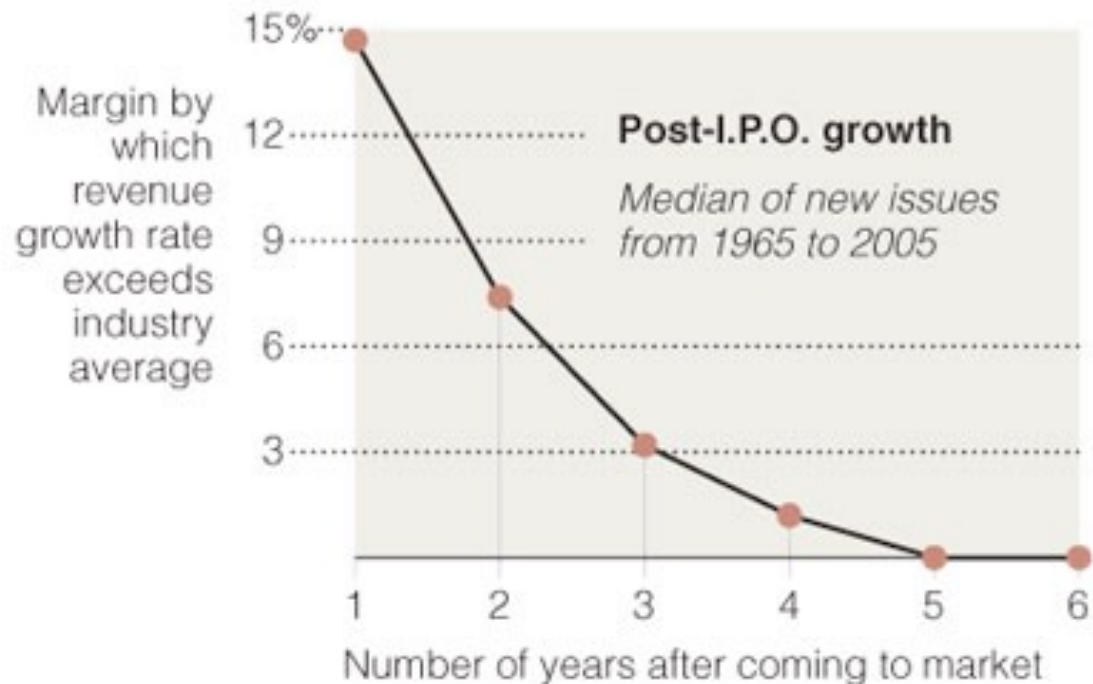
- **Selection bias:** The companies that are scrutinized by growth investors, for the most part, tend to be smaller and less followed than companies followed by value investors. Hence, there is a greater chance of finding mispricing.
- **Valuation difficulty:** Value companies are generally easier to value than growth companies. Thus, an investor who can bring valuation skills to the table can take more away from that table, with growth stocks than with value stocks.
- **Sector/Company specific knowledge:** High growth firms are often in nascent sectors, where having a knowledge of the sector (biotechnology, social media etc.) can provide an advantage to investors.

THE PITFALLS IN GROWTH INVESTING

- **The Scaling factor:** As companies grow, they get bigger, but as they get bigger, it gets more difficult to keep growing. If you underestimate scaling problems, you will have trouble with your growth investments.
- **Paying too much for growth:** Growth, by itself, can be good, bad or neutral for value. It depends on how much the company pays (in investments) to get that growth.
- **Playing the momentum game:** Since most investors in growth stocks have given up on trying the value those stocks, because of the uncertainty inherent in them, the momentum game is likely to dominate how these stocks get priced. That, in turn, may cause the pricing gap to increase over time, rather than decrease.

1. SCALING UP IS HARD TO DO...

Typically, the revenue growth rate of a newly public company outpaces its industry average for only about five years.



Source: Andrew Metrick

The New York Times

2. THE VALUE OF GROWTH

- **To generate growth, firms have to reinvest money** (in capital expenditures, R&D, acquisitions and working capital). That reinvestment reduces the cash flows.
- **The effect of growth then becomes a net effect, which weighs off the benefits of having higher earnings in the future (from the growth) against lower cash flows today.**
- **As a shorthand, the value of growth can be written as a function of the “excess returns” the firm earns on its new investments**, with excess returns being the difference between the return on the investment (ROE or ROIC) and the cost of the financing (cost of equity or capital).

IS GROWTH GOOD?

<i>All publicly traded firms</i>									
Region	# firms	ROE	Cost of Equity	ROE minus Cost of Equity	% Positive	ROIC	Cost of Capital	ROIC minus Cost of Capital	% Positive
Africa and Middle East	2,478	8.83%	11.54%	-2.96%	36.36%	6.59%	10.39%	-3.41%	29.80%
Australia & NZ	1,725	-11.82%	8.96%	-21.34%	18.32%	-6.37%	8.83%	-14.99%	18.57%
Canada	2,701	-16.53%	9.06%	-26.36%	11.51%	-7.34%	8.84%	-16.15%	11.64%
China	7,611	3.67%	10.45%	-7.06%	20.84%	3.58%	9.35%	-5.56%	25.60%
EU & Environs	5,782	5.72%	10.24%	-5.43%	31.27%	6.35%	9.12%	-2.25%	32.96%
Eastern Europe & Russia	423	6.51%	10.47%	-4.32%	25.30%	4.60%	10.11%	-4.63%	23.66%
India	4,788	9.77%	11.23%	-1.24%	39.16%	7.76%	10.47%	-2.72%	35.86%
Japan	4,023	7.83%	10.51%	-2.67%	35.30%	8.26%	9.03%	-0.30%	44.97%
Latin America & Caribbean	977	8.90%	12.79%	-4.01%	33.16%	7.87%	10.11%	-1.64%	35.42%
Small Asia	10,176	5.29%	11.23%	-6.76%	25.55%	4.45%	9.73%	-5.39%	25.23%
UK	1,064	2.29%	10.05%	-7.90%	27.16%	6.06%	9.26%	-1.86%	35.15%
United States	6,062	3.28%	9.24%	-6.27%	25.82%	5.77%	8.69%	-2.05%	26.27%
Global	47,810	4.53%	9.06%	-6.07%	27.40%	5.13%	9.26%	-3.95%	28.69%
<i>Only firms with positive operating income</i>									
Region	# firms	ROE	Cost of Equity	ROE minus Cost of Equity	% Positive	ROIC	Cost of Capital	ROIC minus Cost of Capital	% Positive
Africa and Middle East	1,341	12.65%	11.02%	1.03%	50.76%	9.48%	9.79%	-0.94%	42.13%
Australia & NZ	489	11.20%	8.96%	2.19%	56.43%	11.43%	7.91%	3.65%	59.92%
Canada	515	10.88%	9.07%	2.04%	54.75%	9.39%	8.14%	1.33%	56.50%
China	4,761	7.38%	10.25%	-3.23%	32.20%	7.35%	9.32%	-1.83%	39.21%
EU & Environs	3,120	13.21%	10.21%	2.56%	55.17%	11.04%	8.94%	2.11%	53.53%
Eastern Europe & Russia	200	10.37%	10.25%	-0.30%	44.03%	8.07%	10.02%	-1.89%	42.00%
India	3,109	13.19%	11.17%	2.04%	51.40%	10.98%	10.78%	0.48%	47.93%
Japan	3,368	9.28%	10.36%	-1.34%	41.24%	9.47%	8.95%	0.78%	50.98%
Latin America & Caribbean	590	12.69%	11.91%	0.76%	47.44%	9.75%	9.82%	0.18%	47.97%
Small Asia	6,247	9.23%	11.07%	-2.32%	38.77%	7.68%	9.60%	-2.13%	37.63%
UK	536	11.00%	9.81%	1.50%	52.45%	12.10%	8.99%	3.30%	58.96%
United States	1,987	12.33%	8.62%	4.13%	60.75%	13.02%	8.27%	4.74%	64.57%
Global	28,957	10.10%	10.37%	-0.48%	45.25%	9.13%	9.28%	-0.21%	46.49%

AND IS IT SUSTAINABLE?

		Type of competitive advantage (moat)				
		Brand Name	Switching Costs	Network Benefits	Cost Advantages	Legal Protection
Moat Width	Wide	Top brand	Infinite	Global	Permanent	Full
	Narrow	Name brand	High	Local	Temporary	Partial
	No Moat	Generic	None	None	None	None
Place in story		Margins	Customer Retention	Market Share	Profit margins	Pricing Power

3. THE PRICING GAME

- **A momentum game?** It is often easier to make money on growth stocks playing the momentum game than trying to value growth and get it at a bargain.
- **Delusional thinking?** While there is nothing wrong with playing the momentum game, there are many growth investors who delude themselves into believing that they are valuing growth companies.

THE BOTTOM LINE

- **A stigma?** Fewer investors seem to want to call themselves growth investors than value investors and part of the reason seems to be the perception that growth investors not only don't care about value, but that they are more speculators than investors.
- **Not true:** Good growth investors care just as much about value as good value investors do, but believe that their advantages in assessing value are greater with growth assets than assets in place.
- **Better odds:** To the extent that you will be able to generate excess returns only because you bring something different/unique to the table, the odds of doing so are greater with growth stocks, where uncertainty abounds, data is limited and estimation challenges are greater.