Session 19

Growth Investing: Growth at a reasonable price

Test

1. One simple strategy for investing in growth stocks is to invest in those stocks that have delivered the highest historical (past) earnings growth. Why might this strategy not work?
    a. Historical earnings growth is not a good predictor of future earnings growth.
    b. Even if historical growth has predictive power, the market may already be pricing in this growth.
    c. High earnings growth companies may be in riskier businesses than low earnings growth companies.
    d. Earnings growth may not be more the result of accounting ploys than operating success.
    e. All of the above
2. High PE stocks have historically delivered lower annual returns than low PE stocks. If you are a growth investor, which of the following justifications may you offer for still making a bet on high PE stocks?
    a. High PE stocks are usually less risky than low PE stocks.
    b. High PE stocks have lower transactions costs than low PE stocks.
    c. There are periods where high PE stocks do better than low PE stocks, and you are good at timing these periods
    d. High PE stocks generally pay higher dividends than low PE stocks.
3. A widely used GARP (Growth at A Reasonable Price) strategy is to buy stocks that trade at PE ratios less than their expected growth rates. If you adopt this strategy, which of the following are you likely to face?
    a. You will find too many cheap stocks when interest rates are low and the economy is growing strongly.
    b. You will find too many cheap stocks when interest rates are high and the economy is growing strongly.
    c. You will find too many cheap stocks when interest rates are low and the economy is in recession.
    d. You will find too many cheap stocks when interest rates are high and the economy is in recession.
4. The PEG ratio is the ratio of PE to expected growth. One GARP strategy is to buy stocks that trade at low PEG ratios. If you use this strategy, which of the following groups of stocks will you bias yourself towards in your investments?
    a. Low risk, low growth, low return on equity stocks
    b. Low risk, high growth, low return on equity stocks
    c. Low risk, high growth, high return on equity stocks
    d. High risk, low growth, low return on equity stocks
    e. High risk, high growth, low return on equity stocks
    f. High risk, high growth, high return on equity stocks

Explain. What can you do to mitigate this effect?

5. The key to being a successful growth investor is valuing growth potential. Which of the following companies is likely to have the highest value for growth? (You can assume that they have the same cost of capital of 10%)
   a. A company with expected growth = 20%, Return on capital = 10%
   b. A company with expected growth = 20%, Return on capital = 15%
   c. A company with expected growth = 5%, Return on capital = 10%
   d. A company with expected growth = 5%, Return on capital = 15%

   Explain.

Solution

1. One simple strategy for investing in growth stocks is to invest in those stocks that have delivered the highest historical (past) earnings growth. Why might this strategy not work?
    a. Historical earnings growth is not a good predictor of future earnings growth.
    b. Even if historical growth has predictive power, the market may already be pricing in this growth.
    c. High earnings growth companies may be in riskier businesses than low earnings growth companies.
    d. Earnings growth may not be more the result of accounting choices than operating success.
    e. All of the above

Explanation: Historical earnings growth is not a good predictor of future growth and may be the result of accounting choices. It is also possible that the price is set so high for growth companies that even if the growth continues, you will not be able to generate decent returns.

2. High PE stocks have historically delivered lower annual returns than low PE stocks. If you are a growth investor, which of the following justifications may you offer for still making a bet on high PE stocks?
    a. High PE stocks are usually less risky than low PE stocks.
    b. High PE stocks have lower transactions costs than low PE stocks.
    c. There are periods where high PE stocks do better than low PE stocks, and you are good at timing these periods
    d. High PE stocks generally pay higher dividends than low PE stocks.

    Explanation: If history is a good guide, it looks like you have to be a "market timer" to win by investing in high PE stocks.

3. A widely used GARP (Growth at A Reasonable Price) strategy is to buy stocks that trade at PE ratios less than their expected growth rates. If you adopt this strategy, which of the following are you likely to face?
    a. You will find too many cheap stocks when interest rates are low and the economy is growing strongly.
    b. You will find too many cheap stocks when interest rates are high and the economy is growing strongly.
    c. You will find too many cheap stocks when interest rates are low and the economy is in recession.
    d. You will find too many cheap stocks when interest rates are high and the economy is in recession.

Explanation: When interest rates are high, PE ratios will be low for any given level of growth. Thus, if interest rates are high and economic growth is strong, you will too many companies with PE ratios less than their expected growth.

4. The PEG ratio is the ratio of PE to expected growth. One GARP strategy is to buy stocks that trade at low PEG ratios. If you use this strategy, which of the following groups of stocks will you bias yourself towards in your investments?
    a. Low risk, low growth, low return on equity stocks
    b. Low risk, high growth, low return on equity stocks
    c. Low risk, high growth, high return on equity stocks
    d. High risk, low growth, low return on equity stocks
    e. High risk, high growth, low return on equity stocks
    f. High risk, high growth, high return on equity stocks

    Explain. What can you do to mitigate this effect?

Explanation: High risk and low quality growth (low ROE) companies will have lower PE ratios for any given level of growth. In addition, since PE ratios do not move proportionately with growth (if growth doubles, PE ratios will not double), high growth companies will look cheap on a PEG ratio basis. You can try adding additional screens to your PEG ratio screen to screen out these stocks.

5. The key to being a successful growth investor is valuing growth potential. Which of the following companies is likely to have the highest value for growth? (You can assume that they have the same cost of capital of 10%)
    a. A company with expected growth = 20%, Return on capital = 10%
    b. A company with expected growth = 20%, Return on capital = 15%
    c. A company with expected growth = 5%, Return on capital = 10%
    d. A company with expected growth = 5%, Return on capital = 15%

    Explain.

    Explanation: For growth to have the highest value, the growth rate has to be high with high excess returns (return on capital minus cost of capital).