WHITEPAPERS

Value and Growth: Two sides of the same coin

One of today's big debates is whether share markets are falling out of love with so-called 'growth' stocks and falling back in love with 'value' stocks. It can be worth paying attention to broad shifts in sentiment, but I think there is little utility in trying to divide stocks into these two arbitrary categories. Instead, it is better to simply focus on investing at rational prices in extraordinary businesses that have bright prospects. That's certainly what we do each day at Montgomery. In this white paper, I discuss how the meaning of the word 'value' has evolved since the days of Benjamin Graham and the importance of assessing the long-term potential of any company you invest in.

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What is value investing?

'Value investing' is the term applied to a style or discipline of investing. In equities, the concept of 'value' is typically a comparison between a share's current price and an estimate of its worth or intrinsic value. The value of a company's shares can be estimated using a variety of commonly accepted techniques including price-to-sales, price-to-book and price-to-earnings (PE) ratios. The most highly regarded and popularly employed method is the Discounted Cash Flow (DCF), a version of which is described in my book Value.able.

Importantly, great success in value investing has little to do with the ability to build business models in Microsoft Excel or with Python, or the ability to perform a mathematical calculation. Instead, it has everything to do with making superior assessments of a company's prospects. As Charlie Munger once said, in response to a question about what made him a successful investor, "My guesses are better than yours."

Understanding what a business can achieve – and how and when it will get there – requires consideration of its competitive position and the competitive landscape today, as well as how those elements will evolve. These considerations will inform the inputs into investors' models and valuations. If those inputs are rubbish, the result will be too.

Value investing as it's currently known emerged in the first quarter of the 20th century when early practitioners such as Benjamin Graham – the intellectual dean of Wall Street and the founding father of security analysis – were investing in stocks traded at a discount to the liquidation value of their balance sheet assets.

Back then, security analysis was only just beginning to make investing in stocks respectable. It was a time when equities were still shaking off their image as a poor cousin of bonds. So few were the number of practitioners – and so esoteric were the publications offering information about companies and their securities – that it was easy to find cheap stocks if you knew what to look for and where to find the information. Value was hiding in plain sight.

Importantly, many of the companies that fitted the early definition of 'value' – those trading at large discounts to their breakup value – were somewhat pedestrian in nature and of questionable quality. They generally weren't growing. Warren Buffett later nicknamed Benjamin Graham's value investing style as 'cigar-butt' investing – his targets had one last puff left in them.

Unsurprisingly, financially successful early adopters and proponents of value investing became heroes and gurus. The style also attracted a universe of fans. However, it is likely through some combination of the style of the early practitioners of security analysis – and the fact that the stocks they invested in offered little growth – that many commentators, rating agencies and observers came to see the value investing style as synonymous with investing in low-growth stocks with low price-to-sales, low price-to-book and low PE ratios.

It is worth noting an essential distinction at this juncture. Value emerges when a security is under-priced in the market compared to the present value of its prospects for cash flow generation. But the mere existence of a low price-to-sales, low price-to-book or low PE ratio does not mean a security is under-priced. In other words, a security is not under-priced just because it carries low valuation parameters.

The distinction is important because modern comparisons of 'value investing' and 'growth investing' generally use this rather limited definition of value.

Joined at the hip

It has been impossible to escape the implausible volume of published research and media commentary noting that value stocks have never performed so poorly relative to growth stocks. However, it's unfortunate that investment candidates and styles have been divided into the mutually exclusive labels of value and growth in the first place.

Whether for convenience or otherwise, managers, products and organisations have differentiated themselves using this delineation in investment styles. The categories have persisted for long enough now that researchers, academics and commentators have created scorecards to compare their success. Of course, continuing to update these scoreboards reinforces the distinction, as does the emergence of value and growth-oriented exchange traded funds.

In July 2003, The *Australian Financial Review* noted: "Managers of value funds look for stocks that are considered cheap based on price-to-earnings ratio and price-to-book ratio … Managers of growth funds invest in companies that are experiencing rapid revenue and earnings growth." Yet the simple fact is that one cannot value an asset without estimating its growth. The higher, faster or longer the growth, the greater the value of the company.

This means that value and growth are joined at the hip; they are two sides of the same coin. They are not opposing investment styles at all and the two should never have diverged in the minds of investors, market participants and observers.

If share market investing is about first identifying wonderful businesses, then about purchasing those businesses at prices likely to produce an above-average rate of return, then the inputs required include expected future sales growth, profit margins and return on equity. Growth naturally becomes a component of determining value.

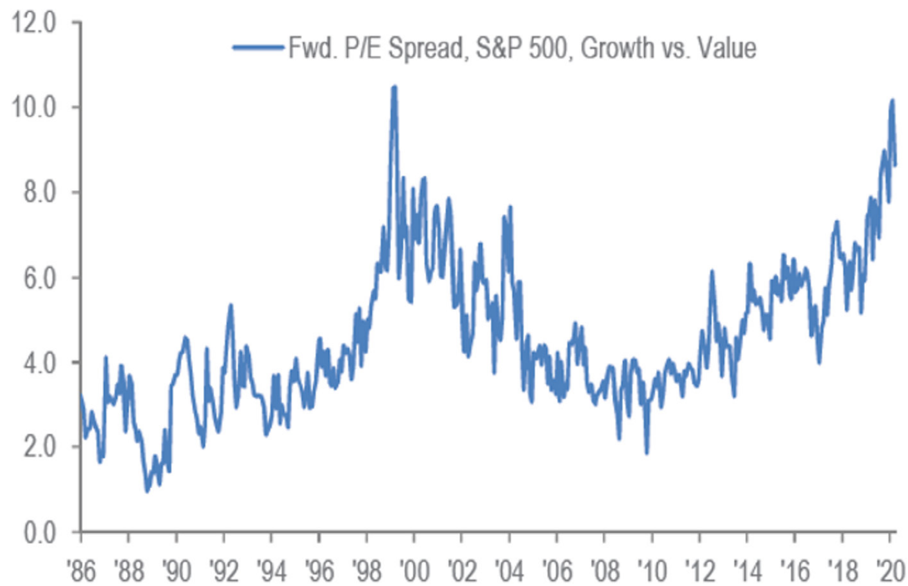
While there are challenges in using conventional methods, rapidly growing companies can be valued and therefore purchased by a 'value' investor, even when trading at a high valuation. No sensible and successful investor would think otherwise, perhaps explaining why Charlie Munger was prompted to also observe that "all investing is value investing."

Ignoring the noise

It follows that the whole idea of dividing the market into value and growth might be folly. It's necessary for investment industry marketing departments to differentiate their employers, but most investors will do just fine focusing on stocks as pieces of businesses and regarding the entire 'value versus growth' argument as noise.

If we put reality on hold for a moment and accept the fantastic notion that some companies issue growth shares and other companies issue value shares, or that at some point after issuance they become growth or value stocks, then the scoreboard that is Figure 1 will make perfect sense.

Figure 1. The Scoreboard: Relative Valuation of Growth versus Value



Source: J.P. Morgan. As at March 2020.

A rising line in Figure 1 reflects an expansion of the forward PE ratios of stocks categorised as growth stocks relative to the forward PE ratios of stocks categorised as value stocks. When the line is rising, growth stocks are beating value stocks; when the line is falling, value stocks are winning.

Figure 1 reveals a substantial relative outperformance of the growth style since 2010. It also reveals, historically at least, some cyclicity to the relationship between growth and value. And given that the dispersion of the two investment styles has not reached current 'extremes' since just before the tech wreck, in 1999, there is some merit in the idea that the line will 'mean revert.' In other words, value investing will, allegedly, begin to win again.

Understandably, recently published scoreboards note the superiority of growth investing and some commentators go further, announcing the death of value investing. But should we care about this debate at all, especially if the notion of 'value' is based on cigar-butt stocks?

At Montgomery we are indifferent to the growth versus value debate. We simply don't carve the market into value and growth categories. We just get on with investing in extraordinary businesses, with bright prospects, at rational prices.

Can a growth stock be good value?

The first question you might ask is how are company shares divided into value and growth to create charts like the one shown in Figure 1?

As noted earlier, the people who construct these scoreboards tend to simply divide the universe into quartiles, quintiles or deciles by PE ratios, price-to-book ratios, enterprise value-to-EBITDA ratios or some other market yardstick. Stocks with the lowest PE ratios might be labelled value stocks while those with the highest PE ratios are labelled growth stocks.

Although it may be true that the highest PE ratios could be assigned to those equities with the highest estimated growth prospects, it doesn't follow that equities with the highest PE ratios are exclusively growth stocks.

To put it another way: stocks with high PE ratios can also be value stocks.

If, for example, an investor estimates the growth of a company's revenue and/or earnings could be much higher than current consensus expectations, even a stock with a PE ratio in the highest quartile, quintile or decile could in fact be excellent value. This is what Warren Buffett meant when he said: "Irrespective of whether the business grows or doesn't, displays volatility or smoothens in its earnings, **or carries a high price or low in relation to its current earnings and book value**, the investment shown by the discounted-flows-of-cash calculation to be the cheapest is the one the investor should purchase."

Facebook, for example

Consider Facebook, which listed in May 2012 with what was then the world's highest market capitalisation for any initial public offering, at US$104 billion. Its PE ratio upon listing was 85 times earnings, which conventional wisdom would argue favours of the idea that it was priced like a so-called growth stock.

In the first two quarters of 2012, Facebook generated disappointing revenue growth and many analysts claimed the company had not found a way to monetise its growing mobile audience. But from the third quarter of 2012, Facebook began reporting revenue and earnings that exceeded analysts' expectations.

An investor who could see Facebook quintupling its 2010 user base over the ensuing nine years, monetising its mobile platform and growing revenue from US$5 billion in 2012 to more than US$70 billion in 2019 would have thought 85 times 2012 earnings was great value. As I mentioned at the beginning of this note, the essential part is the assessment of a company's prospects, not the ability to perform a mathematical calculation.

Indeed, irrespective of whether any analyst or investor actually did reach that conclusion, Facebook in 2012 was both a value and a growth stock. Back then, at IPO, its share price was US$38. That has since risen as much as 660%.

A new world

Unfortunately, most investors aren't invested in these types of companies – ones that can be bought at a reasonable price, while having the potential to deliver significant earnings growth. To understand why, it's worth considering how companies can grow their earnings.

The first way is to borrow money, which also increases balance sheet risk. The second is to issue more shares and increase the company's equity, though the problem with this approach is that additional capital dilutes those existing shareholders who don't participate in the raising on a pro-rata basis. The third way to grow earnings – and a preferred option for companies that can generate high returns – is to retain profits.

The final option, and first prize, is a company that doesn't need to retain profits to grow them. Simply raising prices without a detrimental impact on unit sales volume is a zero-cost and zero-investment example of how to achieve this. Once again, the PE ratio is deficient because it cannot account for the quality or cost of growth that companies exhibit.

Back in 1998, just prior to the first internet bubble, there were an estimated 150 million internet users globally. As of October 2020, that number has skyrocketed to almost 4.7 billion people, encompassing 59% of the global population. Today, 150 million people – the global total in 1998 – are using the internet in Brazil alone.

When the first internet boom kicked off at the end of the last century, it could be argued that the infrastructure required to support users and leverage the internet's full potential did not exist. Today, we have the computers and networks to power phenomenal growth in the adoption of, and use cases for, the internet. And given that less than 60% of the world's population is connected, the runway for growth also seems long.

Facebook, Apple, Amazon, Microsoft and Google – the FAAMG companies – are collectively worth more than US$8.3 trillion, and account for almost one quarter of the US$33.4 trillion S&P 500. Moreover, it can be argued these businesses are displaying economics that were previously unfathomable.

Warren Buffett and Charlie Munger have long advocated the purchase of businesses that can sustainably generate high rates of return on equity. Their purchase of See's Candies in 1972 at a multiple of equity per share effectively cut the umbilical cord to Benjamin Graham as they reached out for high-quality companies with growth potential, generating superior returns on equity. Such returns can only be generated by the presence of a competitive advantage, and the most valuable competitive advantage is the ability to charge a higher price for a product or service, without a determinantal impact on unit sales volume.

The FAAMG companies have this most powerful of competitive advantages. Although we may see a political win against their monopoly power, there is no doubt that monopoly power exists. Whether through scale, technology, patents, intellectual property, innovation, network effects or barriers to entry, the competitive advantages these companies enjoy are rare and valuable assets.

This is a justifiable reason for owning FAAMG shares, which helps explain their popularity among investors. They may be labelled growth companies, but because they could continue to accrue more economic value relative to more traditional companies with lower valuations, they could also be seen as value companies.

Price is not value

Comparing the success of the value investing method to the growth investing method relies on a rather limited definition of value. Often that definition includes the PE ratio.

Basic arithmetic can also show how the PE ratio, for example, can fail to identify value.

The company in Table 1 begins the period with $10 of equity, generates a constant 5% return on equity (ROE) and retains all of its profits, such that its payout ratio (POR) is zero. If we assume this company always trades on a one-year-forward PE ratio of 10, we will buy the company's stock at $5.25 and sell it two years later at $5.79, generating an internal rate of return (IRR) of 5%.

Table 1. Company generating 5% ROE with a PE ratio of 10

	Year 1	Year 2	Year 3	
Equity(b)	$10.00	$10.50	$11.03	$11.58
ROE	5%	5%	5%	5%
EPS	$0.50	$0.525	$0.551	$0.579
POR	0%	0%	0%	0%
DPS	$0.00	$0.00	$0.00	$0.00
Equity(e)	$10.50	$11.03	$11.58	$12.16
P/E	10	10	10	
Share Price	-$5.25		$5.79	
Cash Flows	-$5.25	$0.00	$5.79	
IRR			5%	

Now look at the company in Table 2, which also starts with $10 of equity and pays no dividends but generates a ROE of 20%. Buying and selling the shares of the company in Table 2, on a forward PE ration of 10, generates an IRR of 20%.

Table 2. Company generating 20% ROE with a PE ratio of 10

	Year 1	Year 2	Year 3	
Equity(b)	$10.00	$12.00	$14.40	$17.28
ROE	20%	20%	20%	20%
EPS	$2.00	$2.40	$2.88	$3.46
POR	0%	0%	0%	0%
DPS	$0.00	$0.00	$0.00	$0.00
Equity(e)	$12.00	$14.40	$17.28	$20.74
P/E	10	10	10	
Share Price	$24.00		$34.56	
Cash Flows	-$24.00	$0.00	$34.56	
IRR			20%	

While these examples are hypothetical, it is clear that the cheapest – or best value – of the two were the shares of the company described in Table 2, because they generated a higher return for the investor.

Interestingly, however, both had a PE ratio of 10, suggesting that PE ratio doesn't offer any insights as to which stock could be called value and which could be called growth.

Upon reflection, you may observe the shares of the company in Table 2 were better value and they offered more growth, to use the words with their common meaning. Or perhaps they offered better value because they provided more growth.

It's also worth noting that because both companies in this hypothetical example were bought and sold on the same PE ratio, typical scoreboards tracking the performance of growth and value – like that in Figure 1 – might place them both in the same category, undifferentiated.

It is relatively easy to demonstrate that the PE ratio doesn't determine the returns for a true value investor, even if the investor might attribute some importance to the measure. And those so-called growth managers – those that buy a portfolio of companies with the best growth prospects – are in fact value investors if their portfolio of companies generates growth in earnings that exceeds consensus expectations at the time of purchase. This probably explains why both value and growth fund managers may carry at least some of the same stocks.

Estimating value relies on estimating growth

Popularity plays a large part in determining the willingness of investors to pay a high multiple of earnings or revenue for a company's shares. But it doesn't follow that the most popular stocks are always those with the best growth prospects. Collectively, investors err in their estimates of growth and companies themselves can disappoint. And so, companies with the highest PE ratios aren't uniquely the best growth stories.

As we've demonstrated, the relatively recent convention of classifying growth and value stocks purely on PE ratio or some other market multiple is flawed. Stocks with high PE ratios can be value stocks, and stocks with low PE ratios may have them for a very good reason. The conventionally accepted method of classifying value and growth stocks is subjective, arbitrary and engineered for convenience.

Estimating the growth of a company's earnings or cash flows is necessary to estimate the value of a company's shares. And while attributing titles to stocks like 'growth' and 'value' is convenient for differentiation, they really are two sides of the same coin. In order to come up with a value, you have to estimate the growth.

Instead, successful investing requires a sound understanding of a business's prospects. Making superior judgements about qualitative factors such as the way a competitive landscape will develop and evolve is much more important than determining that a company is trading on a multiple of 30 times next year's earnings. Superior judgements regarding intangibles – such as how events will unfold in the future, which management teams are superior and which companies are more likely to take market share – are necessary when estimating value.

In that context, the Charlie Munger aphorism that "my guesses are better than yours" makes perfect sense. A stock can be on a high PE ratio, but if superior judgement reveals its future growth to be faster or longer lasting than most other market participants realise, then value is again available in plain sight – as it was for Benjamin Graham and his peers.

Bookending value investing

That last point is worth exploring further. On the value investing bookshelf, one bookend is the cigar-butt style employed by value investing's founding fathers, including Benjamin Graham. Moving along the bookshelf to the right, we accept that an estimate of growth is necessary for the estimate of value, and that more value is conferred on businesses that can grow faster or for longer than is being estimated by market consensus.

Imagine a scenario where attendees to a dinner hear the host quipping that they'd be willing to pay almost anything – certainly more than $10 million – for some rare, hard-to-find thing. The thing might be a work of art, a rare vehicle or some other artefact or collectible, but the point is the guests now know what someone else is willing to pay for it. Finding the item for less and acquiring it, even if at a record price, is a form of value investing if the buyer knows they will be able to sell it for more.

Of course, real-world opportunities offering such certainty are extremely infrequent, but the example serves to break the chains of current accepted wisdom as it applies to value investing. That is perhaps the opportunity for us and for you. While many value investing advocates remain wedded to the cigar-butt style that popularised it towards the middle of the last century, others have adapted, understanding that value and growth should never have been separated into mutually exclusive styles.

Markets are now global, information transfers across borders faster than one can blink and I can buy a product as easily from the other side of the world as I can from the store down the road. The infrastructure that supports this new world order vastly increases the profit potential of companies able to successfully harness and leverage it. The value of these businesses can therefore grow to be much higher than previously thought possible.

Meanwhile, there have never been more entrepreneurs ready to tap a never-before-seen pool of capital for innovative ideas. And innovation continues apace. New technologies and business models have the potential to disrupt the disrupters. The superseding wave of companies then have the potential to leverage the value opportunity by a multiple, through better efficiencies, faster speed to market, longer growth or greater share of wallet.

Finally, many new businesses are light on capital. Their products are built with lines of code rather than on assembly lines, meaning costs are low and profitability is extremely high.

The economics of the best companies exceed the margins and profitability of past winners by a factor. Incremental sales can be almost pure profit. As companies succeed in capturing market share and retaining profits, their returns improve.

These businesses also become more profitable as they become larger. This is certainly the case with FAAMG stocks, which have all increased their return on equity as they have grown larger. The value of such economic power cannot be overstated. Think of this as you might a bank account. You start a bank account with $1 million earning a 10% interest rate. As the bank account grows to $100 million it begins earning a 20% interest rate, then as it grows towards $10 billion the interest rate rises to 40%. These economics now exist, as do very long runways for growth, even if Benjamin Graham could never have imagined them.

At Montgomery, we believe buying companies below an estimate of their value will deliver excellent returns. We also believe excellent returns, and therefore value, come from buying companies that ultimately generate earnings growth in excess of consensus estimates. Our approach to investing spans the value investing bookshelf.

Investors should not be concerned by the scoreboard in Figure 1. Instead, they should be concerned that some analysts, with little practical business experience, have been recommending stocks at implied growth rates that are practically impossible for the underlying companies to achieve. When that happens, high-PE-ratio stocks are not good value and they destroy returns. The Figure 1 scoreboard would show growth stocks underperforming, but that's not an issue with growth investing or any particular investment style – it's an issue with the analysts' estimates.

If, in the future, growth underperforms value, it won't be because the PE ratios were higher. It will be because the predicted growth was not realised. And value investors will suffer too if their estimates of growth prove to be optimistic. As we noted earlier, the key to successful value investing is to correctly estimate the pace of a company's growth and its longevity.

Our brand of investing focuses on quality and prospects as an input to value. Buying stocks simply because they have low PE ratios isn't our gambit. We aren't value investors in the Graham mould, nor are we value investors as measured by scoreboard illustrated in Figure 1.

If we can buy a business today with equity that then grows meaningfully, while maintaining its return on equity, our investors will do well. And they won't need to worry about Brexit, China or the US Federal Reserve's next move. They also won't need to worry about being labelled a growth investor or a value investor, because they will be both.

Value investing is not limited to low valuation metrics or parameters. Value will be found in many forms. Remember, two sides of the same coin.

Do you want to get in contact with the team at Montgomery?

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