live mint

Print Close

Thu, Aug 11 2016. 09 28 AM IST

Value versus growth, or both?

Intelligent and sophisticated value investors look at the whole scenario and have no implicit assumptions.

Vikas Gupta

Shyamal Banerjee/Mint

Self-image of a value investor: Buy low, sell high
How a value investors sees a growth investor: Buys high, sells low

Self-image of a growth investor: Buy high, sell higher

How a growth investor sees a value investor: Buys low, sells lower

This is an age-old battle between so-called competing styles: value versus growth. These are the two warring fundamental investing camps that have been around for decades. This is also how the regulators look at it and how mutual funds classify and label themselves: value funds, blend funds and growth funds. This is how the financial media classifies and talks about funds, fund managers and investors. This is also how the academicians have analysed the styles, and how index companies create indices: value index, core index and growth index.

But most sophisticated investors look at this quite differently.

Typically, the criteria commonly looked at is the price-to-earnings ratio (P-E ratio). At any point in time there is a P-E ratio of the ‘market’. And usually, all stocks below the market’s P-E ratio are considered ‘value’ and the ones above it are considered ‘growth’ stocks. Some might look at the price-to-book value (PB) ratio. Value stocks are considered ‘bargains’ and growth stocks are considered ‘expensive’.

Academicians have carried out studies showing that value (i.e., PB ratio) or bargain stocks beat the markets over the long term. And they have earned Nobel prizes in the bargain (no pun intended). Their explanation of why value stocks provide higher returns is that they are riskier. There hasn’t been much proof from them about why these stocks are riskier; just hand-waving arguments about value stocks being closer to bankruptcy.

Studies by analysts focused on mutual fund performance have also shown that a majority (75-95%) of the funds are unable to beat market indices over the long term. While a majority of value funds also underperform the markets, a larger percentage outperform compared to growth funds. Here, too, the value style seems to be doing better than the growth style.

But is value really better than growth? And is this even the right question to ask?

In the typical characterisation of value, the focus is on the P-E ratio. The traditional value investor, the classic Benjamin Graham approach, does focus on the price paid. The implicit assumption is that if a low-enough price is paid, even a low fundamental performance of the company will result in a high return.

The growth investor focuses on growth in the company’s fundamentals, typically, earnings growth. The implicit assumption is that if a company with a high earnings growth is bought, even the high price paid for it will result in a still higher price when future earnings growth continue.

They are both right. But as Charles Munger, Warren Buffett’s business partner, put it aptly: “The whole concept of dividing it up into ‘value’ and ‘growth’ strikes me as twaddle. It’s convenient for a bunch of pension fund consultants to get fees prattling about and a way for one adviser to distinguish himself from another. But to me, all intelligent investing is value investing.”

Buffett, too, has spoken about the issue: “In our opinion, the approaches are joined at the hip.”

Intelligent and sophisticated value investors—in the mould of Buffett and Munger—who buy fundamentally strong companies at a discount to their intrinsic value, look at the whole scenario and have no implicit assumptions. They verify the conservative intrinsic value of the company based on its proven fundamentals and whether the company is available at a significant discount to this, i.e., has a huge margin of safety.

When one looks at a stock from the perspective of discount to intrinsic value rather than low price multiples, there is no longer any difference between value and growth.

A growing company can be a value investment when it is available at a significant discount, and be a growth company too since it is growing earnings at a pace faster than a typical company. It might still be available at a relatively high P-E or P-B compared to the market P-E or P-B ratios.

A smart investor wants to buy a growth company but doesn't want to pay for the growth portion.

Given that growth investors focus on the fundamental growth and don't pay too much attention to the price paid, they find it acceptable to pay a premium. At times, when they do pay attention to the price, they are turned into momentum chasers. They start confusing the price growth of the stock as valid justification rather than an earnings growth.

Typical value investors, with their focus on low P-E or P-B ratios, put too much emphasis on the low price and less emphasis on the fundamental business quality. In this case, they are exposed to value traps. These companies could be loss-making or highly leveraged or misallocating capital. In all these cases, even a low P-E or P-B might be a premium to intrinsic value of the company.

A smart investor understands that all investing is about doing a conservative estimation of the company's proven capability to generate cash flow (or demonstrated earning power) and then buying at a discount to the intrinsic value.

The best investment results come from investors who buy growth companies at a discount to their intrinsic value. Munger, Buffett, Peter Lynch and Philip Fisher are some of them.

Vikas Gupta is executive vice-president—traded markets and investment research, ArthVeda Fund Management Pvt. Ltd.