Research Report - 01/18

Value vs. Growth

A Comparison of Investment Strategies

Introduction

"Investment is most intelligent when it is most businesslike"
- Benjamin Graham

The most prominent representative of the value-strategy are Warren Buffett and the founder of this investment style, Benjamin Graham. Graham and Buffett generally agreed on a set of principles that have come to be referred to as "value investing" but they deployed those principles very differently.

The idea of value investing originates in Graham's Belief that careful analysis of a firm's financial statements could support an investor in uncovering bargain stocks. The term value investing is a commonly used by present investors and often misunderstood. Value investing is not easy, and it never has been easy. If anyone tells you it would be, we recommend you ignore them as they: (a) seem not to know what they are doing, and/or (b) might be trying to deceive you. To succeed over the long-term, one must invest for the long term, not by quarter, but year by year.

In general, the value strategy is characterized by investing in securities with underlying values that exceed their prices. In other words, this approach is concerned with finding stocks whose price does not reflect the fundamental worth a company. The reasons for a stock being undervalued – which means that the price is lower than the underlying value – can be manifold. Some examples are negative developments in the industry in which a company operates, an overreaction to a poor earnings report or other internal or external reasons. One of these reasons is sufficient to result in the stock being undervalued and, therefore, a potential long-term investment opportunity. As a consequence, an attractive company is one where the price differs from a measure of value of that firm. Thus, common criteria that may characterize value stocks are low price/earnings, price/cashflow or price/book value ratios. Morningstar defines value stocks slightly more generic as those with small ratios of price per share to different measures of value, including sales, earnings, book value, cashflow and dividends.

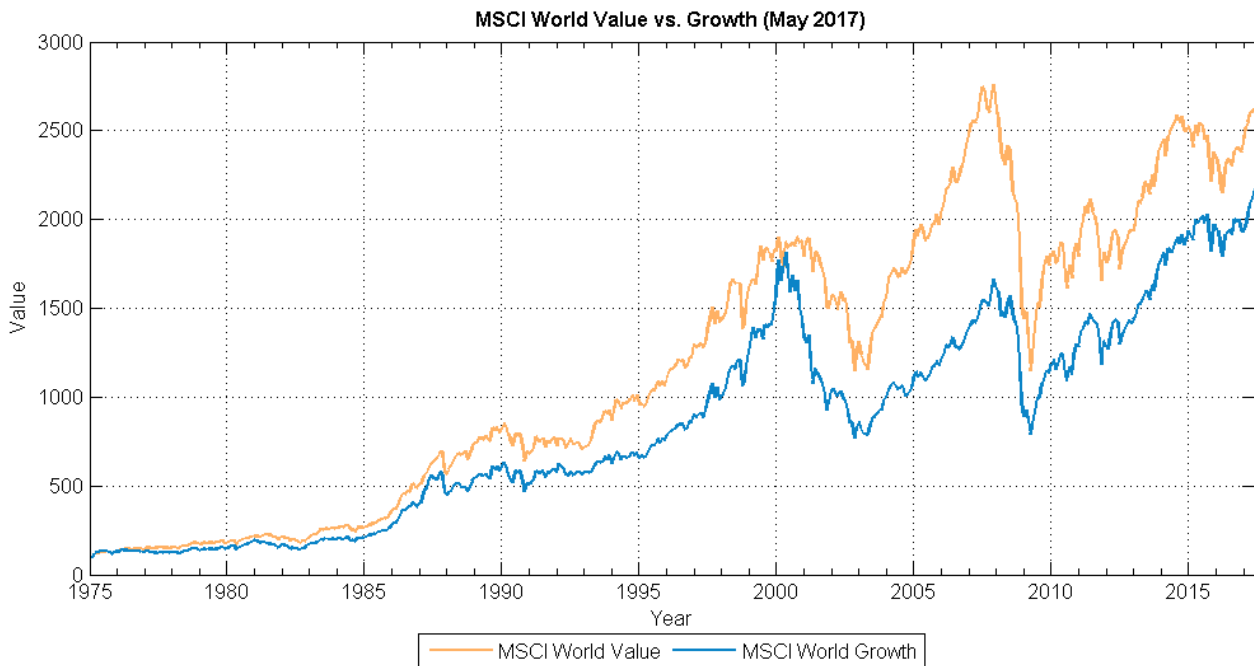
"To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework."
- Warren Buffett

Certainly, there exist different strategies in pursuit of value investing. A common form in recent years are strategies with cash-flow-based measures. Valuation threshold for the purchase of a stock may vary as well, with a 70-80% being one example. The idea of the value threshold is directly related to the concept of the margin-of-safety, which will be explained in more detail in a subsequent chapter.

In many comparisons and discussions, the value strategy is opposed to another well-known investment style, the growth strategy. According to the growth strategy, investors focus on companies for which they expect above average growth, for instance in terms of earnings or cash-flow. In contrast to the value strategy, companies that are attractive for growth investors have high price to value ratios. In the subsequent sections, we will compare both strategies in terms of performance and will point out the characteristics of the value strategy in more detail.

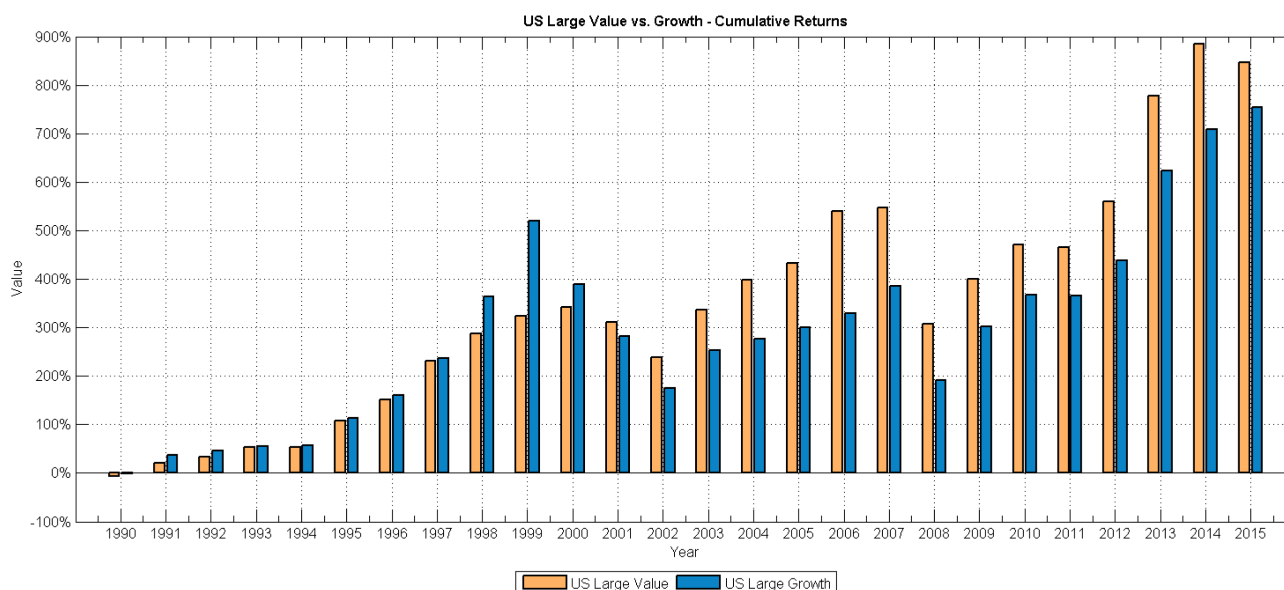
Performance of Value vs. Growth

Growth and value do not move in Tandem. Value stock have historically offered returns with less risk on the long run than typical growth or momentum-oriented stocks. A comparison of the MSCI World Value with the MSCI World Growth from January 1975 to May 2017 shows that the value-approach outperformed the Growth-Investment approach in this time horizon.



The average return of the MSCI World Value is with 8.00% p.a. on almost half a percent higher than the 7.53% p.a. earned by the MSCI World Growth (MSCI, 2017a). The MSCI World Value Index captures securities with large and medium capitalization according to the value style across 23 different developed markets. In contrast to that, the MSCI World Growth Index contains large- and mid-cap securities with growth characteristics in the same 23 developed countries. As a consequence, their performances can be considered as representatives of these two value styles in the developed world.

A similar picture can be obtained from the US market between 1990 until 2015. Taking, on the one hand, the average of the Russell 1000 Value Index and the Lipper US Index of Large Value funds to represent large US value stocks and, on the other hand, the average of the Russell 1000 Growth Index and the Lipper US Index of Large Growth funds, the performance of both strategies in this period can be highlighted.



As illustrated in the previous graph, the value strategy outperforms the growth strategy for large US corporations over the period from 1990 to 2015. The average annual return for US Large Growth of 8,60% underperforms the return of US Large Value of 9,03% (Fidelity Investments, 2016). The Nobel prize-winning economist Eugene Fama and the economist Kenneth French empirically observed that value stocks outperform other securities – and termed the additional return earned with value stocks the so-called "value premium". They found that this premium averaged 7.68% p.a. for the period 1975 to 1995 and about 6% p.a. in the period between July 1926 and December 2012. Moreover, in their study from 1998 value stocks outperformed growth stocks in 12 out of 13 major markets. More recent results from the last 12 months from May 2017 show that, the large value portfolio of Fama & French clearly outperformed the large growth portfolio with 31.57% p.a. compared to only 17.18% p.a. return. Finally, Bodie, Kane & Marcus conclude in their book "investments", which is a standard reference for finance and business professionals alike, that the evidence for value stocks typically shows that they outperform growth stock in the long-term in most countries.

In the subsequent question, we will explain why we consider the value investing strategy to be the most suitable strategy for investors in the long-run.

About the Difference between Price and Value

As an investor, one should not confuse the real success of an investment with its mirror of success in the stock market. The fact that a stock price rises does neither ensure that this coincides with the underlying business doing well nor that it reflects a change in the underlying value. Likewise, a price fall does not necessarily reflect adverse business developments or value deterioration.
explained, investors incur the largest losses when they purchase low-quality securities during periods of favorable business climate. They misjudge and confuse earnings power with the ability to generate good earnings during positive market conditions. However, "fair weather investments", which are acquired at "fair weather prices" will most certainly suffer large losses as soon as the weather changes (Graham, 2006).

On account of this, it is pivotal for investors to distinguish stock price fluctuations from underlying business reality. This is not meant as a recommendation to ignore the market – ignoring a source of investment opportunities would obviously be a mistake - but we want to stress that one has to think for oneself and should not be directed or driven by the market itself. In our view, value in relation to price, not price alone, should determine investment decisions. If you see “Mr. Market” as a creator of investment opportunities – meaning, where price departs from underlying value - you have the makings of a value investor. If, however, you insist on looking to “Mr. Market” for investment guidance, you might be best advised to hire someone else to manage your money. Since security prices can change for numerous reasons and, because it is impossible to know what expectations are reflected in any given price level, we think that investors must look beyond security prices to underlying business value - always comparing the two as part of the investment process. At the same time, this requires estimating the value that underlies a business – and this in turn requires a certain knowledge of an investment.

Most investors insist on trying to obtain perfect knowledge about their impending investments, researching companies until they think they know everything there is to know about them. Even though this seems a very intuitive approach to avoid unexpected losses, investors have to learn to live with less than complete information. There reasons are apparent: First, no matter how much research is performed, some information always remains elusive, and second, even if an investor could know all the facts about an investment, he or she would not necessarily profit from it in the future. This thought should not be confused with the conclusion that that fundamental analysis is not useful, since it certainly is. But information generally follows the well-known 80/20 rule: the first 80 percent of the available information is gathered in the first 20 percent of the time spent. The value of in-depth fundamental analysis is subject to diminishing marginal returns. Most investors strive fruitlessly for certainty and precision, avoiding situations in which information is difficult to obtain. It is however those situations that are characterized by high uncertainty, which are frequently accompanied by low prices. By the time the uncertainty is resolved, prices are likely to have risen. As a consequence, lack of information can in certain situations also go hand in hand with investment opportunities that others that seek complete information would avoid.

Imprecision and the Margin of Safety

It would be a severe misperception to think that all the facts that describe a particular investment are or even could be known. Even if the present could in some way be perfectly comprehended, most investments are dependent on outcomes that cannot be accurately foreseen. Even if everything could be known about an investment, the complicating reality is that business values are not carved in stone. Without a doubt, it would be rather simple for investors if the value of a business remains constant and the stock prices moved in a predictable way around this underlying value. However, it is obvious that this is not the case. How do value investors deal with the analytical necessity to predict the unpredictable? But if you cannot be certain of value, after all, then how can you be certain that you are buying at a discount? The truth is that you cannot. In our view, the only answer is conservatism. Since all projections are subject to error, optimistic ones tend to place investors on doubtful base. In these cases, virtually everything has to go right, or losses may be incurred. Conservative forecasts can be more easily met or even exceeded. Investors are well advised to make only conservative projections and then invest only at a substantial discount from the valuations derived therefrom.

Business value cannot be precisely determined. Reported book value, earnings, and cash flow are,

after all, only the best guesses of accountants who follow a fairly strict set of standards and practices designed to rather achieve conformity than to reflect economic value. Projected results are still even less precise. But not only is business value imprecisely knowable, it also changes over time, fluctuating with numerous macroeconomic, microeconomic, and market-related factors. Notwithstanding, investors must almost continuously reassess their estimates of business value in order to incorporate all known factors that could influence their appraisal. At the same time, they are at any given point in time not able to determine the value of a business with precision. But exact precision is not an imperative requirement for a successful investment strategy. In their famous book “Security Analysis”, Benjamin Graham and David Dodd discussed the concept of a range of value – "The essential point is that security analysis does not seek to determine exactly what is the intrinsic value of a given security. It needs only to establish that the value is adequate – e.g., to protect a bond or to justify a stock purchase or else that the value is considerably higher or considerably lower than the market price. For such purposes an indefinite and approximate measure of the intrinsic value may be sufficient" (Graham & Dood, 2009). Indeed, Graham frequently performed a calculation known as net working capital per share, a “back-of-the envelope” estimate of a company's liquidation value. His use of this rough approximation was a tacit admission that he was often unable to ascertain a company's value more precisely.

The estimation of value of a stock and the difference between this value and the actual stock price are the core aspect of value investing. In value investing, we have by definition a difference between the price of a security a value-investor is willing to pay and the value he or she estimates the security to have. This difference is the safety margin. The aspect of the bargain is the key to value investing. Because investing is as much an art as a science, investors need a margin of safety. This margin of safety is dependent only on the value of a security in relation to the price of the corresponding stock. The margin of safety may at a low price be a generous margin while at a high price the margin may be non-existent. The existence of a margin of safety does not guarantee that an investor can not incur losses with a security. However, the larger the margin of safety, the larger is also the change that he or she will profit from an investment rather than facing a loss. Hence, the margin of safety is directly related to the potential return as well as the risk of an investment. Investors always should expect prices to fluctuate. If an investor is not capable or willing to tolerate a certain amount of volatility, then we would not recommend them to invest in securities.

Volatility of security prices may even create investment opportunities. For instance, short-term price declines actually enhance the returns of long-term investors. If an investor holds cash, he or she is able to take advantage of such opportunities. If an investor is fully invested when the market declines, his or her portfolio will likely drop in value, depriving them of the benefits arising from the opportunity to buy in at lower levels. This creates an opportunity cost, the necessity to forego future opportunities that arise. This highlights the advantage of holding a certain amount of cash readily available for investment opportunities that may arise. It should be kept in mind that these investment opportunities should be sold when they reflect the underlying value. A related aspect is that current holdings should be replaced if better bargains are discovered. A better bargain is characterized by a higher margin of safety – which also means less risk of incurring a loss.

Difficulty of Setting Return Targets

Numerous books and articles have been written on discount rate estimation so we at Osiris Asset Management would like to summarize our view on this pivotal topic. Most investors are familiar with the capital asset pricing model (CAPM). In our view, academic proponents of this model – and

corporate finance in general – mistakenly equate volatility with risk. Volatility is not risk. For example, nonperforming corporate debt will have a high beta (given volatility expansion) but for a distressed investor (i.e., a person skilled in the evaluation of nonperforming corporate debt) such debt could represent a near-riskless investment, especially in cases with large margins of safety. However, this does not mean that volatility statistics in general, and factor models like the CAPM in particular, offer no insight into discount rate estimation. To explain this, first consider that risk transfer is often priced in the insurance industry via the volatility-adjusted expected loss of a risk at some level of confidence. In simplified form, this is effectively what the CAPM does for security pricing: adjusting a base, risk-free rate by the amount a security covaries with the market (covariance being a volatility metric). Understanding the implications of this within the context of an investment and/or corporate finance strategy could be invaluable. The reason for this is in our opinion that very few people deeply understand what a reasonable discount rate for a given investment or firm is. Neither do they understand what makes it reasonable and why, and how a firm could practically earn that return over time. Using the cost of capital approach remains a valid way.

The main aspect that an investor should understand is that setting an objective for the rate of return that he or she aims to earn does not make that return achievable. Indeed, no matter what the goal may be, it might be out of reach. Stating that one wants to earn, for instance, 15 percent a year, does not tell by itself how to achieve it. In our opinion, all an investor can do is follow a consistently disciplined and rigorous approach. This will make it most probable that the returns will then come over time. Consequently, investors should target risk rather than targeting a desired rate of return, even an eminently reasonable one. With the focus on a risk target, value investors will not invest in businesses that they cannot readily understand or those they regard as excessively risky. The majority of institutional investors, unlike value investors, feel compelled to be fully invested at all times.

A final point that has to be made in relation to return targets is the performance that the target as well as the evaluation of the returns is based on. Most institutional and many individual investors have adopted a relative-performance orientation. They invest with the goal of outperforming either the market, other investors, or both. They are apparently indifferent as to whether the results achieved represent an absolute gain or loss. Good relative performance, especially short-term relative performance, is commonly sought either by imitating what others are doing or by attempting to outguess what others will do. Value investors, by contrast, are absolute-performance oriented. Their interest in returns is limited to the aspect how they relate to the achievement of their own investment objectives. This highlights their absolute-performance orientation, which means that they are likely to prefer out-of-favour holdings that may take longer to come to fruition but also embody less risk of loss.

Despite their focus on absolute performance, value investors have a second emphasis on risk. Most other investors appear to be preoccupied with the performance they may achieve and not at all with how much they may lose. Value investors focus on both of these aspects – the returns as well as the risk associated with them.

The Essence of Value in Contrast to Growth

Value investing employs a bottom-up strategy by which individual investment opportunities are identified - one at a time - through fundamental analysis. Value investors search for bargains security

by security, analysing each situation on its own merits. The entire strategy can be concisely depicted as "buy a bargain and wait." Value investing by its very nature is contrarian. This implies a focus on securities that are out-of-favour and not popular at that time. The idea behind this strategy is that out-of-favour securities may be undervalued while popular securities almost never are. What the majority of investors, or in more animalistic terms – “the herd”, is buying, is by definition “in favour”. Securities in favour have already been bid up in price on the basis of optimistic expectations and doubtfully represent good value that has been overlooked. If value is improbable to exist in what “the herd” is buying, where may value exist? Value can presumably be found in what these investors are selling, unaware of, or ignoring. When “the herd” is selling a security, the market price may fall well beyond reason. Ignored, obscure, or newly created securities may similarly be or become undervalued. Investors may find it challenging to act as contrarians since they can never be certain whether or when they will be proven correct. Since they are acting against the crowd, contrarians are almost always initially wrong and likely for a time to suffer paper losses. By contrast, members of “the herd” are nearly always right for a period. Not only are contrarians initially wrong, they may be false more often and for longer periods than others. Market trends can continue long past any limits warranted by underlying value. It is clear that holding a contrary opinion is not always beneficial to investors. When widely held opinions uphold their false judgement of a price, nothing is gained by swimming against the tide. This is the main disadvantage for an investor that attempts to follow a value strategy. However, also here, patience is key to the investment success of a value investor.

Growth-oriented investors are confronted with several different difficulties. The first of these difficulties is overpaying for purely growth factors. Warren Buffett has stated that, "For the investor, a too-high purchase price for the stock of an excellent company can undo the effects of a subsequent decade of favourable business developments." It is logical that the faster the earnings or cash flow of a business is growing, the greater that business's present value. However, determining the value of growth prospects is difficult. Especially since it is difficult to estimate growth. While investors tend to oversimplify growth into a single number, growth is, in fact, comprised of numerous moving parts which vary in their predictability. Also, the growth strategy is focused on the future and earnings that are predicted to occur in the future while the value strategy focuses on the value of the earnings power at this point in time. It’s also this difference in terms of the perspective that separates these two investment strategies.

Conclusion

The idea of value investing is to always buy at a significant discount to underlying business value and ensure a suitable margin-of-safety. Value investors are not “super-sophisticated analytical wizards” who create and apply intricate computer models to find attractive opportunities or assess underlying value. The crucial part is discipline, patience, and judgment. Investors require discipline in order to avoid the vast amount of unattractively priced investments. The disciplined pursuit of bargains makes value investing to a large extent a risk-averse approach. The greatest challenge for value investors is maintaining the required discipline. Being a value investor usually means standing apart from the crowd, challenging conventional wisdom, and opposing the prevailing investment trends. Even though this may appear extremely challenging, over the long run the value approach works so successfully that few, if any, advocates of the philosophy ever abandon it.

It’s all about the thinking since investment success requires an appropriate mindset. If you decide to participate in the financial markets at all, it is crucial to do so as an investor, not as a speculator, and to be certain that you understand the difference.

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