Growth Investing: Against the tide of history

Aswath Damodaran
In passive investing, history has picked a winner...

Figure 9.14: PE Ratios and Stock Returns - 1952-2010
But there are periods when growth outperforms value..
And “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 additional 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.
1. **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.

2. **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.

3. **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.

• **The cost of 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.

• **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.
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.

Post-I.P.O. growth

Median of new issues from 1965 to 2005

Source: Andrew Metrick

The New York Times
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).
The Momentum Game

**Tools for intrinsic analysis**
- Discounted Cashflow Valuation (DCF)
- Intrinsic multiples
- Book value based approaches
- Excess Return Models

**Drivers of intrinsic value**
- Cashflows from existing assets
- Growth in cash flows
- Quality of Growth

**Tools for pricing**
- Multiples and comparables
- Charting and technical indicators
- Pseudo DCF

**Tools for "the gap"**
- Behavioral finance
- Price catalysts

**Drivers of "the gap"**
- Information
- Liquidity
- Corporate governance

**Drivers of price**
- Market moods & momentum
- Surface stories about fundamentals

---

Value of cashflows, adjusted for time and risk

INTRINSIC VALUE

THE GAP
- Is there one?
- Will it close?

PRICE

---

---