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Growth and value

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STOCKMARKET investors are divided, slightly artificially, into the value and growth schools. In the caricature, value investors care about the price and ignore the company's prospects; growth investors care about the prospects and ignore the price.

The schools go in and out of fashion. In the late 1990s, it was all growth; in the early years of this decade, all value. Over the long term, academic research has tended to suggest that value investors perform better. This seems to be because investors like to be on the "winning side"; they feel much better owning a technology stock, where it is possible to dream of exponential growth, than an engineering stock, where the future seems to point to inexorable decline. So they overvalue the former and undervalue the latter.

A new paper has approached the problem from a different direction. In theory, the value of a stock is equal to the future cashflows received by investors, discounted at the appropriate rate. The curse of investing is we know neither what those cashflows will be, nor the right discount rate to use. But because we have data going back many decades, we do know what cashflows investors actually received from individual stocks. As to the discount rate, we can use either the return from the overall market or that return suitably adjusted for a stock's volatility (its beta).

The result of the work is that the market paid on average a 50% premium for growth stocks, relative to value stocks, than a clairvoyant investor would have been willing to pay. Investors were right to think these companies would grow more; they just paid too high a price to get that growth.

That does not mean the value effect will work this year, or every year. But it does suggest that investors should show extreme scepticism if asked to pay high multiples for fashionable stocks. The odds are simply against you. Very few companies grow their profits at a rapid rate for an extended period.

* Clairvoyant Value and the Value Effect by Robert Arnott, Feifei Li and Katrina Sherrerd, Journal of Portfolio Management, Spring 2009, Volume 35 Number 3