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Spotlight

Elements of Style

Investors should strive to move beyond the conventional value versus growth argument.

Commentators often break down asset managers into two camps—value and growth. Although conventional wisdom has it that value managers buy stocks at bargain prices and growth managers prefer companies growing earnings faster than average, as with most things the reality is a bit more complex. After all, one would be hard pressed to get a growth manager to state that he buys stocks at unattractive prices, just as it would be to get a value manager to proclaim that she doesn't care about growth. Indeed, at a Morningstar Investment Conference a few years back one diligent attendee seemingly asked every panel of investment managers whether they thought of themselves as growth or value managers. To the surprise of many, few of the managers proclaimed themselves either. They viewed the terms as arbitrary—crude shorthand for low P/E versus high P/E stocks—and thought of themselves as more nuanced stock-pickers.

To be sure, there are real differences in the philosophical underpinnings behind the approaches that we refer to as value and growth. The risks associated with the biases and assumptions underlying the purest forms of these strategies are distinct and much more complex than represented by their mere location in the style box. By seeking to understand the rationale driving a portfolio manager's approach, an investor is better able to identify its benefits and limitations, and thus determine whether that manager can overcome biases inherent in the process to produce consistently strong long-term results.

The Problem With Pure Value Investing

Yes, so-called value managers are generally most interested in buying stocks at a discount to historical measures. At the heart of such a strategy is an often unspoken, and strong, faith in the principle known as regression to the mean. Despite the proclamations of efficient market theorists, stocks do become temporarily undervalued and overvalued. These trends, however, eventually correct themselves through normal economic and market forces toward long-term averages. Value-oriented managers seek to ride these fluctuations above and below the mean, by buying stocks cheap and selling them dear.

Although a powerful tool, regression to the mean is not perfect. It can proceed so slowly that it outlasts investors or so strongly that it fluctuates wildly about the mean, causing unwary investors to become whiplashed. More importantly, the mean itself is not static and may be unstable, hence the caveat above implying the need for "normal" conditions. Market extremes or an unforeseen paradigm shift may create a new, yet to be determined, mean. The most famous example of which occurred in 1959, when bond yields outpaced stocks dividend yields for the first time. Rising inflation and a change in the perception of the riskiness of stocks made that a lasting change, much to the chagrin of investors of the day betting on the supposedly inevitable course reversal.[1]

By frequently focusing on backward-looking metrics such as price/earnings and price/book, pure value managers are particularly susceptible to the foibles of regression to the mean. In theory, value managers need only ensure that a company can continue to do what it has done in the past, as regression to the mean does all the heavy lifting. As a result, they can fall into the trap of not looking ahead for changes that might tilt the mean. Any slow moving regression or paradigm shift could prove disastrous. Financial firms—a value manager mainstay—have been the stalwarts of the US stock market since the early 1990s, even holding up relatively well amid the bursting of the Internet bubble. Only after the sub-prime lending

meltdown and subsequent credit crisis of 2007/2008 did it become evident that past results for many firms were a house of cards built on extreme leverage and poor lending practices—leading to a shift in the mean expectations for earnings that have led to severe losses in stock prices.

The Problem With Pure Growth Investing

While value managers can get into trouble by counting too much on a return to normality, the stereotypical growth manager often suffers from thinking that past success can continue indefinitely. The technology boom of the late 1990s serves as a classic example. Caught up in the momentum and euphoria of the "New Economy", most growth managers dismissed the power of regression to the mean as they connected the dots of recent past performance into a linear projection that soared forever higher into the future. While growth-oriented managers are willing to pay what they consider a reasonable price today for potentially increasing or sustainably high growth-rates, there sometimes is a tendency to overreach. Like their value counterparts, growth managers frequently fail to look ahead at what might go wrong.

A penchant for investing in "story" stocks exacerbates the problem. Many growth managers seem able to tell "the story" about why a company they own is the next big thing that will exceed expectations and conquer all possible rivals. Sometimes these stories take on a life of their own beyond all reasonable facts and analysis of fundamentals. Such was the case with Enron, a growth story based on faith and not the soundness of its business model—one which was eventually shown to be fraudulent.

Best of Both Worlds

The drawbacks inherent in each philosophy in its purest form help to explain why prominent investment managers, such as those at the Morningstar conference, don't think of themselves as just "value" or "growth" managers. Indeed, as investment sage Warren Buffett has noted, "In our opinion, the two approaches are joined at the hip: Growth is *always* a component in the calculation of value."[2] Such an insightful view, however, highlights the difficulty for investors in distinguishing between investment managers. Not all "value" funds invest the same way, nor do all "growth" offerings. Investors need to be careful in thinking that just because they have the ubiquitous style box covered that they are fully diversified or insulated from the various pitfalls of regression to the mean.

Successful asset managers willingly combine elements of both styles as a way to minimize the risks of each. Any such strategy, however, must contain an effective forward-looking element—such as a bottom-up calculation of fair value—that brings discipline to the process. This tends to reduce the reliance on regression to the mean for value managers—as they set their own goal instead of relying on a potentially moving target—while providing a reasonable upside limit for growth managers to adhere. In satisfying criteria for both value and growth styles, managers are more likely to better understand the biases of each, allowing them to better anticipate any potential risks that lie ahead. As a result, investors are best served by worrying less about a particular manager's devotion to value or growth than in ensuring that their manager has a clear, forward-looking process for assessing risk and picking stocks.

[1] Peter L. Bernstein, *Against the Gods: The Remarkable Story of Risk* (New York: John Wiley & Sons, 1996), 172 - 183.
[2] *Chairman's Letter to the Shareholders of Berkshire Hathaway Inc.* (1992)

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