

Greg Smith: Investing for growth gives way to value



Looking for value, the way Warren Buffett does, is coming back into favour. Photo / AP

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By Greg Smith
OPINION:

It has been one of the most volatile starts to a year on record. The catalyst for investor angst is not Omicron, but instead fears over rising interest rates, and the knock-on effect on economic growth.

This has given rise to some concerns over stock market valuations, which have been elevated, particularly in the technology sector. Tech stocks have been at the epicentre of this year's sell-off, with the Nasdaq Composite index in correction territory, and recently down as much as 17 per cent from its November high.

The tech-laden index has made one of the worst starts to a year in the half-century of its existence, on a par with the 10 per cent fall in January 2008 during the global financial crisis.

Volatility has continued into February. The prospect of rising interest rates has thrust the spotlight on the surge in valuations of growth stocks that has occurred since the onset of the pandemic.

As a result, many high-priced tech names have gone into reverse, with more than half of the Nasdaq constituents having fallen 50 per cent or more from their 52-week highs. This has

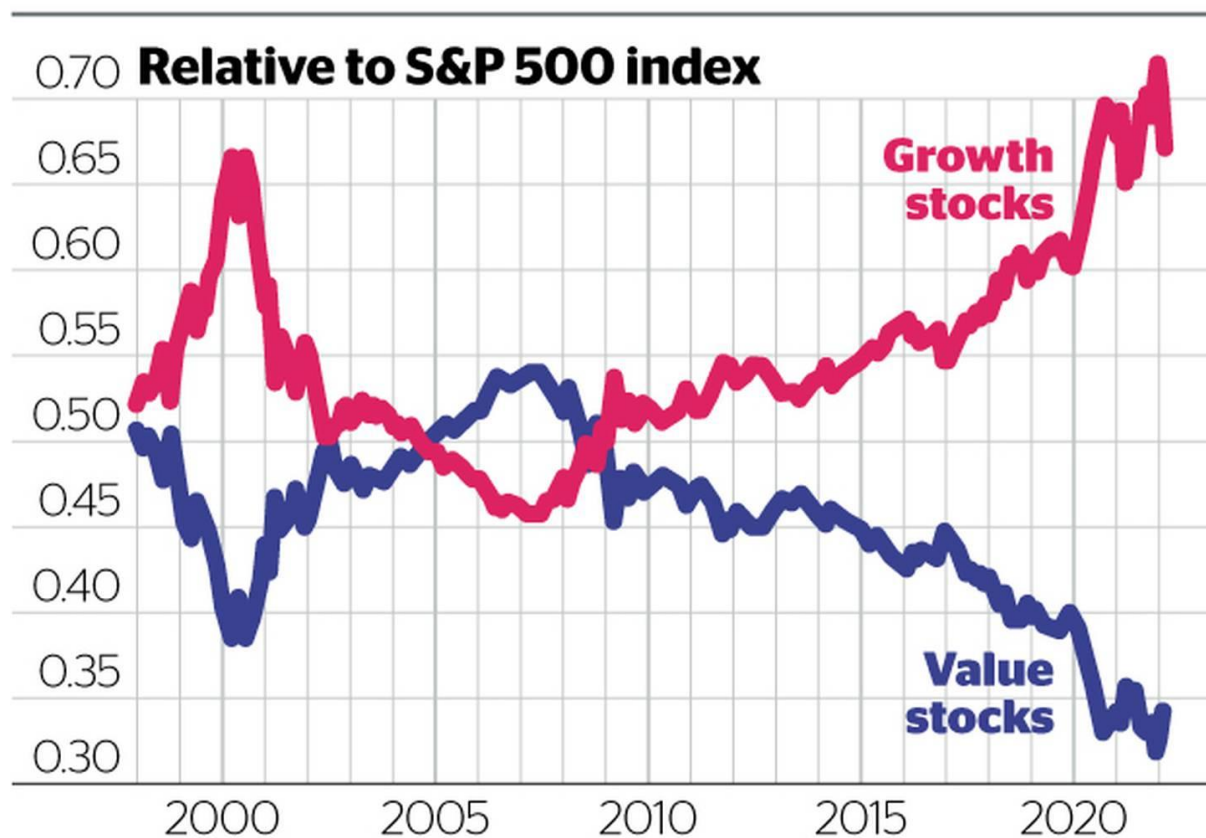
also led to questions over whether "growth" has had its day, and a change towards "value" style investing may be the story from now.

The term "value investing" is widely used — and often misunderstood. Many investors will know that "officially", the concept was developed by Columbia Business School professors Benjamin Graham and the lesser-known David Dodd in 1934. It was later popularised in Graham's 1949 book *The Intelligent Investor* (well worth a read if you get the chance).

Effectively, a value investing strategy involves identifying companies which are trading below their intrinsic value, which is modelled through the analysis of quantitative inputs (balance sheets, profit & loss, etc). Qualitative inputs (such as, but not limited to, the company's brand, business model, competitive positioning and management) are also assessed as part of the investment process.

Warren Buffett is one of the best-known disciples of value investing and arguably its most consistently successful proponent ever. Buffet studied under Graham and was mentored by him, and throughout his career has been at pains to point out what a successful value-based investment strategy is.

Growth v value



Source: Standard & Poor's and Haver Analytics / Herald Network graphic
One of Buffett's best-known quotes is that "It's far better to buy a wonderful company at a fair price, than a fair company at a wonderful price." This goes to the essence of the value investment ethos, which involves buying (high-quality) stocks at a discount.

Growth investing, meanwhile, is a widely popular alternative to value investing, and in many ways at the opposite end of the spectrum. This investing style effectively seeks out companies that exhibit above-average rates of earnings growth, and the assumption is made that they are likely to repeat this in future. Growth investors are typically willing to "pay up" for such levels of growth and pay above market multiples on a variety of valuation measures.

Investors using a growth style tend to take a view on a business' free cash flows well into the future. The higher interest rates are, and the longer the time before cash flows are expected to be generated, the less each dollar of that future cash is worth.

Given the above relationship, it may not surprise that growth stocks have been highly sought after while interest rates have been ultra-low, particularly since the global financial crisis. Substantial stimulus has been injected into the financial system during that crisis, and also during the pandemic. Central banks have maintained cash rates at or near zero, while also flooding the system with liquidity (for example, quantitative easing) to keep bond rates low.

These stocks have also been in demand as many high-growth sectors, led by technology, have had their earnings turbocharged by the pandemic, and by more people staying at home. Many older economy/value style sectors (think financials, industrials, reopeners) have in contrast been hampered by Covid, so have been less in favour.

This, and the era of low interest rates, have all served to extend the outperformance of growth vs value. This period of outperformance has endured longer than at any other time in the past 50 years.

In our view, there are several reasons why the environment in the years ahead may be much more favourable for value investing as opposed to growth strategies. Indeed, there is a case that this baton change may not only be fairly swift this year, but will also last a very long time.

At its simplest, the reality is that the ultra-low interest rate environment is coming to an end. Whether the Fed and other central banks will raise interest rates two, three, four, or five times this year is moot. The inflationary outcomes (successfully) delivered following unprecedented global monetary and fiscal stimulus mean that central banks are now focused on tightening measures, effectively "taking away the punchbowl". Interest rates are going higher, no question.

New Zealand's Reserve Bank was one of the first to go early on rate hikes in October, but markets are now facing the reality that most central banks will be in tightening mode this year. Some are still holding out, with the RBA in Australia sticking to a view that it will not increase rates until 2023 (even if the markets are pricing in multiple rate hikes well before then). But either way, interest rates will be heading north.

As noted, higher interest rates have a disproportionately negative effect on the valuations of growth stocks, which depend on cash flows expected far into the future. A dollar earned in the future will be increasingly worth less than it is today. The bar of expectations will rise, and this may already be playing out in the current United States reporting season. As we also know, where the US heads, the rest of the world tends to follow, and this may be the case with the move from growth to value in 2022.

While companies that have hit the mark (such as Amazon) have been rewarded, those which have delivered a negative surprise on their earnings outlooks have been severely punished, with Netflix, Tesla, Meta/Facebook and Spotify all recent high-profile examples in the US.

Netflix tumbled after having a great December quarter, but warning about the pace of future subscriber additions. Tesla reported a 760 per cent surge in quarterly net income but its shares tanked after Elon Musk said no new vehicle models will be produced this year.

And then there's Facebook's parent Meta Platforms. The company, formerly known as Facebook, last week reported a 20 per cent lift in quarterly revenue, but net income came in below forecasts. The stock fell 25 per cent, losing around US\$250 billion (\$375b) in value, the biggest one-day fall in US corporate history.

Does the reaction to outlook statements from these global tech growth names, which have boomed during the pandemic, mean the day of reckoning has arrived for growth stocks? It is quite possible investors are going to be increasingly aware of the high valuations many growth names continue to trade on despite the recent correction, and despite the prospect of ongoing interest rate rises.



Last week Meta lost around US\$250 billion (\$375b) in value in a single day. Photo / 123RF
Such a global trend could be highly relevant to investors in the New Zealand and Australian markets. The move away from growth will benefit companies that fall into the "value" camp. There is clearly substantial scope for a significant and sustained re-rating as the existing "value gap" closes, but also as "expensive" stocks fall further out of favour with global interest rates rising.

Value stocks should gain the ascendancy in a global economy which is growing strongly (the IMF expects growth of 4.4 per cent in 2022 and 3.8 per cent in 2023). Many "old economy" stocks and sectors tied to the economic cycle could thrive in such an environment.

Against this backdrop, it may be wise for investors to seek out and maintain exposure to high-quality companies with excellent investment credentials, including strong track records, robust balance sheets, great management, great economic moats, and strong long-term earnings prospects.

Ticking all these boxes, and ensuring that the right price is paid for each business, could well be essential to driving performance over the next stage of this cycle. As Warren Buffett also once said: "Price is what you pay; value is what you get."

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