GROWTH V. VALUE V. MOMENTUM

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Long-term investing strategies are often categorized as either "value" or "growth." Both strategies' ultimate goals are to achieve investment returns that are above the market average, under a long-term time horizon.

Traditional Fundamental Investment Styles

"Value" investing chooses among stocks that are selling at a discount to the underlying companies' "intrinsic" values. It anticipates that over time, the market will revalue the shares upwards to their fair value calculations. In the meanwhile, the investor collects income from a value stock's above-average dividend yield. The long-term foundational health of the company's financials and prospects is important for dividends to continue to be paid. Thus, the combination of yield income and the capital appreciation achieved when the stock price ascends to intrinsic value generates an attractive total return for the investor.

"Growth" investing mostly relies on above-average capital appreciation over the investment time horizon. Investors expect the market to continue to place, and even escalate, the premium valuation accorded to the well-above-average revenue and cash-flow streams at the company. To produce this high level of growth, the company is usually positioned as a leader in its industry; it can hold and fortify its competitive advantages, such as innovation, talent and best execution practices, through time. Escalating growth in top-line revenue, shareholder-wealth-building free cash flow and earnings are metrics incorporated into the lofty stock price level.

Examples of Value and Growth Stocks

Ralph Lauren (RL) is a good current example of a value stock. Implementation of a major restructuring program as well as general headwinds within the retail apparel sector have pressured revenues and earnings. Also, the announced departure of its CEO due to "creative" differences with founder Ralph Lauren has hampered stock performance. Fundamentally, RL has long-term intrinsic value not being reflected in its stock price today. The Ralph Lauren brand impressively ranks in the top 100 Premium Global Brands annual listing by Interbrand. It has low debt levels. Selling at a 14% discount to Morningstar's intrinsic value calculation, a 15x forward P/E multiple, and a dividend yielding 2.5%, value investors find the shares attractive.

An example of a growth stock is Facebook (FB). This social media company has the requisite industry leading market position, is innovative, has an abundance of talent in its top executives and it executes business plans impressively. Revenues have grown at a 5-year growth rate of nearly 50%. The stock pays no dividend and is priced at 40 times trailing 12-month earnings.

Momentum: A Basic Technical Indicator

“Momentum” is altogether in a different category than Value or Growth. It describes a trend in a stock’s trading pattern. Traders watch this over the short term, usually over a period of 6 months, perhaps up to one year. A law of physics, Newton’s First, ably explains momentum as it pertains to stocks: A body in motion, stays in motion, a body at rest, stays at rest, unless acted upon by a force. Think of the market as an ecosystem and the stocks within are the bodies that follow Newton’s rule.

Where Marginal Investment Dollars Tend to Flow

Stock market levels are determined by the amalgamation and synthesis of information, ranging from individual company fundamentals, to central bank setting of interest rates, to currency exchange rates, to participant levels of optimism (/pessimism.) The marginal dollar flowing into a stock determines its price level at a point in time. If the stock has been in motion on the upside, it will tend to stay on its upward course. The technical indicators ascribe that it has *positive momentum*.

Benjamin Graham, the 1920s pioneer of security analysis and the “father” of value investing famously said: “In the short run, the market is a voting machine but in the long run, it is a weighing machine.” It describes the interplay of momentum and short-term price motion with long-term stock performance. Often, familiar, “popular” stocks tend to get bid up not necessarily on an unemotional, purely analytical basis, and can often reach valuations that exceed any sort of rational expectation for future returns.

Momentum can affect downside stock price motion also. When a company stumbles, disappointed investors are often quick to unload the shares and the stock can fall precipitously. Recall the BP (BP) Deepwater Horizon disaster in 2010. The stock dropped 54% over the three-month period following the explosion and sinking of the oil rig, as the extent of the environmental damage became apparent. In that case, BP’s shares quickly become unpopular. For that period, there was a dearth of marginal dollars investing in BP. The *momentum indicator was negative*.

Seeking Margin of Safety and a Dividend Stream

When a stock falls below its long-term “intrinsic value,” at some point, value investors not worrying about emotional popularity find the security attractive. Of course, judgement must be made that the company’s stumbling block does not impair its long-term foundational health and prospects. Value investors start anteing up purchase dollars because the discount to intrinsic value allows for a “margin of safety.” Margin of safety is a desired multiple of “reward weight” over “risk weight” (referring back to Graham’s phrase about the market being a weighing machine in the long run.) For patient and confident investors, the combination of the margin of safety multiple and the dividend income stream makes holding the shares worthwhile.

Over the very long term (decades and generations) studies consistently show that Value style returns exceed Growth style returns. Stocks with margin of safety and compounding dividend streams, in the long run, have better returns than those received solely from capital appreciation based on an underlying company's projected future growth rates. This makes sense; escalating growth cannot go on forever; at some point over the course of a company's existence, growth does begin to decelerate. At the point when the company encounters diminishing growth while yet the shares are priced according to the historical growth trajectory, the price is vulnerable. With value, investors have more of a "bird in hand" return potential, as long as the intrinsic value calculation remains intact.

Discipline and Diversification Matters Most

No matter the investment style employed, we believe the tried and true portfolio traits of discipline and diversification still reign high above all else. Investors should always place a premium consideration on a manager's dedication to routinely focusing on these traits. In the long run, fundamental, rational, disciplined, diversified and patient management decisions should continue to produce above-average risk-adjusted returns.