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Revisiting the Case for Growth Stocks

Amid fears of war and daily stock market carnage, it may seem out of place to discuss long-term investment themes. Not too long ago, we saw a cartoon that summed up the feelings of many investors about long-term investing. The cartoon showed a financial adviser urging his clients to think long term. To make his point, he showed them an impressive upward-sloping, long-term performance chart – dated back to the Jurassic Age.

Cartoons aside, we are convinced that one of the most important things for investors to do at times like this is to ignore the emotions of the moment and think seriously about long-term economic and investment dynamics. We have recently been reading up on the history of the vicious 1973-1974 bear market, which unfortunately holds many similarities to today. We were encouraged to learn that some of the best investors of the last few decades were hit very hard during that period, but still managed to emerge as major long-term winners. What distinguished them was that they kept their focus, despite the intense gloom, and positioned their portfolios to rebound strongly when the markets recovered in 1975 and 1976.

Is Growth Investing Dead?

One issue that engages many financial advisers in the current climate is whether growth-oriented investment styles are dead. While there is an endless debate about exactly how to define different investment styles, one popular gauge of growth vs. value splits stocks into two groups. Growth stocks are defined as stocks that are expensive by a price-to-book value measure, while value stocks are defined as stocks that fall into the cheapest half of the group according to the same measure. As shown in Chart 1, growth stocks outperformed value stocks for many years and then came a cropper in 2001, when value stocks outperformed dramatically.

Naturally, results from 2001 convinced many investors to swear off growth stock investing forever, switching to value funds this year just as both growth and value styles took it on the chin. Now the rush is toward bond funds, just as bonds are beginning to look more overvalued by many measures than they have in decades. If a Japanese-style, decade-long deflation seems likely, then bonds may continue to be the investment vehicle of choice. But if growth resumes in the U.S. and other major countries, stock returns should easily beat bonds.

Before getting into the case for growth stocks, let's review some simple arithmetic. With a dividend yield of 2.4% on the Dow Jones Industrial Average, stocks need to have price appreciation just 1.2% per annum to match the return on 10-year government bonds that now yield just 3.6%. In other words, if the Dow maintains a dividend yield of 2.4% and rises back to only 8,600 over the next 10 years (based on 1.2% annual price appreciation), then its return will match the return of 10-year Treasury bonds. Of course, if the total return to stocks can recover toward low double-digits, stock returns will trounce bond returns. That's how dramatically the relative valuation between stocks and bonds has changed during the bear market.

So what about the case for growth investing? Our first observation is simple: In a low-inflation, low-return environment, growth is likely to be a scarce commodity for which investors will pay a

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premium. So we believe that an investment discipline that strives to identify companies with superior growth prospects and reasonable valuations will generate superior returns. With many mature industries facing intense global competition and declining profit margins, the number of "no-profit zones" in the economy could well be on the rise, adding to the allure of growth companies.

How "Creative Destruction" Affects Stock Market Averages

Our next observation is less obvious: In an environment of ongoing structural and technological change, relatively new companies are likely to displace established companies in a process of "creative destruction" that rewards innovative companies disproportionately. One of our strongest beliefs is that the process of structural and technological change is likely to accelerate over the next several decades, implying continual waves of creative destruction.

Many investors have been taught that buying and holding is the best investment strategy for the long run. However, there are some very important caveats to that approach that are not well appreciated. Owning broadly diversified portfolios – such as a basket of stocks that make up the S&P 500 index – has indeed been profitable over long periods. But owning the index has emphatically not been the same as a buy-and-hold strategy focused on specific companies. That's because the composition of popular stock market indexes has been changing at an accelerating rate in recent years.

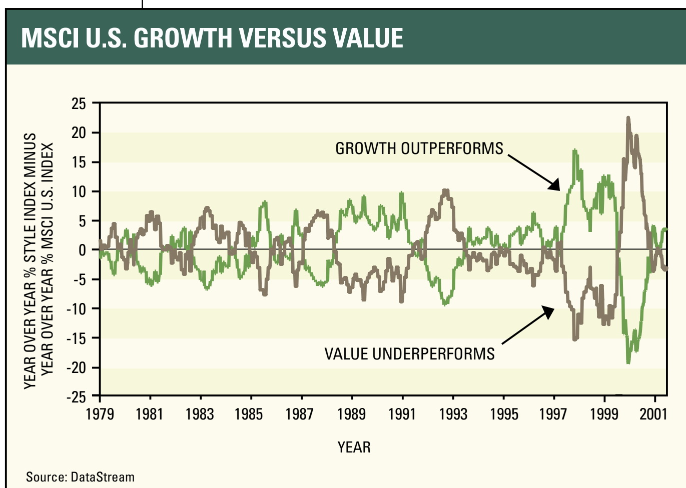

Chart 1: Value stocks outperformed growth stocks dramatically in 2001, but there have been long periods when growth outperformed.

Every year, new companies are added to the S&P 500 Index while old companies are dropped. Virtually every other major stock market index has the same characteristic. In other words, most "passive" stock market indexes function like active portfolios that let their winners run while continually pruning losing positions. Accordingly, the indexes have tended to do better than one might have expected based on overall economic trends. The competitive edge enjoyed by the indexes has been twofold: They have benefited from the value creation associated with dynamic new entrants and avoided value destruction associated with declining firms.

Richard Foster, a senior partner at McKinsey & Company, has studied this process extensively and reached a startling conclusion. Due to the continual churning of companies that make up the S&P 500, there were only 74 companies in the index as of 1997 that had been in the index 40 years earlier. And of those 74 survivors, only 12 outperformed the index over the 1957-1998 period. So even if you had known ahead of time what companies would turn out to be survivors over the next 40 years, a buy-and-hold strategy made up of those companies would have yielded lacklustre returns relative to the overall market.

Have You Driven a Studebaker Lately?

How lacklustre? According to Foster's research, if today's market index were made up of only those companies that were on the list as of 1957, the overall performance of the index would have been about 20% less per year than it actually has been. So the contribution of the new entrants, and the effect of dropping companies whose fortunes have declined, have been key features of the excellent returns delivered by the market averages over long periods of time.

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Creative Destruction, a book published in 2001 by Foster and co-author Sarah Kaplan, chronicles the rise and fall of many large companies. A key focus of the book is how the process of corporate birth and death affects overall stock market performance over long periods of time. One of the authors' major themes, as mentioned above, is that companies that have been long-term survivors have not necessarily been great investments for shareholders. An excellent illustration of that is in some work that Forbes magazine did in 1987 to celebrate the 70th anniversary of its original "Forbes 100" list of the largest American companies in 1917.

As shown in Chart 2, only 18 of those companies had managed to stay in the top 100 from 1917 to 1987. These companies – which included Kodak, DuPont, General Electric, Ford, General Motors, Proctor & Gamble and a dozen others – were clearly well-respected companies that weathered the Great Depression, several wars, numerous recessions and breathtaking technological change. As a group, however, these companies did not perform well for shareholders and earned a long-term return for their investors during the 1917-1987 period 20% less than the return of the overall market. Remarkably, only two of them, General Electric and Eastman Kodak, outperformed the market over the entire period, with Kodak subsequently having turned into an underperformer.

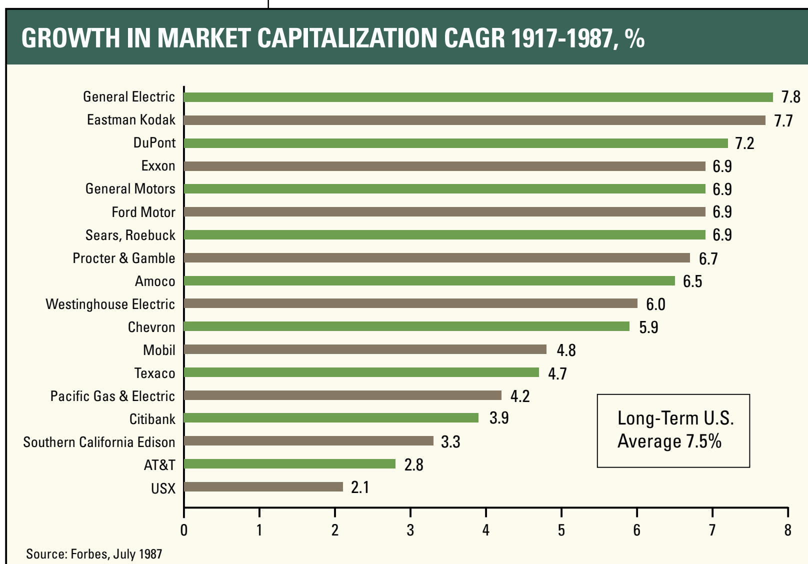

Chart 2: Only 18 companies that were on the "Forbes 100" list in 1917 managed to stay in the top 100 in 1987, and only two of them outperformed the averages.

Of the original "Forbes 100" list from 1917, 61 companies had ceased to exist by 1987 and yet another 21 had fallen out of the top 100 over the period. That illustrates just how tough it would be for buy-and-hold investors to beat the market over time even if they had initially focused on the bluest of the blue chips. Foster details the poignant history of some well-known companies that faded away, including Studebaker, American Locomotive and Anaconda Copper.

Many investors are currently aghast at the hubris of many corporate chieftains who failed to see the risks their companies faced, but a little history can quickly remind us that this is nothing new. Consider this 1968 prediction from C. Jay Parkinson, president of Anaconda: "This company will be going strong 100 and even 500 years from now." Three years later the company filed for bankruptcy.

A key conclusion from this bit of history is that generating superior returns over the long term will require more than owning a list of today's great companies and holding them for the long term. As growth-oriented investors, we believe in continually striving to identify which companies are up and comers and which are facing decline. The goal is simple: to let the winners run while continually pruning losers. There is no guarantee that this approach will work every quarter or every year. However, we believe that anticipating the dynamics of the creative destruction process is likely to be one of the best ways to generate superior returns over the long haul – and we are not talking about geological time scales.

Many forms of value investing focus on identifying mature companies that are temporarily selling below their warranted valuation level, and such strategies can clearly generate excellent returns if they are well executed. But one reason we believe that growth strategies will also come back into favour is that the total return to shareholders from investing in mature companies –

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like the "survivors" we mentioned above – has generally been below that of the returns generated by the dynamic new entrants.

Within specific industries, the average TRS (total return to shareholders) for young firms has been markedly higher than for older firms (see Chart 3). That doesn't mean that there are not occasionally great values among the mature firms. It's simply that the odds of finding great performers have tended to be higher among the new entrants. This is again based on the work of Foster and Kaplan, who theorize that small and mid-size firms are often undervalued relative to their potential growth, even when their P/E ratios may be higher than those of mature firms. Put differently, lower P/E ratios for mature firms have often been no guarantee against such firms delivering disappointing returns or eventually going the way of Studebaker, American Locomotives or Anaconda.

Fast Forward

The recent recession and stock market distress has currently slowed the pace of industrial change by temporarily curtailing the amount of risk capital available to entrepreneurs. However, that does not suggest to us that the process of creative destruction will grind to a halt. If anything, the trend over recent decades has been for the pace of change to accelerate over time.

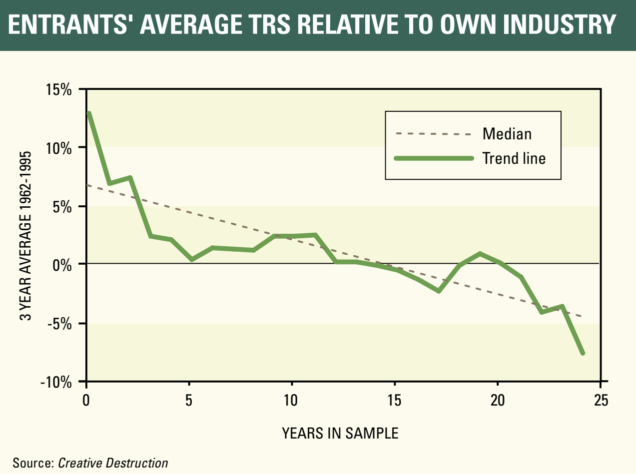

Chart 3: Within industries, new entrants have typically enjoyed a higher TRS (total return to shareholders) than mature companies.

In the 1920s and 1930s, for example, the turnover rate of companies in the S&P 90 Index averaged about 1.5% per year. That meant that a new entrant to the index could expect to remain on the list for more than 65 years. The corporations of that age were built on the assumption that change would come very gradually. In the 1990s, the average turnover rate of the S&P 500 reached nearly 5%, implying an average lifetime on the list of 20 years, not 65. Foster and Kaplan project that by the year 2020, the average lifetime on the index of a corporation will have fallen to about 10 years, as fewer and fewer companies fall into the category of "survivor."

This is not a particularly extreme assumption. Even though the turnover of the S&P 500 was about 5% on average for the 1990s, it approached 10% in 1998. As capital markets normalize and get back into the business of providing risk capital, we expect to see turnover in the constituents of the major stock indexes tick up once again, with a decent balance between the "creation" and "destruction" sides of the ledger. If that view is correct, it is likely that nearly 75% of the company names on the S&P 500 list in 15 years will be names most people have never heard of today. As a result, we believe that the process of anticipating technological and structural change and structuring portfolios accordingly will be more important than ever in the years to come.

During this intensely painful period, when the "destruction" side of the ledger has temporarily overwhelmed the "creation" side, we still believe that there is a bright future for growth stock investing. In the past, major rallies have inevitably followed major market shakeouts. In the rally to come, our goal will be to thrive, not just survive.

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