Cabot
WEALTH MANAGEMENT

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Cabot Wealth Management

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For years, value investing beat the market. Many academic studies and funds are based on it. Now, compared to growth investing, value has failed for more than a decade. Value practitioners are calling for a comeback, while others are calling it "dead." This argument has spilled from wonky investment committee meetings onto financial TV shows and the popular press. We look at some history and examine arguments on both sides.

WHAT IS VALUE INVESTING? WHAT IS GROWTH INVESTING?

First let's define some terms. There are two major "schools" of investing.

Value Investing: **Buying stocks whose price is low (or "cheap") when compared to their intrinsic value, or their earnings, sales, or assets.** Value investing is bargain-hunting; it places a heavy emphasis on discounts. We all love discounts, but this comes with a tradeoff: usually a company's shares are cheap because there is something wrong. The business may not grow or may be temporarily troubled.

> The underlying assumption of value investing strategies is that the market overreacts to bad news and punishes (by selling) stocks of companies that are struggling, leaving those shares priced less than they are worth. Eventually, the news fades or improves and the stocks rise to reflect true worth. That reversion to a normal price from a discounted one is what value investors are trying to capture. Quintessential value stocks today (and their perceived flaws) are large banks (stodgy, opaque) or auto companies (low margins, volatile earnings, lots of debt) and energy companies (no product differentiation, no pricing power, declining long-term demand.) Of course, at times these categories of companies were "hot." The challenge of the value investor is to pick the areas that can be hot again, or whose price reflects much more trouble than really exists, such that even bad news will not cause a stock drop.

Growth investing: **Buying stock of companies whose earnings are growing at an above-average rate.** Because recent growth tends to be followed by more growth, and recent stock strength tends to be followed by more strength, a growth investing strategy relies heavily on momentum. Growth investors buy stocks that are "working" and that have a rosy outlook. This style comes with a tradeoff: The stock price of fast-growing companies is usually high relative to their earnings, sales or assets, so a slowdown in the company's growth rate, or other bad news that deflates high expectations, can result in a big fall (in contrast to value stocks where bad news may be "in the price.")

> The underlying assumption of growth investors is that markets often underestimate future possibilities, and stocks under react to big long-term trends or big opportunities, sometimes by a wide margin. This century's quintessential growth stock, Amazon, started by selling books online. An astute growth investor would have seen Amazon not as a bookstore but as a platform for ecommerce… while also distinguishing it from other online businesses like Webvan and Pets.com, which ultimately failed. The rewards and risks are high in growth stocks because their worth depends on earnings that may be uncertain and/or far into the future. In many ways value and growth are opposites. A value investor might ask "What can go wrong that's not in the price?" Growth investors may (more optimistically) ask "What could go right that's not expected?"

WHY DOES THIS MATTER, AND WHY NOW?

It matters because style is a large determinant of equity returns. Like a pendulum, value and growth have swung in and out of favor. Such cycles can last many years, however there is no rule about length.

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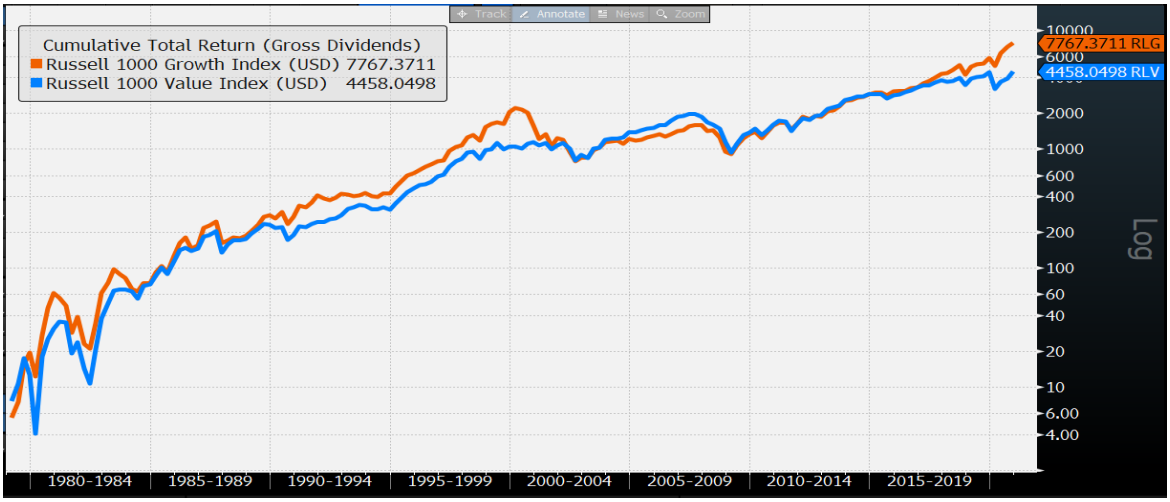
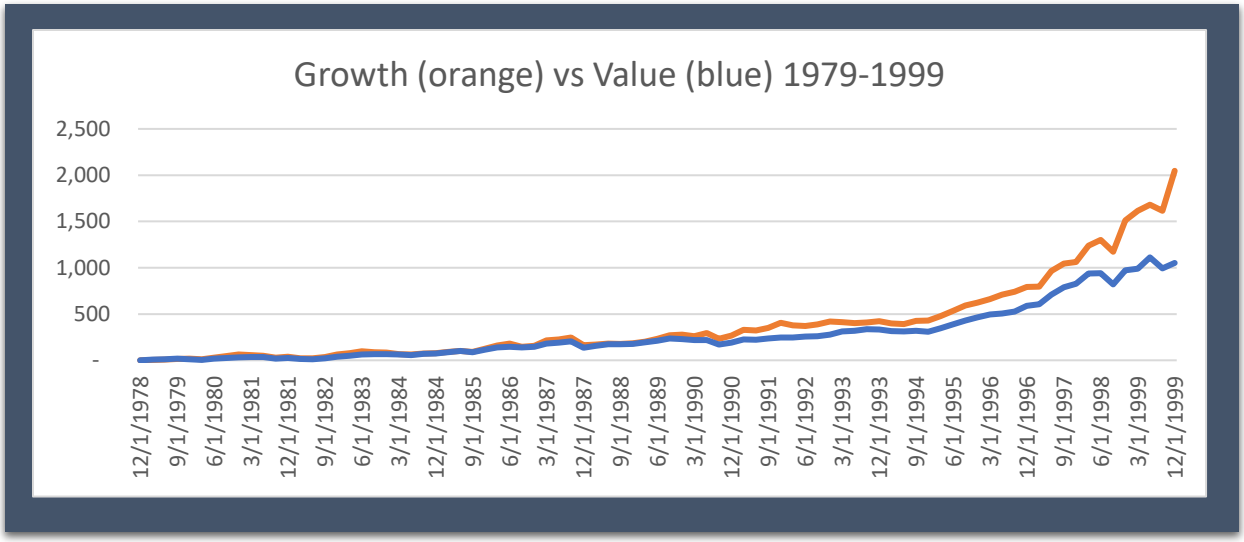
Index Provider FTSE Russell's composite of the 1000 largest US value stocks is known as Russell 1000 Value Index. It builds its index based on low price-to-book, i.e., stocks whose market value compared to accounting value (assets minus liabilities) is lowest.

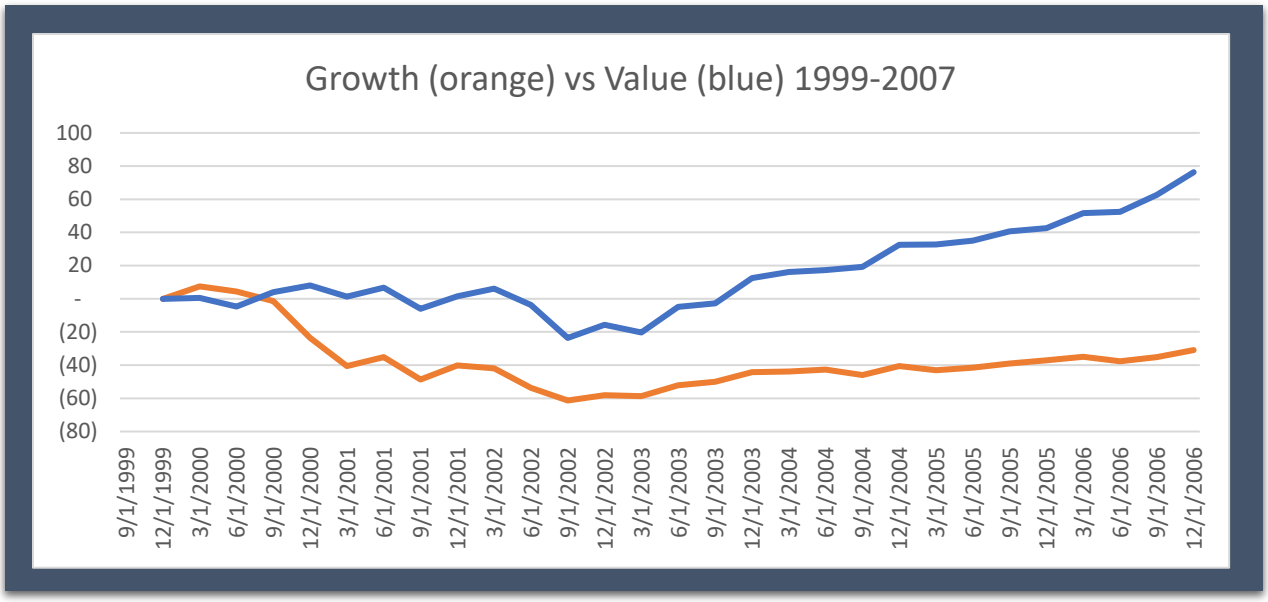
Similarly, FTSE Russell has a growth-oriented index called the Russell 1000 Growth Index, constructed based on forecast earnings growth and historical revenue growth. Here is a comparison over time. We use a logarithmic scale so that percentage changes are visible across the whole time period:



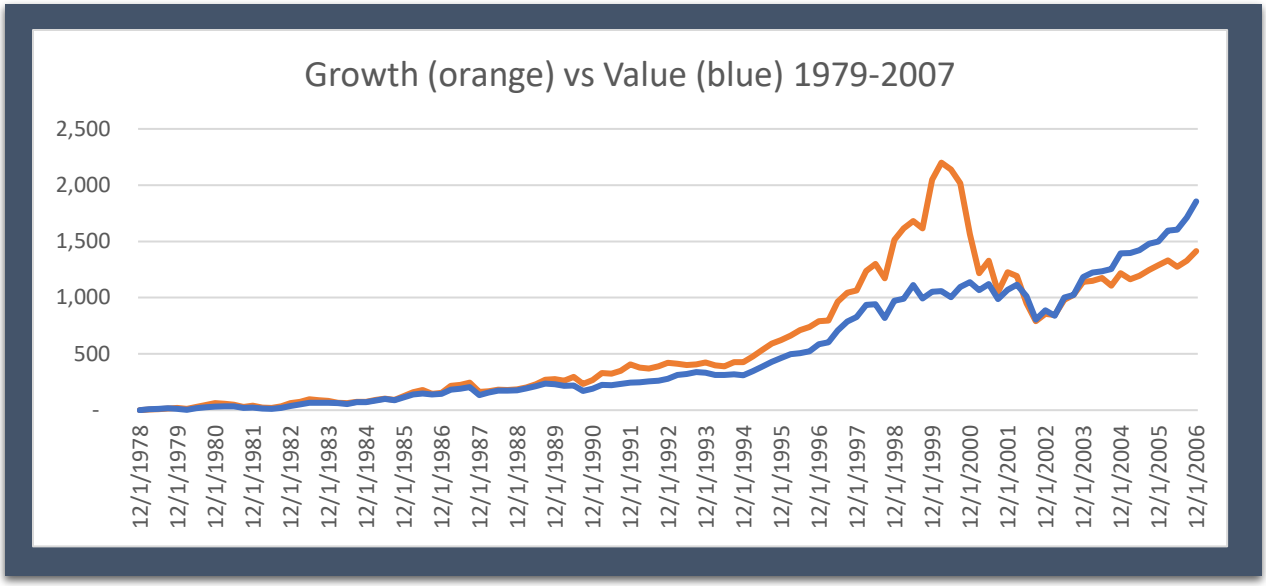
Based on 40+ years of data, one might conclude that it pays to go for growth. The difference over the period is hundreds of percentage points of return. However, this conclusion suffers from recency bias- an overemphasis on the latest data. Depending on your measurement period, the picture can change:



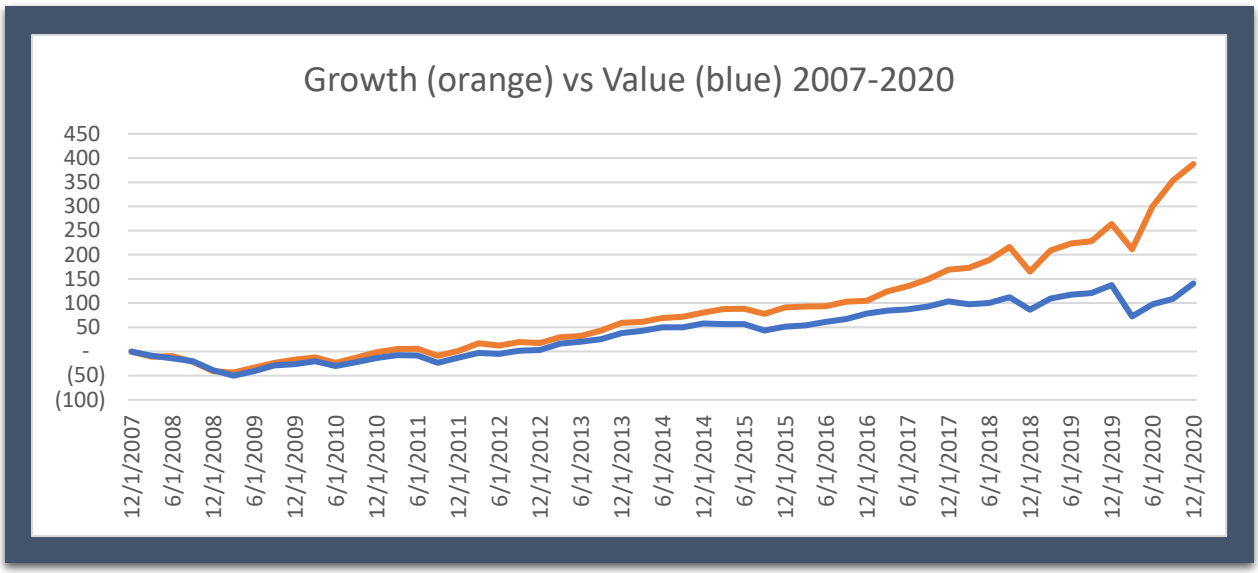
No brainer! Anyone looking at history of Growth vs Value at the peak of the tech bubble would have concluded that Growth wins in the long term. You would have had plenty of company, support and encouragement from the herd. But then…



Growth lost 30% while Value gained 80%! You might have reexamined your data, even going all the way back to 1979 to avoid recency bias…



Would you have changed your conclusion based on "the long term?" You would have had plenty of company, from financial media to academic research, helping you conclude that buying cheap stocks is the way to win over the long term. All the star investors at that time, from Warren Buffet to Ken Heebner to Bill Miller were value practitioners praised for dodging the tech bust by staying rational and buying bargains. Can you guess what happened next?



**Note: all charts depict Total Returns including dividends of the Russell1000 Growth Index and the Russell 1000 Value Index. I used year-end dates for simplicity (12/31/78, 12/31/99, 12/31/06) except for current data which runs to early December 2020.*

For this illustration I have carefully picked inflection points with the benefit of hindsight. The swing of the pendulum from growth to value and vice versa is irregular and unpredictable. It's not rhythmic. There is no prescription for its duration or strength. And you can see the damage that can be done, even over decades, by leaning the wrong way and especially by switching disciplines at the wrong time.

What now? It is tempting to conclude the pendulum is due to swing toward Value. It is also tempting to conclude that Growth is the right long-term choice. We'll examine the arguments on both sides by looking at some forces behind this pendulum.

WHAT IS BEHIND THE RUN OF GROWTH VS VALUE?

Both Growth and Value investing have intuitive appeal: Buying bargains makes sense, even if those companies are not in top shape. Buying companies with bright outlooks also makes sense, even they cannot all live up to lofty expectations. Both investing styles also have plenty of empirical historical evidence behind them. Finally, there are highly successful practitioners in both camps.

Going back to the first chart which showed 40 years of returns, Growth investing is in the lead today. To examine whether this is sustainable, or just a matter of timing, let's examine what has driven the difference, with an emphasis on the past decade.

Tailwinds for Growth Stocks 

We are in a low-interest rate, low-inflation world. That favors growth companies. Here is why: In general, money has a time value. A dollar in the future is worth less than a dollar today. (If you disagree with this, then give me $100 today and I'll return it to you in 10 years!) When interest rates and inflation are high, future dollars are worth MUCH less than they are today. But when interest rates and inflation are low, that discount shrinks. Growth stocks generally have more of their profits in the future, sometimes far in the future, compared to value stocks. Falling interest rates make those "future" earnings worth more. And interest rates have been falling for the better part of 4 decades.

U.S. 10-Year Treasury Yield

Source: Board of Governors of the Federal Reserve System (US), 10-Year Treasury Constant Maturity Rate [DGS10], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DGS10, January 18, 2021.

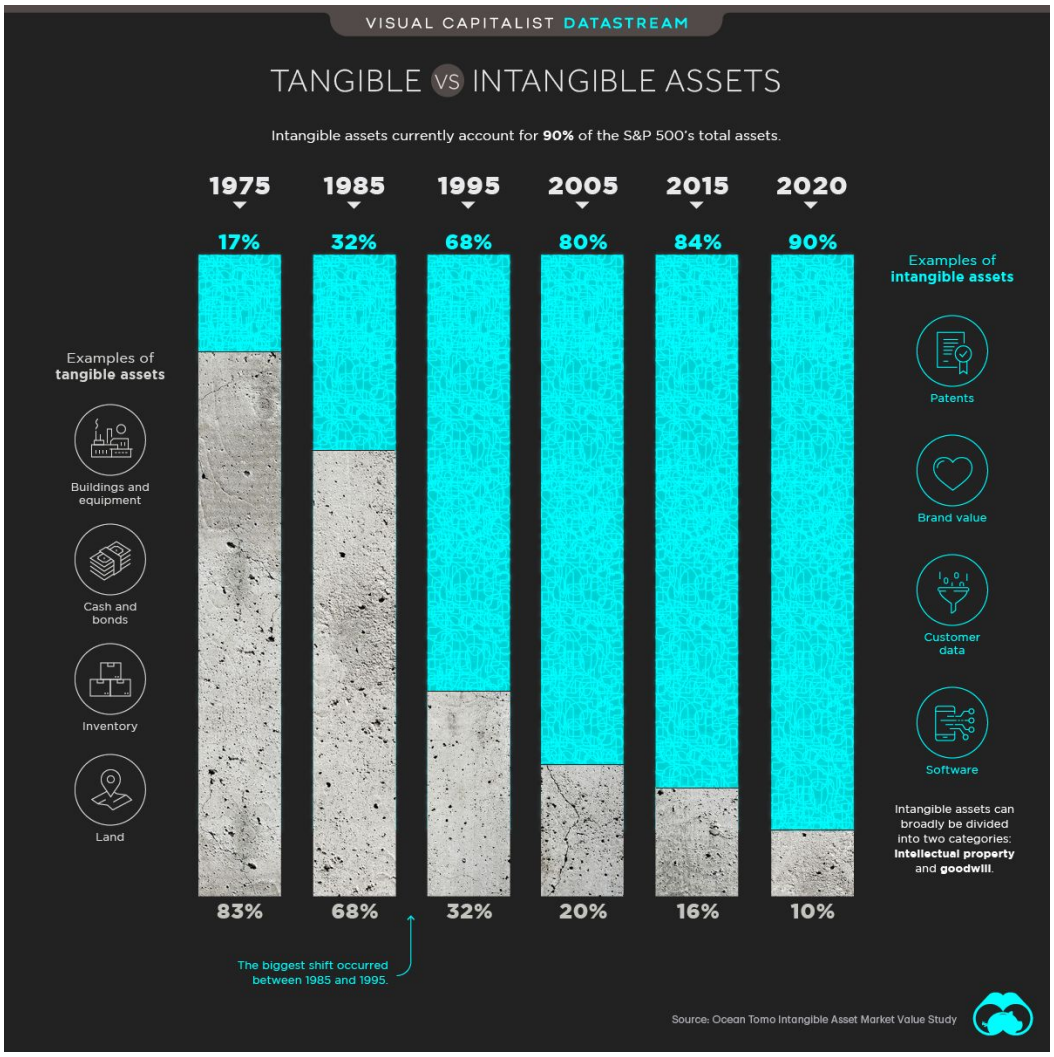
An increasingly digitized world has produced many businesses that "scale up" easily and very powerfully. For instance, a software company can grow its sales without any new factories or vehicles. A producer of cars or food or widgets cannot say the same. Today's dynamic new companies can get bigger faster than ever before. Other examples include biotech companies that can charge a very high price for a successful drug. Or a "gig economy" company that relies on the labor or capital of independent contractors (Uber, Lyft, or AirBnB.)

Many growth businesses today benefit from network effects: more users make the product better, creating a virtuous (and monopolistic) cycle. Think of internet search, social media, online commerce, or payment processing. Ubiquity plus troves of user data make those products better. Users beget more users. Competitors don't get off the ground, and growth companies keep growing rather than attracting rivals that might slow them down. Growth companies in these winner-take-all type businesses have also had abundantly available capital to acquire others, and lax antitrust enforcement for decades.

Headwinds for Value stocks

Too often, Value is defined by accounting statistics that are not relevant in today's economy. Comparing a company's Price to its Book Value used to be a reliable short cut to finding stocks that were overly punished, because book value was a decent measure of actual worth or liquidation value, as if you sold off all the assets and paid off all the debt. No longer. Physical assets told us something in a manufacturing economy, but not one that is based on services and intellectual property. Customer lists, secret recipes, patents, software coded… these are often the real source

of profits, and they are intangible. They show up on a company's books book value only if they have been acquired, and not if they have been developed internally. That renders book value meaningless for large swaths of the economy. Here is a great illustration of the rise of intangible assets over physical assets:



- If the accounting for intangible assets does not reflect reality, and these assets comprise MOST of book value, then book value has lost its meaning as a measure of value. How about other traditional valuation metrics, like Price/Sales and Price/Earnings? Studies show these are better, but not as helpful as in the past. Sales can come at various levels of quality (subscription vs one-time, for instance) and earnings also have "apples-oranges" comparison problems: a company's spending on intellectual property (research & development) hurts earnings immediately, spending on actual property (a factory) gets spread gradually over time.

In classical economics, companies rise and fall as competition drives profits down and up. Sick companies would revive. But turnarounds are rarer these days. Winning companies keep winning and losing companies seems to stay on their backs. Why? We already mentioned powerful network effects and lax antitrust enforcement. Another virtual and vicious cycle comes from stock options: services and intellectual property drive the economy. These require human capital, and stock-based compensation is encouraging the most talented humans to work for companies with stock momentum. Growth companies can more readily compete for the best talent.

Sectors matter. Banks and oil companies, long associated with value, have had a tough run. Both sectors faced a massive boom and bust cycle in the past 15 years, which destroyed value. Both face increasing regulation. Technology, long synonymous with growth investing, has only boomed… and it boomed even more so when the Covid-19 pandemic accelerated longstanding growth trends like the move to cloud computing, ecommerce, and streaming.

WHY MIGHT THINGS REVERSE?

We have looked at several reasons that growth stocks have been winning the race in recent years. But not all are permanent. Will value have its day? There are some reasonable arguments for this:

Historically, value stocks outperform from the bottom of a recession, when the economic tide begins to "lift all boats." That is because the bottom of the market (and of the economy) is accompanied by peak pessimism. From there, the smallest improvements have outsized impact on troubled companies. Imagine a company that investors thought might have a 50% chance for going bankrupt. When that possibility disappears, the stock reacts very positively.

Eventually, valuation – based on cash flows, not book value – does matter. The tech bubble was a good lesson that trees can't grow to the sky, and neither can growth stocks. Recent data suggests that the valuation gulf between the most expensive 20% of the market (growth stocks) and the cheapest 20% (value stocks) has gotten historically wide.

WHAT TO DO FROM HERE?

We believe the indications are that the pendulum has swung too far toward growth stocks recently. Interest rates can't get much lower. The pandemic's boost to technology and internet businesses is not sustainable. An economic recovery propelled by fiscal stimulus, easy monetary policy, and of course a vaccine will combine to create that tide that lifts all boats. It makes sense to lean toward stocks whose price reflects extreme pessimism.

But pessimism alone is not a criteria. We still want well-run companies with good long-term prospects. There are some cases where pessimism and good fundamentals overlap. We like a mix of growth- and value-style stocks in any portfolio but have been leaning toward value lately. Since the pandemic began, we have added to Bank OZK, a regional bank whose excellent lending history is being ignored by the market. We've added to Sysco, a food distributor whose main customers, restaurants, have been devastated in the pandemic. We think when restaurant patrons come back- and they will- Sysco's competitive positions will be stronger than ever. Finally, we've added to Omnicom, an advertising agency. Advertising is a cyclical business, but as the economy opens, companies will need expert help to reach potential customers and promote their business.

In all these cases we're very careful about how WE define value. It is not the same as the Russell Index. Price/Book value is deeply flawed, as mentioned above. But there is certainly something to buying stocks at a discount to what they are really worth (not their accounting worth). The best way to do this is to ask ourselves, "Would we buy the whole thing?" You would not buy a bad business just because the price is low compared to its sales or it book value. What if it is losing money? What if it is saddled with debt? Looking at a business as an *owner* of the business helps you see all the flaws and risks that aren't apparent in a simple price/book calculation. If you are comfortable with the flaws and risks when considering the price, then THAT is a good definition of value… albeit one that requires a lot of work!

CONCLUSION

We think value investors could have their day, after a miserable decade. The pendulum has swung very far in favor of growth. Some reasons for that are structural, but others are temporary. This looks like a good time to look for neglected names instead of celebrated ones.

Our view comes with a MAJOR caveat. Value defined statistically is not a good representation of worth. The *principles* of value investing are sound (buy something for less than it is worth), but not all accounting measures are helpful in this regard. It pays to view a company the way an owner would: not as a statistic, but as an ongoing entity with an asking price.

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Craig is portfolio manager of Cabot's Growth & Income strategy, a diversified equity portfolio that aims for moderate risk by focusing on quality companies trading at discounted valuations. Craig joined Cabot in 2011 as an equity analyst responsible for finding, researching and monitoring investment ideas across sectors and geographies. Prior to Cabot, Craig spent 2 years at Gerson Lehrman Group managing primary research products for institutional investors, and 10 years at Putnam Investments in various positions, including equity analyst covering the media and telecommunications sectors. Craig holds a B.A. in Economics from Cornell University. He is a CFA® Charterholder and member of the Boston Security Analysts Society. He volunteers teaching financial literacy at Year UP and Citizen Schools.

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