MAI Capital Management Insights

Value versus Growth

How the changing economy is disrupting traditional measures of value

By Chris Grisanti, JD, CFA

The investment world is an awfully big place, and to make it more manageable, investments are often grouped by characteristics that might help investors prefer one over another: large cap versus small; foreign versus domestic; start-ups versus mature companies. For more than 50 years, one of the most frequently used divisions is growth versus value. But are investors really getting what they think they're getting when they buy into the Growth or Value camps? We suspect that most investors — and even some investment managers — are using old-fashioned notions of growth and value, and making investment decisions that might not stand up to the light of day (or, more important, to the pressure of a bear market).

Today's value and growth definitions are confusing, to say the least: "Growth Stocks" are growing, perhaps more quickly than the average company. But in different parts of the economic cycle, JP Morgan or Dow Chemical can grow their earnings faster than the market and both are classified as value stocks. Growth stocks are generally more expensive with higher P/Es -- justifiably so, their supporters would say, because you are "paying up for growth". But in a pandemic or just a slow economy, many stocks normally thought of as value stocks (e.g. financials, airlines, materials, energy) sell at high P/Es as their earnings shrink. As we sit here today, Delta Airlines has a higher P/E than Google. Which is the value stock?

Our favorite example of the confusion of the value and growth labels is Apple. It is a huge, mature company (value), but growing quickly with market dominance in several areas like services and wearables (growth). It had a P/E of 11 as recently as 2018 (value) but now has a P/E of 28 (growth). It generally sells a hardware product (value), but its margins are way higher than the market's (growth). If you're confused, you're not alone — there are numerous value and growth mutual funds that all hold Apple stock.

The original definition of a "value stock" from the 1950s, was clear and based on accounting principles: An investor could derive the net worth of Company X by looking at its balance sheet assets and subtracting its liabilities. Then you would compare its net worth to the company's current stock market capitalization; if you could buy the stock for less than its net worth (per share), Company X was a "value stock".

These days, though, there's one big problem. This formulation depends on the valuable assets of the company all being listed on the balance sheet, but increasingly, they're not. Companies aren't hiding them or committing fraud; it's just that assets are not as quantifiable as they used to be. The most important flaw in the value/growth determination is that extremely valuable assets are not turning up on balance sheets anymore and that makes companies that have lots of valuable but non-balance-sheet assets look much more expensive than they really are.

This is critically important, and if you do not appreciate this, your investing will suffer in the 21st Century. A few examples can show how real value may be hiding in a growth disguise: Ford Motor Company creates a new car line and builds a $10 billion factory. Because the factory will last for decades, that investment goes on the balance sheet and value investors will find Ford stock $10 billion more attractive in the future. Contrast that with the following: (1) Apple spends $10 billion on R&D for the new Apple Watch. That investment is expensed (i.e., is shown as an expense on that year's income statement) and never appears on the balance sheet. (2) Disney creates The Lion King. It costs a lot to make (about $40 million), but it spawns a Broadway show, countless stuffed animals and a 2019 remake that alone grossed over $1.6 billion. Yet the original $40 million investment is nowhere on the balance sheet — and even if it were, it sure doesn't reflect the enormous value of The Lion King to Disney. (3) Google has a de facto monopoly on the search engine business, so much so that it has become a verb "to google" something. That is Google's "factory" for selling advertisements. It is growing by leaps and bounds, and is much more profitable than Ford's new $10 billion factory, but it appears nowhere on Google's balance sheet.

In these examples, Ford looks like the attractive value stock according to the traditional definition. But you don't have to be a professional investor to appreciate this analysis misses the mark by a wide margin. How do you value research and development for Apple products, unique and enduring content for Disney, or Google's 'search factory'? We can argue over the answer to these questions, but it is nonsensical to assign a value of zero to some of the most valuable assets in corporate America, and that's what a strict value investing analysis does.

It's not that value investing is a discredited idea – the idea of determining a company's net worth and comparing it to its current market price remains the bedrock of good investing. Rather, it is the inputs to the net worth formula, based on old-fashioned assets, that need to be updated. The solution is for investors to sharpen their pencils and assign values to these intangible assets and then figure out if the companies that have these hidden assets are value investments. We don't need to reinvent the wheelas we have tools that can help us model how much profit might come from the Apple Watch or Disney movies or Google's search engine.

But if you don't appreciate that the world has changed – that often a company's most valuable assets don't even show up on the balance sheet – you run two risks. First, you could miss out investing in terrific companies that aren't that expensive when you factor in their intangible assets. Second, you run the risk of seeking shelter in what you perceive as inexpensive 'value' stocks that have attractive assets on their balance sheet, but little ability to make profits in a changed world.

As always, we value the confidence you have placed in MAI to be your trusted advisor. If you have any questions regarding your portfolio or would like to discuss any changes to your financial situation, please feel free to contact us at any time.

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