

# Don't be blinded by the glamour of growth

**Everyone loves a growth story. Yet growth is not necessarily conducive to equity returns.**



January 11, 2013

Economic growth has long been an attractive prospect for investors. Economies such as Brazil, China and India have been hailed for their rapid growth and seemingly limitless returns. Likewise, fast-growing companies such as Facebook, Google and LinkedIn excite investors with similar hopes.

In the article "[Blinded by Growth](#)" published in the *Journal of Applied Corporate Finance*, IESE's [Javier Estrada](#) warns that relying on growth can be an unwise decision where investors are concerned.

Estrada examines growth within economies and its effect on equity returns, before moving on to study the effect of corporate growth on returns.

He then reviews the relative benefits of investing in growth-oriented companies versus value-oriented companies, ruling in favor of the latter.

## **Economic growth & equity returns**

Many investors assume that investing in fast-growing economies, such as China or India, is a sure way to good equity returns. However, as the historical data show, this is a fallacy.

Over a 100-year period, a 42-year period and a 23-year period, there is no correlation between economic growth and equity return.

Why does this happen, contrary to conventional wisdom? Estrada highlights three main

reasons for this discrepancy.

- *Multinationals' disproportionate share of equity returns.* Often the companies that benefit the most from the growth of a given country are based in a different country. Companies such as Nike, Coca-Cola and Nokia obtain a substantial portion of their profits from selling products in fast-growing economies, and the shareholders of these and other multinational companies profit from such growth.
- *Exposure of local large companies to international markets.* The largest companies — those that have the most weight in the local stock market index — tend to sell their products and services in international markets, making them somewhat isolated from local business cycles. As such, changes in the local economy may not have a large impact on the profitability of these companies.
- *Investors' tendency to overpay for growth prospects.* Perhaps the most critical factor is the price that investors pay for growth. More precisely, it is the possibility that investors are so eager to participate in a country's growth prospects that they largely ignore the price they pay to do so. In this way, investors are so blinded by growth prospects that they are willing to participate at any price.

## Corporate growth & equity returns

Just as investors take for granted that fast-growing economies will provide excellent equity returns, the same assumption is made about corporate growth. Once again, this is a mistake.

Excellent corporate performance may translate into low returns for investors, while mediocre performance may end up producing exceptional returns.

Take the performance of Google from the start of 2006 until June 30, 2010. The share price went from \$414.90 to \$445, thus growing at 1.6 percent per year. Since Google does not pay dividends, that is all the return investors pocketed.

Interestingly, however, Google's earnings per share over the same period went from \$5.02 to \$23.03, thus growing at an annual rate of 40.3 percent.

Hence, although Google's earnings grew at over 40 percent per year, the return pocketed by investors was a meager 1.6 percent per year.

What is the reason for this? Although Google's earnings grew at a very high rate, its price/earnings ratio — that is, valuation — moved in the opposite direction, cancelling most of the positive impact of the earnings growth on returns. Put simply, investors overpaid for

growth.

## **Growth-oriented Vs. value-oriented companies**

Growth-oriented companies are those with high growth prospects — more often than not, "glamour companies" for which investors are willing to pay a high price.

Value-oriented companies, by contrast, are mature companies with moderate growth prospects, often temporarily out of favor, and for which investors are willing to make modest payments.

The evidence clearly shows that, over the long term, value outperforms growth, a well-documented phenomenon that many refer to as the "value effect."

For example, in the United States between 1927 and 2011, value and growth provided investors with annualized returns of 12.8 percent and 9.5 percent, respectively. What's more, despite their higher returns, value investments do not suffer from higher volatility.

Although Estrada concedes that his study represents a far from exhaustive exploration of the relative risk of value and growth, his findings show that the higher returns of value do not seem to be a compensation for bearing higher volatility, higher shortfall risk or higher beta, i.e., an asset's volatility relative to the market.

## **No free lunch**

Value investing by no means offers a free lunch for investors; there may be hidden or unquantifiable risks, adds Estrada. Investors may find that, for various reasons, investing in out-of-favor companies is much easier said than done.

It is not easy to be a contrarian investor; plowing funds into companies the market shuns, while avoiding those the market loves, is a path that few choose to follow.

For example, how many people would have had the nerve to invest in utilities or railways, not in Internet stocks, during the period between 1997 and 1999?

If the market is willing to pay high multiples for some companies and low multiples for others, many investors may think that the market may know something they do not.

While value outperforms growth in the long term, Estrada acknowledges that there are periods in which the opposite happens. Even so, only the investors who stick to value through

thick and thin can obtain the higher returns discussed.

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