

Style advice for investors

At the start of the New Year, many investors rethink their investment strategies, mulling over the question of: **value or growth?** Although both growth and value managers look out for the most attractive buys, their approaches differ, says guest contributor Jens Moestrup Rasmussen.

Jil Sander or Dolce & Gabbana? Mercedes or Porsche? Bordeaux or Champagne? In every decision, style matters – the same goes for the question of value versus growth. In the world of finance, value is known as conservative, price-sensitive and safety-conscious. Growth is more about vision and daring.

The value investor sees an opportunity in buying low-priced shares of companies with proven business models, analysing the entire universe of equities to filter out those currently undervalued in trading. Considerations such as industry, region or country are not a factor.

Value – the quest for intrinsic share value

Economist Benjamin Graham originated the theory of value investing. As early as 1934, Graham determined that two metrics are of primary importance for the purpose of valuing an enterprise: the company's stock market share price and its intrinsic, true value. These two values may vary over the short to medium term, which presents an opportunity for the value manager, who buys only shares priced lower than their actual value. Some prominent examples of value shares are the supermarket chain Safeway, the fashion company Tommy Hilfiger and the Brau Union brewery owned by the Heineken Group.

Capital preservation more important than projected growth

In contrast to growth investors, value managers focus exclusively on current and historic corporate earnings and dividends with an eye towards future earnings potential. Intrinsic value is calculated on the basis of such metrics as price/book value and price/cash flow ratios and dividend yield. Shares trading at up to 50 per cent below their theoretical value are considered a bargain – for example a stock trading at €50 with an intrinsic value of €100.

Investors looking for safety are

well advised to invest in value. Growth managers tend to invest in higher-priced shares reflecting high growth potential. Value managers on the other hand only buy shares in solid companies at bargain prices, limiting risk. The difference between the current share price and intrinsic value is known as the safety margin, representing a kind of airbag (see graphic). The wider the margin, the safer it presumably is to buy the shares.

Empirical studies have shown that over the long term, share prices will approach their intrinsic value. This period of time can however, vary significantly in practise. Value shares are held for three to five years on average. Once market prices reach the intrinsic value, value managers will sell, without regard to future growth projections.

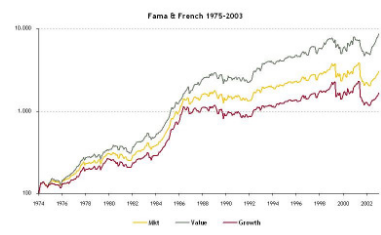
Dot.com frenzy the heyday of growth investing

Value investing was the dominant style in the mutual funds industry until the end of the 1980's. That changed with the new economy boom that got underway in the mid-90's. Tech companies like Cisco, Microsoft and Google revolutionised the information and communications sectors, triggering the dot.com frenzy. Tech stocks skyrocketed to prices many times that hitherto paid for blue chip shares. Despite relatively modest assets, these equities fired the imaginations of growth fund managers, whose day had arrived.

Web 2.0 or true value?

Market trading is always geared to future developments, but investing styles vary substantially. With shares in the new Web 2.0 companies, for instance, investors expect

Growth and value compared (indexed)



Jens Moestrup Rasmussen
Head of Equities at Sparinvest

Jens Moestrup Rasmussen is known as the Danish Warren Buffett and manages Denmark's largest value fund. Sparinvest was founded by a group of savings and loans banks in 1968 as Denmark's first mutual fund company. Sparinvest's Luxembourg subsidiary has been expanding European distribution since 2001. Sparinvest currently manages over 30 funds for institutional and private investors, with assets totalling in excess of €14.5 billion under management.

In contrast to the value approach, growth investors attempt to identify growth markets at an early stage, then subsequently pick the companies with the strongest growth prospects. The main focus is on superior revenue and earnings growth. A key yardstick for growth stocks is thus the price-earnings ratio (PE). This figure tends to be high with growth stocks, as earnings of younger enterprises or from new product segments are generally low.

Growth and "tenbaggers": the future is all that counts

The growth strategist presumes that most market participants underestimate the future growth of particular companies or industries, true growth potential not being priced into current trading levels. Coca-Cola, Microsoft and Starbucks are examples of former growth stocks, which today are better typified by companies like Ebay.

For growth investors, the primary buying criterion is projected share price appreciation. Peter Lynch, known as one of the most successful growth investors, was always on the lookout for what he called 'tenbaggers', shares set to appreciate at least ten-fold within a defined period of time. Of course, such returns do not always materialise according to growth managers' expectations, as the bursting of the IT bubble in the year 2000 illustrated.

Accordingly, growth-stock investing requires a greater risk tolerance.

Studies of historical data like the ones conducted by Fama & French have shown that value has always come out ahead of growth over periods of roughly 30 years or more (see graphic). Over the short to medium term, however, value and growth shares tend to alternate in leadership.

Value usually beats growth in early cycles of economic expansion, as shares of solid companies acquired cheaply during recessionary periods generally increase in price. Many value stocks are to be found in cyclical industries such as food, chemicals and automotive.

Growth tends to have the edge in recessionary phases. Growth investors focus on buying shares in markets and industries identified as being most insulated or least impacted by economic downturn. These typically include equities from the pharmaceuticals, technology and software sectors.

When growth turns into value - and vice-versa

Growth and value designations will vary over time as a rule. Hot growth stocks cool down eventually, like Microsoft and The Body Shop, becoming value stocks. By the same token, undervalued companies may show accelerating growth through new investments or products, taking on the characteristics of and trading like growth stocks.

No matter which style accords most with your risk profile, no investor should put their money exclusively in growth or in value assets. Instead, a balanced portfolio containing different asset classes and investment styles is recommended.

It's just like the clothes in your closet – it's important to have the right mix of Zara, Esprit, Hilfiger, Jil Sander and Dolce & Gabbana. Only then are you prepared for any occasion.

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them to generate business and hence growth in future. Value-style investing involves buying equities at below their intrinsic value in order to profit down the road as the market corrects pricing upwards.

The Value Investing Method (safety through bargain-hunting)

