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Value v Growth.

The Great Hoax.

"The whole concept of dividing it up into "value" and "growth" strikes me as twaddle. It's convenient for a bunch of pension fund consultants to get fees prattling about and a way for one advisor to distinguish himself from another. But, to me, all intelligent investing is value investing. That's a very simple concept. And I don't see how anybody could really argue with it."

*Charlie Munger
Berkshire Hathaway*

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When a fund manager is being interviewed they are often asked to define their investment philosophy or 'style'. They usually respond by saying they either follow a "growth" style or a "value" style a "Garp" style or that they are style "neutral". By answering in this way however, the manager perpetuates the myth that such distinctions not only exist, but are also founded on some ancient academic bedrock.

For the record Clime does not label it self a 'growth' or 'value' manager nor even a style neutral manager – we proudly declare ourselves a "style-don't-care" manager. For at best, The traditional answers are a marketing message and at worst show an entrenched lack of understanding of the elements of successful 'investing' (as distinct from speculating or index tracking).

A large proportion of investors mistakenly believe that investing for growth is the antithesis of investing for value and that the factors that a typical value investor will look for in an investment may be different from that which a growth investor will look for.

Early empirical studies created the distinction and newer studies simply and erroneously confirm the two schools indeed exist. But like the Emperor's New Clothes, not everything that can be imagined actually exists.

Almost daily we see the evidence of uncertainty about the subject of investing (as opposed to speculating). The uncertainty seems no more apparent than in this discussion about whether "growth" or "value" style investing has greater merit.

In an article taken from the Reuters news service entitled *Money flows back into stock funds* and published in the *AFR* on July 24, 2003, the author writes;

"Managers of value funds look for stocks that are considered cheap based on price-to-earnings ratio and price-to-book ratio...Managers of growth funds invest in companies that are experiencing rapid revenue and earnings growth."

First, it is important to note that book value, P/E ratios and the like have little if anything to do with value. Note first that if book value were the guide to value, a company would be worth more simply by purchasing more assets regardless of the productivity of those assets. A company might engage in folly and buy a machine that manufactures vinyl records or it might buy a steam engine and thereby increase its book value (and be 'earnings accretive') and according to the above statement, render the company more valuable. In a moment we'll address the other issues but first a few more quotes:

“At most, the big investors might accept the value approach – buying shares selling at lower price-earnings multiples and higher yields – only for part of their portfolio.

AFR, July 25, 2003

“For years, two great armies of investors have done battle on Wall Street. In one camp stand the growth investors, willing to pay dearly for companies that they believe can generate big profits for years to come. In the other camp are the value investors. They’re leery of the rosy forecasts. They’ll buy only into companies with real assets and solid earnings in the here and now and at bargain prices.”

Jeffrey M. Laderman

Source: Business Week Page 47
Saturday, 12 June 1999

“But there may be a more profound reason for value (investing's) underperformance ...What has changed is the economy. It is no longer driven by manufacturing and smokestack industries, but by rapid-fire innovations in technology and services. In this sort of economy, big winners are not metal-benders, such as General Motors, but those that can manipulate bits and bytes, like Microsoft Corp. The traditional measures that value investors use to pick the stars on the investment horizon, such as low price-earnings or low price-to-book value ratios, give the wrong answers.”

Jeffrey M. Laderman

Source: Business Week Page 47
Saturday, 12 June 1999

“There are still many sceptics who say the value rally won't last long, and it already has wilted a bit in recent weeks. Mr Markus Barth, director of international quantitative strategy at Merrill Lynch in London, says value stocks will soon be giving back much of their gains in the present environment of higher interest rates and slower earnings growth. Value managers have had their moment in the sun, and they will be left with a

nice tan if they take profits in value stocks before they come down again, Mr. Barth said."

Source: The Wall Street Journal
Page 27
Wednesday, 4 October 2000

"...whether using the value approach or the growth approach, fund managers are forever constructing their models and feeding information into computer models in an unending search for the true touchstone of value and ultimate outperformance. ...So, how do we know if shares are cheap or not? It's a case of back to the old fundamentals of dividend yield, P/E ratios, price-to-book value and even more exotic measures."

Source: AFR, Page 38
Saturday, 11 October 1997

"The pace-setting US stock markets still look relatively high. Large growth stocks still dominate but most of the leading investment managers interviewed ... were looking for a gradual readjustment to reality as value replaced growth in investors minds."

Source: AFR, Page 37
Saturday, 17 July 1999

So is anything wrong with the above excerpts? In short yes. For starters, Value and Growth are not some opposing investment styles that really exist.

As Charlie Munger of Berkshire Hathaway once said:

"The whole concept of dividing it up into value and growth strikes me as 'twaddle'. It's convenient for a bunch of pension fund consultants to get fees prattling about a way for one advisor to distinguish himself from another. But, to me, all intelligent investing is value investing."

If share market investing is about identifying wonderful businesses and purchasing those businesses at prices likely to produce an above average rate of return - and what else is investing if not this? (all else becomes some form of speculation) - the inputs required include expected future sales growth, profit margins and return on equity. 'Growth' therefore becomes a component of determining 'value'.

The same inputs are required and outputs produced whether the company is accepted as a 'value' stock like WAN today or a 'growth' stock like Cochlear. Let's examine a quick example to hopefully put the matter to rest.

Table 1.1

	Company A 'Growth'	Company B 'Value'
Price	\$25.00	\$25.00
EPS	\$0.60	\$2.40
Dividend	\$0.02	\$2.00
EPS growth*	15.00%	4.00%
Dividend Yield	0.06%	8.00%
Price Earnings Ratio	42	10
IRR	15%	14%

* we 'know' what growth will be for 40 yrs

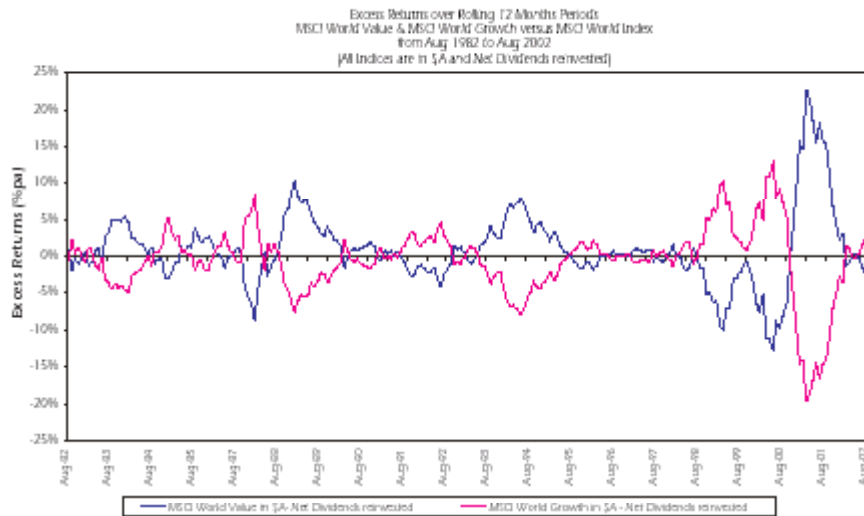
According to the excerpts above, Company 'A' in Table 1.1 would be the growth stock. The dividend yield is less than 1% and the Price earnings ratio is 42 times earnings. Company 'B', with a dividend yield of 8% and a P/E ratio of 10 would be labeled the 'value' stock. If we make an assumption that we know exactly what the growth of retained earnings and dividends will be over the next four decades we discover that purchasing shares in company 'A' will produce the higher return. The higher return indicates the buyer of shares in the 'growth' stock received better 'value'.

Dividend Yield and Price Earnings ratios therefore have very little if anything to do with determining value. Company 'A' represented better value even though it had a lower dividend yield and higher price earnings ratio. Value is presented by the return that is received by the investor. The higher the return received the better the 'value' at the time of purchase.

Some investors and marketing departments agree with the above but then justify their use of the growth and value labels to define portfolios rather than individual shares. The belief is that you can better understand the behaviour of a share portfolio by defining it as 'growth' or 'value'. Value portfolios tend to outperform at different times to growth portfolios. Often a chart such as the one appearing at the top of the following page is produced leading to the conclusion that investors should invest in a 'blend' or 'mix' of 'growth' and 'value' fund managers.

Aside from suggesting that such a strategy serves to produce mediocre returns and incur high fees, our response to this is: if the portfolio is made up of both West Australian News and Cochlear is the

Growth and Value returns relative to the MSCI World Index



Source: Data stream. Date: August 2002

MSCI World Value and MSCI World Growth are sub-indices of the MSCI World Index. Price/Book ratios are used to determine whether a company is classified as 'value' or 'growth' within its own market, and the two indices are then constructed from the respective 'value' and 'growth' categories.

Past performance is not necessarily indicative of future performance.

portfolio a growth portfolio or a value one? Then, if it cannot be defined, the above dissection is inventive at best at fanciful at worst. It is true that portfolios made up of all Cochlear type company shares purchased at Cochlear prices will behave differently to a portfolio made up of all West Australian News type company shares purchased at West Australian News type prices, but who, acting rationally, would build such a portfolio in the first place?

In an attempt to clear up the confusion regarding the growth and value dichotomy, Warren Buffett wrote in the 1992 Berkshire Hathaway Letter to Shareholders

"the two approaches are joined at the hip: Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive."

A company can therefore represent good value even if a high price to book ratio, high price-earnings ratio, and/or a low dividend yield exist. According to Buffett,

"growth benefits investors only when the business in point can invest at

incremental returns that are enticing - in other words, only when each dollar used to finance the growth creates over a dollar of long-term market value. In the case of a low-return business requiring incremental funds, growth hurts the investor."

Table 1.2 helps to explain what Buffett may be referring to when he says, "*in other words, only when each dollar used to finance the growth creates over a dollar of long-term market value*". Suppose a company with \$5.00 of equity per share is able to generate returns on incremental capital of 20%.

Table 1.2

	Year 1	Year 2
EQPS	\$5.00	\$6.00
ROE	20.00%	20.00%
EPS	\$1.00	\$1.20
DPS	\$0.00	
P/E	10	10
Price	\$10.00	\$12.00

The company's earnings per share would equal \$1.00. If the dollar was retained in the business and the company in the second year was again able to generate a return on equity of 20%, this would equate to 20% growth in earnings which if multiplied by a constant price earnings ratio of 10 produces \$2.00 of additional market value. The one-dollar retained has created \$2.00 of market value.

Table 1.3 however reveals the impact on market value for a company generating a low return on equity of 5%.

Table 1.3

	Year 1	Year 2
EQPS	\$20.00	\$21.00
ROE	5.00%	5.00%
EPS	\$1.00	\$1.05
DPS	\$0.00	
P/E	10	10
Price	\$10.00	\$10.50

In this example the company has again generated \$1.00 of profits that will be retained. Because the Return on Equity is only 5%, the equity we are required to enter for illustration purposes to generate \$1.00 of earnings is \$20.00. The additional dollar retained however has generated only 50 cents of market value. In other words the "growth" has had a negative impact to the tune of 50%.

As Buffett notes,

"Growth is always a component in the calculation of value...whose impact can be negative as well as positive."

For every dollar retained by the company in Table 1.3, shareholders will lose 50 cents. Businesses able to generate only low rates of return on equity should not "grow" but instead return profits to shareholders by way of dividends. Unfortunately even though many companies are advised by corporate finance departments to do just that, they ignore the advice instead retaining profits and seeking to inflate their own egos as they inflate the size of the business. As we quoted Buffett earlier, "In the case of a low-return business requiring incremental funds, growth hurts the investor."

And as Buffett also notes,

"irrespective of whether the business grows or doesn't, displays volatility or smoothness in its earnings, or carries a high price or low in relation to its current earnings and book value, the investment shown by the discounted-flows-of-cash calculation to be the cheapest is the one the investor should purchase."

...And finally as John Burr Williams wrote,

"The value of any stock, bond or business today is determined by the cash inflows and outflows - discounted at an appropriate interest rate - that can be expected to occur during the remaining life of the asset."

Even a 'growth' manager should keep one eye on the price and probably does, if he doesn't, then such individuals are merely 'momentum speculators' playing the greater-fool principle: buy at any price because a greater fool will pay more for it tomorrow. This however would not be called investing but 'gambling' that there is someone else who will indeed pay more. Without 'value' then you are not an investor. And to determine value you need to have some certainty about the future, anything less is speculation.

Successful investing requires and understanding that growth contributes to value and recognizing that value and growth are two sides to the same coin, will provide a quantum leap in the potential for long term investing success. In our ongoing efforts to invest successfully, we only select those opportunities that have both sound prospects for growth and are offered at an attractive price. This is not GARP or style-neutral investing – labels that imply some active thought as to whether a company fits some portfolio-defining criteria.

Remember all you need is the ability to identify a company's growth potential – it can be strong or flat - and the ability to wait until that company is cheap based on that potential. Fortunately many investors are coming to realise the merit in the above approach but unfortunately the focus now is on the word 'cheap' – trying to determine the exact price that should be paid for a share. The world's second richest man Warren Buffett has already admitted to making this mistake and said at the 1997 Berkshire Hathaway annual meeting

"Generally speaking, it's more important to be certain about a business being wonderful than it is to be certain the price isn't 5% or 10% too high. That's a philosophy that I came slowly to originally. I used to be incredibly price conscious. We used to have prayer meetings around the office before we would raise our bid an eighth. But that was a mistake - in some cases, a huge mistake. We missed things because of that."

And Charlie Munger at his 1996 Wesco annual meeting added support to this line of thinking by noting:

"...paying high price-earnings multiples and high price-to-book multiples is OK because you have intelligently decided that the good prospects are so sure that you're still getting more value than you're paying for even if you're buying a bunch of so-called growth stocks at 35 times earnings. And if it's sound, it's because you're getting more value than you're paying for. But it's still value investing."

As our example showed earlier, paying a price earnings multiple of 24 times earnings, is still value investing if the ultimate rate of return is higher than that available elsewhere. Investing is most intelligent when it is most business like, not when one doggedly adopts a mantra that is flawed to begin with. There is no empirical or valuable difference between growth and value. They are both required and so when evaluating companies in which we expect to generate very high returns for our clients, we use both and so should you.

Roger Montgomery
Managing Director
August 2003