

Diversify Your Stock Portfolio by Valuation

By David Anderson, CFA

In uncertain times, which is better — growth investing or value investing? Everyone agrees that the purchase price of an investment ought to represent good value; that is, the anticipated return should justify the associated risk. However, *good value* doesn't have a universal definition; it becomes obvious only after the fact.

Undaunted, the ever intrepid consultants divide the universe of investment managers into three style categories: value, growth, and a combination of the two labeled *blend* or *core*. This strategy explains how value and growth investing compares and advises you on how to protect yourself from manic changes in the market.

Value versus Growth: Taking Lessons from History

So what's the difference between value and growth investors?

- ✓ **Value investors generally look backward at history.** They examine financial statements to estimate an intrinsic value of a stock and compare it to the current price. If the current price is significantly lower than the estimated intrinsic value, the value investor purchases the stock, anticipating that other investors will recognize the disparity and *their* purchases will drive up the market price so that it equals or exceeds the estimated intrinsic value. The fly in the ointment is getting everyone to agree on the definition of *intrinsic value*.
- ✓ **Growth investors look forward.** They postulate that companies growing at above-average rates will provide above-average returns. Generally, the higher the anticipated growth rate, the more investors are willing to pay. The fly in their ointment is the realization of that growth. For the stock price to appreciate, the company has to achieve the growth expectations.

A growth investor's most disconcerting moment is discovering that a stock declined 10 percent in one day because the company's earnings missed analysts' forecasts by 5 cents. Wiping out 10 percent of the market value for such a minor shortfall seems awfully excessive. However, the strong reaction suggests that investors believe the company's growth rate has hit a turning point and will begin to slow.

A value stock's earnings typically fluctuate with the economy; these stocks tend to do well when the economy is accelerating out of a recession. Growth stocks are expected to be impervious to economic fluctuations. However, what makes economic sense can be trumped by Wall Street's propensity for manias. Read on.

Growth manias

Wall Street's mantra is "anything worth doing is worth overdoing," and growth versus value is no exception. In the uncertain times of the last 40 years, growth-stock investing has twice been taken to extremes. In the early 1970s, Wall Street became enamored with *one-decision stocks*: Companies such as IBM, Xerox, and Polaroid were projected to grow at above-average rates indefinitely, and analysts believed that stock valuation was irrelevant. Investors merely had to make the one decision to purchase and hold. Of course, they were blindsided by the 1970s inflation that drove up expenses faster than revenues. Rather than growing, profits declined and so did stock prices, as much as 80 to 90 percent in many cases.

In the second episode of growth stock mania, the advent of the Internet drove huge demands for technology products. On top of that, as the year 2000 approached, corporations had to deal with the dreaded Y2K issue and the fear of global software malfunctions. It was a perfect storm for the demand of technology products and services. However, January 1, 2000, came and went, leaving behind a tremendous supply of unneeded products and services. The result? Stock price declines of 80 to 90 percent for many.

Value manias

Value stocks aren't immune to manias. The value sector contains a large percentage of bank and financial services stocks. The inflation of the 1970s generated a lot of real estate lending by banks and savings and loans. However, when Congress shortened the real estate depreciation schedules in 1986, many real estate projects became untenable. Stock prices of major banks declined as much as 75 percent from 1989 to 1990.

Because value-oriented stocks sat out the growth stock mania of the late 1990s, they didn't have major gains to surrender in the bear market of 2000 to 2002. However, they made up for it by funding the mania in housing prices from 2004 to 2007. After the marginal buyers were sucked in with teaser adjustable-rate mortgages, no was one left to buy. Supply overwhelmed demand, which in turn started the decline in home prices. Financial panic ensued when bonds backed by shaky mortgages turned bad as housing prices declined. Again, stock prices declined dramatically.

However, one segment of the value-oriented universe did extremely well through the housing debacle of 2007 to 2008. Energy and commodity prices soared beyond anyone's wildest expectations. Ten years ago, the price of oil was scraping \$10 per barrel. The low prices of the late 1990s caused oil companies to de-emphasize finding new energy sources because of the low return on investment. But as demand from emerging nations such as China and India increased, supply couldn't keep up with demand, and energy and commodity prices skyrocketed along with their associated stock. But high energy prices sow the seeds of their own decline. At some point, the economic dislocations caused by higher energy prices will overwhelm the growth in demand for energy, and prices will decline. The only question is when.

Find the Right Balance and Avoid Manias



Should you invest in growth funds or value funds in uncertain times? Fortunately, you don't have to choose one over the other. Managing your portfolio can be a matter of shifting the emphasis as you participate in growth and value funds as well as blended funds:

- ✓ Emphasize growth funds when economic growth is slowing.
- ✓ Emphasize value funds when the economy begins to accelerate. These periods are usually accompanied by a steep yield curve, when short-term interest rates are much lower than long-term rates. Banks are a large component of the value sector, so a steep yield curve usually precedes higher bank profits.



How do you approach the value-growth question and protect yourself from manias? Here are some guidelines:

- ✓ **When purchasing either kind of fund, examine how well the current portfolio manager navigated debacles of the past.** Keep in mind, however, that past performance doesn't guarantee future results.
- ✓ **Don't believe the hype.** Exercise common sense. Investment management is a closed world, and managers feed off of one another. When an investment theme looks extreme, head for the exits; if it looks too good to be true, it probably is.
- ✓ **Read a mutual fund's annual and semiannual reports to get a sense of the fund management's thinking.** Watch out for language that echoes some of the more hyperbolic language used by the talking heads on the business news channels.
- ✓ **Examine a fund's holdings for style drift.** In the late 1990s, value managers suffered because their funds were dramatically underperforming their growth counterparts. In desperation, value managers added growth stocks to improve performance. Unfortunately, many did this at the market peak, which caused their value funds to decline like a growth fund in the following bear market. Value funds that remained true to their style performed much better in the bear market of 2000 to 2002.



In all cases, develop your own investment policy with a target asset mix based on your tolerance for risk (see Strategy #38 for information on assessing your risk tolerance). Rebalance your portfolio when asset-class weightings experience significant gains and declines. The decision to emphasize growth or value stocks or funds should be only a nuance in a long-term strategy of diversification that matches your investing goals with your risk tolerance.