Sionna Investment Managers®

INSIGHT

July 2023

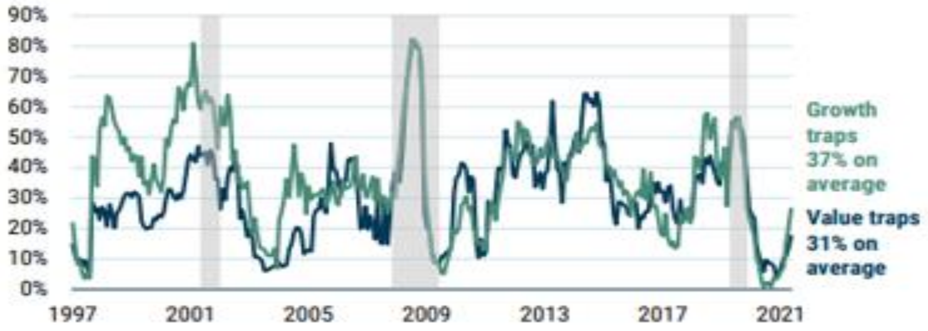
A New Type of Trap

As value investors, we are often asked (sometimes more often than we would like!) how our investment process avoids the well-known value trap. So, at the 2023 Value Investor Conference held in London, when Ben Inker of GMO spoke about a little-known concept – that of growth traps – he confirmed our long-held suspicion that growth stock disappointments can be bigger threats to investor portfolios than the oft discussed value trap. His analysis piqued our interest.

Inker defines a trap as a stock whose sales disappoint relative to forecasts and whose future sales estimates drop.[1] A trap is commonly associated with the value style of investing. Sometimes stocks with low valuation statistics, like price-to-earnings, price-to-book and price-to-cash flow, typical of value stocks, end up “cheap for a reason.”

Traps are associated with growth stocks too. In fact, the following graph shows that growth traps are slightly more common in the universe of growth companies than value traps are in the universe of value companies (37% vs 31% going back to 1997). The graph also shows that the percentage of value and growth traps is not static, rather it has a cyclical element. Traps in general are higher in recessions and lower in the early stages of recovery from a recession.

Weight of Value Traps and Growth Traps



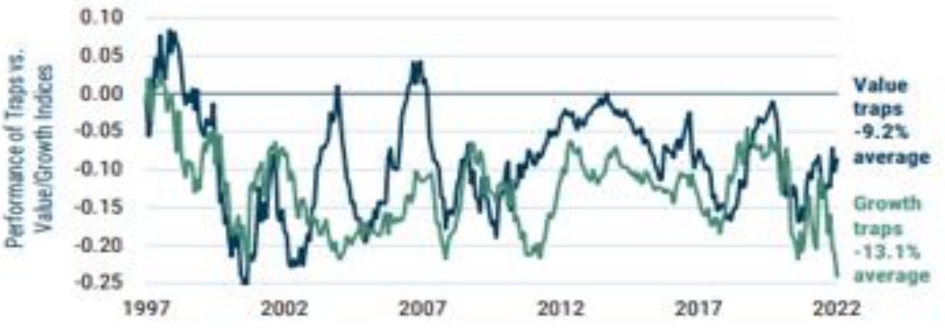
Data as of December 1996 through April 2022 | Source: GMO, IBES, Compustat, MSCI
Recession dates are moved forward 10 months to account for the lag in receiving revenue data and declaring "traps."

Source: GMO. Growth Traps Snap Shut – More Portfolio Pain to Come? May 2022.

The next graph shows something even more noteworthy. While both types of traps are painful to the investor’s portfolio, on average, growth traps underperform their growth peers by 13.1%, while value traps underperform their value peers by 9.2% – a difference of almost four percentage points!

[1] Inker uses sales to measure traps as there is more clarity in its definition and it cannot be gamed as easily as other figures in the income statement.

Performance of Value and Growth Traps vs. Their Style Indices



Data as of December 1997 through April 2022 | Source: GMO, IBES, Compustat, MSCI
Returns are for the preceding 12 months.

Source: GMO. Growth Traps Snap Shut – More Portfolio Pain to Come? May 2022.

Intuitively, this result makes sense. Growth stocks are growing their revenues faster than most companies in their industry or the broader market because they have an innovative idea, product, or service that no other business offers. These businesses often sacrifice profitability to grow, investing as much as possible into growing the business. This outsized potential can capture investor excitement and the enthusiasm can push share prices higher. Typically, they will trade at higher valuation multiples.

Some investors will pay up for these stocks because they are expecting higher earnings over the long run and these companies generally have a history of meeting or exceeding expectations. So, when they fail to deliver on these expectations (because outsized growth is unsustainable over the long term) their stock price can be punished severely. First, because the company did not deliver on its expected growth, and second, because its future growth will likely be lower than what was originally projected, resulting in a lower valuation multiple on the stock.

In Canada, Shopify is a recent example of what reduced expectations can do after years of exceptional growth. In late 2021, when Shopify's stock was trading ~US$145 some analysts projected a US$180 intrinsic value for the company based on expanding its total addressable market and operating margin potential. In February, after Shopify's results came in largely in-line with expectations but missed its monthly recurring revenue estimates, its share price dropped to ~US$69 – and so too did analyst projections. By May, after the company reported financials showing a deterioration in operating metrics and slowing future growth, its stock price fell even further but did not bottom until it reached ~US$26 approximately one year later. This example demonstrates how precipitous and painful a growth trap can be.

Value stocks, on the other hand, are stocks that may have disappointed investors, perhaps because the industry is going through change, or the company is navigating a specific issue, making it unloved. As a result, these stocks tend to trade at lower valuation multiples (until clarity emerges). So, if a value stock's revenue underwhelms, its stock price tends not to fall as much as a growth stock would (as the previous graph demonstrates) since some of the disappointment was already priced in.

There is another part of the story of traps that is important: value stocks and growth stocks are not static concepts. A growth stock today can become a value stock tomorrow and vice versa. In fact, these dislocations can often provide opportunities for bottom-up, long-term, value-minded investors like Sionna. We look for temporarily unloved stocks with good and improving fundamentals and hold them until they become market darlings once again. Stella-Jones is a recent example.

Stella-Jones is a Canadian producer of treated wood products, with 80% of its sales going to the U.S. and the remaining 20% to Canada. Its major products are rail ties and utility poles, typically for replacement of existing infrastructure, with some modest growth. Stella-Jones has a long history of generating an above-average return on equity and growing its earnings per share above the market. Most of this growth has come from consolidating the industry over time. Stella-Jones has significant market leadership in its two main product segments and customers tend to be large and make repeat purchases. Class 1 railroads must maintain their active rail lines every year.

Utility companies often look to the best value for poles as their revenue is capped and poles in existence are on the upper end of their lifespan. When Sionna purchased the initial position in the company in 2017 in our large cap strategy at ~$40-45, Stella-Jones was going through a cyclical weak point. Its rail customers had experienced volume weakness and were managing their inventory such that Stella-Jones' sales were weak for an extended period. In the absence of growth, the wind was taken out of the company's stock price, which gave us a good entry point. Fast forward to 2023, and recent growth expectations in its utility poles business, due to the U.S. infrastructure bill combined with higher pricing, has put a tailwind behind the company's stock price that has begun to reignite outsized growth prospects. As a result, we are in the early innings of harvesting strong gains in our overweight position as Stella-Jones' share price begins to reflect this strong outlook. Its stock price has reached ~$68 at the time of writing. And given this outlook, it is likely that Stella-Jones is recapturing hearts of growth investors as its earnings power accelerates, thus possibly expanding its earnings multiple, setting up the scenario of a value stock transitioning into a growth stock.

Traps are a fact of life for all investors. At Sionna, we try to avoid traps using our consistent and time-tested investment process. We look for companies with a history of profitability and good growth outlooks run by prudent capital allocators. Financial strength is important as companies can make improvements with the long term in mind, further reinforcing their market positions and increasing shareholder value. We prefer to buy positions in these companies when their stock price is undervalued and unloved. In addition, our diversified portfolios lessen the impact of any single investment that disappoints by diversifying the portfolio across sectors. In these ways, we endeavor to preserve capital and increase risk adjusted returns within a well-diversified portfolio.

With the choppy start to 2023 that seems to have reignited the growth prospects of a concentrated group of well-known tech stocks, perhaps the question should be, how do you avoid a growth trap?

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