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The Limitations of Categorizing Stocks into Growth and Value Buckets

The practice of dividing stocks into rigid "growth" and "value" categories, or buckets as they are often referred, has become somewhat commonplace in today's investment landscape. Unfortunately, this binary classification system is far from perfect and can create significant limitations as it relates to portfolio construction. Nowhere is this division more prevalent than in the dominant world of ETFs and passive investing. While the growth-value dichotomy may, on the surface, offer a seemingly simple framework for asset allocation, its shortcomings quickly become apparent when issues such as overlap and excess industry concentration are considered, which are often the case within style-based ETF products. For example, the MSCI Canadian Value Index is 85% comprised of financial and energy stocks, making it more of a niche, sector-like product and not well suited as a core offering.

The heavy focus placed on these two buckets in recent years has not helped the cause of the bottom-up, fundamentally focused value investment manager. There is a clear difference between a value ETF or index constructed using one-size-fits-all standard metrics, and a seasoned portfolio manager selectively buying stocks of good businesses at discounted valuations. Traditional value investing, which involves buying below intrinsic value with a margin of safety, is not the same as simply purchasing low-multiple stocks, but sadly most value ETFs and indices regularly equate the two, creating challenges for active managers when attempting to describe and differentiate their active, fundamental approach to portfolio construction.

ETFs established to match an index such as a value or a growth index are constructed very mechanistically based on traditional valuation metrics such as price to earnings, price to book value, price to cash flow, etc. The portfolios are rebalanced, usually every quarter. Stocks that were solely in the growth index one quarter could also show up in the value index the following quarter and vice versa depending on short-term factors such as an inflection in the rate of earnings growth or a sudden change in valuation multiple. For example, energy is often considered one of the more cyclical sectors of the market, and stocks within the category are typically labeled value stocks. If, however, the price of oil jumps meaningfully in a given period, the earnings and cash flows of oil producing companies would likely rise with a greater magnitude. This momentum in earnings growth could then result in oil-producing companies' stocks moving into the growth index when the index is next rebalanced, creating an overlap issue – not to mention an identity crisis for the poor old energy stock.

We rigorously follow a value investing style at Sionna and have been ardent supporters of value as an investment style throughout our long careers, believing there to be no other logical approach to building wealth and preserving capital over the long term than the process of buying stocks of good businesses when the market is pricing them below fair value. That said, we have on occasion taken issue with the term "value stocks", a label commonly used by pundits when referring to old economy stocks or cyclical company stocks as if, by definition, a stock falling into one of those categories must be a value stock. The term often feels like it carries a negative connotation and is used to describe an entirely separate area of the market or a distinct asset class. The truth is, portfolio managers seeking value priced opportunities don't hunt within a separate pool of stocks labeled "value stocks", they search the broad market for mispriced opportunities, often agnostic to the sectors they are searching within.

Unfortunately, the growth versus value framework creates a false separation between two attributes that often coexist within a chosen stock. To quote Warren Buffett when referring to the two concepts of growth and value, " … the two approaches are joined at the hip: growth is always a component in the calculation of value…." Many businesses can demonstrate characteristics of both categories: their stock trading at a reasonable or cheap valuation while the underlying business is simultaneously delivering healthy sales and earnings growth. Take for example the following publicly traded company, which has grown its sales and earnings rather consistently over the past 10 years at compound annual growth rates of approximately 10%. The company achieved this growth while maintaining consistent profit margins and generating a return of roughly 14% on equity per year on average.

The stock was valued as high as 19x earnings and as low as 10x earnings at differing points over that 10-year period, even though the long-term positive fundamentals of the business remained firmly in place over the period. Should this stock be considered a value stock or a growth stock? Should the distinction even matter? The answer to the first question likely depends on when and at what valuation the stock was purchased, but it can most certainly be considered as both value and growth. As for the answer to the second question, should the distinction matter? It is an emphatic no.

The company in the above example is a consumer staple operating in the food retail industry. The fact that the business grew consistently at a rate more than double the rate of global GDP over the same period easily qualifies the business as a growth company – its underlying business value was compounding at an impressive rate of roughly 10% per year! At a very simplistic level, the average valuation multiple accorded to the business over the 10-year period was roughly 14x earnings. When the stock was priced meaningfully below that average level (i.e., closer to the 10x), a value opportunity arose in the stock, allowing investors to purchase a stake in this fine business at a discount to its fair value. This growth company had also become a value stock.

The company we are referring to is one of the world's largest food retail groups, with operations in both Europe and America, and a core holding in our High Conviction and International strategies – Ahold Delhaize. It is noteworthy to point out that in the example above, Ahold Delhaize was referred to as a "growth company" and not a "growth stock". This is yet another problem created when labeling stocks either "growth stocks" or "value stocks"…it's simply not an apples-to-apples comparison. "Growth" is a term used when describing the nature and prospects of the underlying business, whereas the term "value" relates solely to the price being paid for the stock. Hence why both attributes can, and ideally should coexist in a stock investment.

The growth-value framework, while providing a seemingly convenient platform for discussing investment strategies, ultimately falls short in substance and risks forcing artificial constraints on portfolio construction that could hamper performance. By moving beyond these limiting buckets and focusing on fundamental analysis of individual companies, investors will undoubtably make better, more informed decisions unconstrained by less-than-ideal classifications. Investors are better served over the long term by focusing on fundamentals such as competitive advantages, capital discipline, cash flow generation and attractive valuation – criteria that transcend simplistic growth-value dichotomies.

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