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Value or growth investing? No theme runs forever… Here's the biggest rule of building wealth in market

Synopsis
The distinction between value and growth investing is not straightforward as it often appears. The traditional definition of value as buying stocks with a low price-to-earnings ratio or price-to-book ratio may not be accurate in understanding the market. Investors must exercise flexibility in their investment philosophy as no theme runs forever, and certain geographies, sectors, asset classes, and investment strategies work for a limited period.

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Devina Mehra, Chairperson and Managing Director of First Global, is a gold medalist from IIMA as well as from Lucknow University where she broke several records. She had a seven-year-long stint at Citibank in Investment Banking & Corporate Credit/ Risk before becoming a member of the Bombay Stock Exchange in 1993 - her proprietorship which later corporatised and became India's leading institutional brokerage firm, First Global. She spearheaded First Global's globalisation over two decades ago, making First Global the first Asian (ex-Japan) firm to become a member of the London Stock Exchange and then the NASD.

First Global has since become a leading quantitative global asset management firm managing both PMS schemes in India as well as global funds.

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A question I often get… as does virtually every fund manager and investor is "Are you a value or a growth investor? Why?"

The answer is not quite as simple as it appears.

One, value and growth are artificial distinctions, especially the way most people define it...which is at a very rudimentary level.

Most define value as buying stocks with a low price to earnings (PE) or low price to book (PB).

There were many foreign institutions which called themselves value investors that entered the Indian market from the 90s and bought stocks trading at single digit PE multiples, without understanding why those particular stocks were trading at such low multiples.

They got their fingers burnt in stocks of many promoter groups like Mafatlal, Scindia, Videocon etc, either because the businesses were in their sunset phase or because the management was not quite clean. Either way, most of these stocks have since faded into oblivion.

The Indian market, which is generally a smart one, was pricing them low for a reason.

India rarely gives a free lunch, which is why companies with good steady cash flow even without very high growth are normally valued high: for example the FMCG bunch. For the same reason, it is almost impossible to get high dividend yield quality stocks in India.

Two, the low PE or PB ratio might not be the right definition of value at all.

When Ben Graham, the patron saint of those who swear by value, was alive, he himself changed this 'low multiple as value' definition and in the last editions of his book, "The Intelligent Investor" had written that intangible assets were becoming more important and have to be incorporated into the value equation... Meaning the traditional way of looking at PB no longer held.

Extract:
"It may be pointed out that under modern conditions the so-called "intangibles, eg. good-will or even a highly efficient organization, are every whit as real from a dollars-and-cents standpoint as are buildings and machinery."

Earnings based on these intangibles may be even less vulnerable to competition than those which require only a cash investment in productive facilities. Furthermore, when conditions are favorable the enterprise with the relatively small capital investment is likely to show a more rapid rate of growth...

We do not think, therefore, that any rules may reasonably be laid down on the subject of book value in relation to market price, except the strong recommendation already made that the purchaser know what he is doing on this score and be satisfied in his own mind that he is acting sensibly."

Think about how much more this statement will be true nearly five decades later when we have moved on even more to intellectual capital instead of physical capital.

The twist in the tale? Ben Graham himself made the bulk of his fortune in Geico, an insurance company - not at all the sort of value stock he wrote about all his life!

As I always say, pay attention to what investors and fund managers actually do, and not just to what they say. But that is a topic for another day.

Three, whichever way you define value or growth, no theme runs forever. Therefore you cannot be locked into a single investing philosophy.

Certain geographies, sectors, asset classes and also types of investing themes work for a period of time and then they stop working. The key rule in investing is to be flexible.

The market does not care about any fancy stories you spin or for that matter, any philosophy or ism!

To give only one example, the 'steady' FMCG stocks performed well in 2019 and 2020 and thereafter became laggards...just as they have done several other times in the last few decades.

A corollary to this is that investors and fund managers who say that they invest in their circle of competence are essentially saying that they invest in their comfort zone.

The types of stocks or sectors or themes or investing strategies that they like won't be the right places to be in all the time.

These go in and out of favour.

Plus a portfolio that contains only one type of stocks has higher volatility & drawdowns for precisely these reasons.

At the beginning of this year, many started to say that 2023 would globally be the year of value investing as the interest rates going up had made growth stocks less attractive.

The reasoning being that growth stocks depend on future earnings, rather than current ones and as interest rates go up, future cash flows are discounted at a higher rate and therefore their current value goes down.

For example, when the interest rate is zero, $100 received 5 years hence is the same as $100 received today. But if the interest rate becomes 5%, the 5 year out cash flow is valued at less than $80 today.

Unfortunately for them, the market rarely works on a very simple rule of the thumb level.

Thus, among the best performing markets in the world in the first quarter of the year was the Nasdaq, which is considered the epitome of growth investing!

Not only that, 90% of the move of the S&P 500 is also accounted for by just 7 Tech stocks i.e. the growth stocks.

Why? Partly because Nasdaq had a disastrous 2022 where it was among the worst performing markets in the whole world.

Consequently, it is not just important to understand the direction of the economy and the interest rates but also to what extent the markets have already discounted those or in other words, how much of it is already priced in.

Markets don't make it that easy for you to remain one step ahead... but that is their whole fun.