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EQUITY

Growth and Value Investing: A Complementary Approach

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Growth and value investing are often seen as competing styles, with one outperforming or underperforming the other during different periods of time and market cycles. While the approaches may differ, Stephen Dover, head of equities at Franklin Templeton Investments, and Norm Boersma, chief investment officer of Templeton Global Equity Group, say growth versus value doesn't have to be an either-or proposition. The pair outline the differences between a growth and value-driven investment approach, and why they can be complementary strategies. They also discuss recent market volatility and why they think the spotlight may be back on value.

Tune in to hear our latest "Talking Markets" podcast.

TALKING MARKETS WITH FRANKLIN TEMPLETON INVESTMENTS

Here are some highlights of the views of speakers represented in the podcast:

- **Stephen Dover**: Value managers are usually looking for a reversion to a mean that something is undervalued at this point and it's going to come back. Value managers are often called contrarian managers because they're looking at what everybody else does and they do the opposite.
- **Norm Boersma:** Volatility in markets is normal. We started to think after a few years of very, very low volatility that that's a more normal situation, but it actually isn't. We look at volatility as an opportunity in a lot of cases. We're looking for mispriced stocks, and if there's not a lot of volatility, you don't get a whole lot of mispricing.
- **Stephen Dover:** Historically, value can underperform for a very long period of time and then very rapidly catch up and the greater the dispersion between the growth and the value styles, the greater the likelihood that that change will happen fairly quickly.
- **Norm Boersma**: Today, probably the biggest risk, and the one that I think is on a lot of investors' minds, is just what happens as the central banks around the world start unwinding the quantitative easing that they've put in place. They're no longer the buyer of last resort for bonds and interest rates start rising. And, it's been compounded a little bit by fears that the economy is finally to the point where we have some inflation.

The full transcript of the podcast follows.

Host/Richard Banks: Hello and welcome to Talking Markets with Franklin Templeton Investments: exclusive and unique insights from Franklin Templeton.

I'm your host, Richard Banks.

Ahead on this episode, a look at why value investing has been challenged during the extended equity market bull run and the changing conditions that could turn the tide. Speaking with Norm Boersma and Stephen Dover is Kristine Hurley. We hope you enjoy their conversation.

Kristine: We are in person with Stephen, and Norm joins us by phone. Thank you both for your time.

Norm, let's start with you. For those who don't know about value investing, can you talk about what it is and the strategy behind it?

Norm: It's really about trying to buy something on sale. And the difficulty in doing that in the stock market is it's not like walking into a grocery store and looking around and there was a "for sale" sign. In the stock market, prices of shares trade every day and the prices change every day and sometimes quite dramatically and there's no sign saying, "for sale." So you need to have a strategy, a way of kind of coming at the valuation of the companies that allow you to really have a benchmark, to judge the prices of the shares and look for things that look too cheap. Stocks trade or should trade in long term against the prospects of the company.

A sale of a company is really created when investors for some reason are widely concerned about the company's prospects. That causes a situation where more people are interested in selling than buying and the share prices decline. And what we're really doing is taking a look at companies deriving their long-term value by looking through kind of the near-term prospects for the company, which is what the markets are typically focused on. And that allows us to sort of see situations where investors have broadly decided to, to sell down a stock. And we look at it and say, well, the actual prospects are much more optimistic than the market is discounting. And that's really a situation where a stock is on sale. And then take a step back, be patient, and let the markets basically realize that they've created situations where they've mispriced a stock and, over time, that stock price will gravitate back towards the proper valuation.

So you're really looking for situations where markets have overreacted, mispriced something, created a sale opportunity. And by having a disciplined investment approach, take advantage of that.

Kristine: Stephen, value investing is often compared to growth investing. Can you explain the relationship between the two strategies?

Stephen: What makes a stock worth something? How do you decide it's worth something or not worth something? It's actually pretty simple. It's a discount of all the future earnings that that stock is going to have.

It could be a house, it could be a bond, it could be anything. If you and I could sit here and we could agree on what all of those earning streams are going to be and we could agree on a discount rate, then we could agree on what that instrument or that stock is worth. Now that usually doesn't happen and I'll talk about why the discount rates are not a very good indication or are harming, particularly value investors, right now. But if we could agree, that'd be simple. But we don't because value managers are usually looking for a reversion to a mean that something is undervalued at this point and it's going to come back. Value managers are also often called contrarian managers because they're looking at what everybody else does and they do the opposite.

Growth managers are an optimistic bunch. They think that growth, particularly in the long term, is going to be much better than everybody else thinks it's going to be. That's what makes them growth managers.

Let's come back to that issue of the discount rate and why growth is outperforming so much recently, and one reason is the discounted value of money. So here is the way that it works. You look at your earnings over a long period of time and you discount those earnings back at an interest rate. Now, that interest rate is usually the government rate for that period of time. So for the moment, let's just say it's 10 years. Over the last 10 years, since the global financial crisis, the monetary policy has artificially pushed down interest rates. The lower an interest rate is, the greater the value of future earnings. Growth companies, by definition, have more future earnings than they have current earnings. That's how the earning streams differ. That makes, all things being equal, when you have artificially low interest rates, growth companies worth more than value companies because earnings in 10 years becomes more valuable than earnings in one year. Value managers focus more on the certain earnings in the short term. Growth managers, those optimists, are saying earnings are going to go on forever.

Kristine: Stephen, given growth investing strong run, what could be a cause for the pullback back in growth strategies and what might be a catalyst for value to outperform again?

Stephen: I think probably the first thing is if we see signs of normalizing monetary policy, if we see signs of inflation and rising interest rates, which clearly we are. The second thing would be if the growth companies cease to grow. If you look at companies that are getting into sectors or broadening out wider than their core in sectors that have lower margins, so their earnings growth is not going to grow as much as it could. So growth investing is, by definition, very much dependent on that constant earnings growth out there in the future. And if it looks like that's not going to happen, that could turn things around and you see a lot of creepage of value managers moving over to growth, and as you see that, growth stocks get overvalued and then you have a return back to the mean which would be value investing.

Kristine: If you look more historically without the influence of quantitative easing, what historically does drive the two different strategies?

Stephen: Well, I think that if you look at the difference, value had usually performed over a long period of time, and that's because the growth managers tend to be too optimistic. But there are times of great disruption, and when you have periods of great disruption, growth tends to outperform.

Over the last 10 years, which has been one of the biggest outperformances by growth ever, I think. Four or five growth companies constitute a majority of the growth in the markets. And in a kind of funny way, growth became a value play, particularly after the technology bubble. People were scared of growth, value outperformed. So in this kind of ironic twist, growth became value, right? There was a fear of growth or there was this whole idea that growth wasn't going to happen. When you look at disruption, I think it's very hard to pick who the winners are going to be. It might even be better to pick out who the losers are. And I was just thinking, if you look back to the technology names before the technology crisis, who did it look like was going to win? It looked like it was going to be—let's see if you can remember these names—Yahoo, CompuServe, Alta Vista, Compaq computer, Netscape. Great companies, multi-billion dollar companies, great big impact on the indexes. They're all gone or bought out or something else has happened. And, and that's, you know, that's the difficulty of growth. The other big change with growth and the other thing that's really helped growth companies, I think, is passive investing, and the huge move towards the, the indexes. And our growth managers within our firm, they're looking for growth and what they're trying to avoid is becoming momentum investing.

So what's momentum investing? That's really investing in whatever went up the most yesterday. And if you think of passive investing, if you think of index investing, what are you doing? You're really investing a little bit more in the stock that went up the most yesterday. And that means that yesterday's winners are going to be today's winners until they're not, because the inverse happens when things unwind. And that's what is a little bit of a concern to me about the market right now is because the unwinds can happen very, very fast.

So what happens with value? Historically, value can underperform for a very long period of time and then very rapidly catch up and the greater the dispersion between the growth and the value, the greater the likelihood that that change will happen fairly quickly.

Kristine: Norm, what happens to value stocks if interest rates continue to rise? Do you believe they can outperform growth?

Norm: So interest rates rising is really a sign that the economy is doing well and that there is growth in the economy. We're sort of in that situation now where rates are starting to rise around the world, partly as a reversal of quantitative easing, but really in reaction to the fact that we have synchronized growth around the world. And typically, when you look at the value sector, especially now that you've got a number of stocks in there, there's a big weight in financials for instance, that are very interest-rate sensitive, so rising rates are actually helpful to those stocks. So, that would be sort of one strong argument that value will tend to do better. And the other part is a lot of value stocks are in cyclical industries. Of course, growth helps those industries to perform better, so that's another tailwind. And then value stocks, quite often on an individual basis, if you're not looking at sectors or countries, are situations where something has gone wrong. But it's much easier to fix, much easier to sort of get that company back on track if you have a growth tailwind, as opposed to a recession headwind. And so again, value tends to do better.

Kristine: Where are you finding opportunities in the market today? Are there any specific countries or sectors?

Norm: In terms of sectors, financials will tend to do well as rates are rising and we're enjoying growth around the world.

Health care stocks have in general been under pressure because of worries about pricing concerns in the US and, and, there are quite a few companies that have been facing at least short-term issues and that's created quite a few opportunities there in the specialty pharma space and in the biotech space and energy, where oil prices have been low, they're starting to recover, there's still good value, especially in the integrated stocks. So there are quite a few areas of opportunity, but there are also some areas that have gotten expensive; the technology sector has been very, very buoyant. Material stocks have also done very, very well. And then when you look at the geographical spread, the United States has done phenomenally well. So it's not surprising that you find that that's a more expensive market.

Europe has lagged behind. If you take a look at earning spreads between the US and Europe, the earnings in Europe actually have quite a bit of room to move up. Part of that is in the financial sector, as I mentioned earlier, that scenario that we are finding some value in.

Kristine: Stephen, do growth investing and value investing emphasize different sectors and how does that impact their performance over time?

Stephen: So the answer to that, like so many questions, is kind of yes and no. So if you do it by the purely P/E [price/earnings] ratio then by, by almost stereotype, technology companies are growth, financial companies and commodity companies are value. But I think from a value investor's point of view, there shouldn't be any sector that you cannot invest in at different times. Value managers aren't against companies that have growth. They are against paying too much for companies and that kind of wild enthusiasm that sometimes happens.

Kristine: Norm, the recent bout of market volatility spooked many investors, but most likely it won't be the last. How do you view this kind of situation and all the noise that comes with it?

Norm: I mean, volatility in markets is normal. We started to think after a few years of very, very low volatility that's a more normal situation, but it actually isn't. Stocks tend to move fairly dramatically from time to time and daily movements can be easily half a percent, one percent, one-and-a-half percent. That's not unusual. And you know, the recent bout of volatility is really a return to somewhat more normal circumstances. Last year we had a very steady progression upwards in price movements in the various markets around the world. Very, very unusual. You know, the worries that the market has at this point in time are really driven partially by the fact that valuations have started to become a bit stretched in some places. People have made a lot of money in the last little while. So there's, of course a concern that they're going to give that back. So everyone is sitting a little bit, nervously watching. And it's pretty normal in a situation like that, that you do have some pullback, and it's almost considered healthy that the market has some corrections to wash out some of the money and then you can kind of restart from a somewhat lower level, somewhat more normal level, to start appreciating again. So, we look at volatility as an opportunity in a lot of cases. As I said, we're looking for mispriced stocks, and if there's not a lot of volatility, you don't get a whole lot of mispricing. So as people pull their money out, they pull it out somewhat indiscriminately and they create some situations where things are somewhat mispriced and we'll step in and take advantage of that. In the same way, as when markets are really, really strong, we'll be selling down the stocks in areas where we feel the prices have gotten too high and they're actually overvalued. So volatility creates some concern, but it also creates opportunity. And for us, it's a sort of natural situation.

Kristine: What risks or challenges do you see on the horizon and how does risk management play to your investment approach?

Norm: Markets always have risks in them, and that's part of investing in markets; that goes along with the volatility. You know, today, probably the biggest risk and the one that I think is on a lot of investors' minds, is just what happens as the central banks around the world start unwinding the quantitative easing that they've put in place. They're no longer the buyer of last resort for bonds and interest rates start rising. And, it's been compounded a little bit by fears that the economy is finally to the point where we have some inflation, and that of course pushes rates higher as well. So, we're in an environment where rates are rising, and first in the United States, but we'll probably see that over the next year or so right around the world. And we have markets that have done well, so the valuations aren't particularly low. And we have, around the world, quite a bit of debt. So those are the fairly easy things to see that people are worried about. I think in a lot of cases, it's really about how the unwinding goes, in terms of the central banks being fairly measured and not being overly aggressive, and giving the markets basically time to sort of absorb what's going on. And, I think the central bankers are quite focused on that, but of course, that's a difficult thing to control because ultimately markets do what markets want to do. We are very conscious to look at the risks we're taking. Those risks would be geopolitical, currency risk, interest-rate risk, economic sensitivity. All the various factors and then as well, we're checking to make sure we're well diversified.

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