# Why growth stocks get too much attention

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SPECIAL TO THE GLOBE AND MAIL
PUBLISHED 5 HOURS AGO


Bitcoin is making a comeback as increased speculation and risk-on times are once again in fashion.

PETER PARKS/AFP/GETTY IMAGES

It is back-to-the-future times. While it may not be exactly Dot Com times, it rhymes – figuratively speaking. It is AI times now. Just like in the late 1990s when companies added ".com" to their names to boost stock prices, today a company can increase its valuation by attaching an AI to its name.

Not to mention that increased speculation and risk-on times are once again in fashion. SPACs are making a comeback and so is Bitcoin. And junior mining companies and other speculative investments are hitting new highs. For example, Bespoke Investments indicated that 858 money-losing U.S. companies have seen their shares up at least 200% since April 9 – the day after the market bottomed out. Does it rhyme?

Growth investors are surprised and dismayed when they hear that stock values are "stretched." They believe that such stocks' superior forward growth rates justify current valuations and that they can still make money in these stocks despite their sky-high price-to-earnings multiples. And they have good company, as most analysts covering these stocks also agree with them judging from the overwhelming buy recommendations.

As a value investor, I read these comments and look at these valuations and my skin crawls. One of the biggest risks an investor faces is valuation risk – paying too much. You can buy the best company, but if you overpay you will not make much money. How do value investors guard against overpaying? The first step of the value investing process (there are two more steps after that, which I have discussed in past columns) is to search for low P/E companies, among other metrics.

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Why is this so? The P/E multiple is a function of the growth rate of earnings going forward. This relationship can be found in a mathematical formula derived from the equity valuation model taught at every university. Companies have low multiples because markets expect low earnings growth. Companies have high multiples because markets expect high earnings growth. However, the way the growth rate comes into the mathematical formula implies growth forever. That is, a high multiple firm is forecast to sustain a high growth rate and a low multiple firm a low growth rate in both cases forever.

The markets tend to be overoptimistic about growth for high multiple firms and overpessimistic about growth for low multiple firms. As a result, investors bid up (overvalue) high multiple firms and bid down (undervalue) low multiple firms. That is why value investors tend to avoid high multiple firms.

But if you do not want to take my word for it, let's look at the evidence. Academic studies have shown that, historically on average, over long time periods, low P/E stocks have beaten high P/E stocks in Canada, the U.S. and around the world. They beat them in good times and bad times, when news is good and when news is bad. How come? If one is overoptimistic about a stock most of the time, they tend to be disappointed in a down market and not so surprised in an up market. When they are overpessimistic about a stock, they tend to be pleasantly surprised in an up market and not so surprised in a down market.

But if it is difficult to see the relationship between P/E and earnings growth, let me share the results of another study that actually looked at growth rates directly. Researchers at the Darden School of Business looked at the stock performance of high growth firms and compared it with the performance of low growth firms over a period of 40 years between 1968 and 2007. What they found was that low growth firms had an average annualized return of 26%, while high growth firms returned a meagre 4%. The low growth firms outperformed the high growth firms by a whopping 22 percentage points on average, annually, over a 40-year period.

Glamorous (high growth) firm stocks tend to attract significant attention, a significant analyst following and significant trading by investors. By the time an ordinary investor decides to buy them, their prices have already been bid sky high. In these cases, it is difficult to make any money. The opposite happens with low P/E or low growth firms.

One can extend this analysis to countries, as well. High growth countries' stock markets tend to become way too overpriced as they attract investors and funds, and as a result they tend to have low forward returns. The opposite is the case for low growth countries. A case in point is the stock market performance of the U.S., the most negatively viewed market in the early 2000s, vs. the BRIC countries, the most favoured market in the early 2000s. Since then, the best performing market in the world has been that of the U.S. and some of the worst markets in the world have been those of the group of countries now known as BRICS. Similarly, until recently, the sentiment by market participants toward Europe was quite negative vis-à-vis the

U.S. And look what's happened: Since the start of 2025 up to mid-July, the European index rose by over 20% vs. 7% for the U.S. market.

So, if you want to invest in high multiple or high growth firms, you must first look at the evidence and understand the history – unless you believe that "this time is different." Sir John Templeton said those are the most dangerous words in the investing world.

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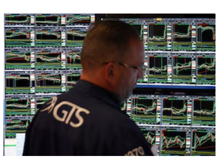


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