Value Versus Growth Stock Investing: A Current Perspective

A conversation with George Athanassakos, PhD, Professor of Finance and Ben Graham Chair in Value Investing at Ivey Business School, Western University, and author of *Value Investing: From Theory to Practice*

Until recently, growth stocks have enjoyed a run of outperformance compared to their value counterparts. While value stocks go through disappointing periods from time to time, the principle that lower relative prices lead to higher expected returns has historically emerged intact. Nearly a century of data in the US and almost five decades of market data outside the US support the thesis that value stocks—those with lower relative prices—have higher expected returns. On average, value stocks outperformed growth stocks in the US by 4.1 percent annually from 1927 to 2021.[1]

Famous value investor Prem Watsa, Chairman and CEO of Fairfax Financial Holdings Ltd, described *Value Investing: From Theory to Practice* as a follow up to *Security Analysis*, first published in 1934 by Ben Graham, the "father" of value investing. Watsa describes the book as a "New Testament" to Ben Graham's "Old Testament." It is the first academic book on value investing that explains both the theory and how to put it into practice.

The book's purpose is to enable readers to find greatly undervalued stock. Value investing is about stock picking—how to find and buy stocks that trade significantly below their intrinsic value. Value investors argue that prices can diverge considerably from value in the short run. If investors can buy stocks that trade significantly below their intrinsic value, and they are patient, over time, the stock prices will eventually approach intrinsic value, and investors will make money. Human nature and conflicts of interest among professionals often move prices away from fundamentals in the short term, creating buying opportunities. However, a requirement to make money is that stock prices ultimately approach their intrinsic value. That is to say that, in the long run, markets become efficient.

George Athanassakos notes that value investing does not require complex, ostensibly precise financial models. He quotes Warren Buffett's advice: "Beware of geeks bearing formulas," while cautioning against relying on false precision. Value investing, he states, is more an art than a science. Theory and formulas always look nice, but they are subject to many restrictive assumptions that very often do not work in real life.

We recently had the opportunity to interview Athanassakos about his work.

***The Analyst* (TA):** It is sometimes said that value investors look for the bird in the hand while growth investors look for the two in the bush. How would you describe the value investing process?

George Athanassakos (GA): It is a three-step process. First, value investors try to identify stocks that appear undervalued. Some investors, like Ben Graham, focus on

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[1] Dimensional Fund Advisors. "When It's Value vs. Growth, History Is on Value's Side." *Dimensional Fund Advisors*, February 2, 2022. https://www.dimensional.com/se-en/insights/when-its-value-versus-growth-history-is-on-values-side.

obscure, small-cap stocks with small analyst followings and low price-to-earnings (P/E) and price-to-book (P/B) ratios, while others, like Warren Buffett, select stocks of companies that have barriers to entry in their industries, and enjoy good sustainability. This step enables the investors to reduce the sample of stocks they will examine in depth later and to make sure that those stocks have desirable characteristics. The second step is to analyze the stocks to determine their intrinsic value. Finally, a decision is made to buy only the stocks that are truly undervalued—that is, they meet a predetermined margin of safety, such as 50 cents of market price for every dollar of value. Value investing is more than choosing stocks with a low P/E ratio. Unfortunately, academic research has focused only on stocks with low P/E ratios, when that is only the first step of the value investing process, creating confusion in the public sphere about what value investing is.

TA: Are there different approaches to value investing?

GA: Yes. Value investing has evolved, even though the core principles remain the same. Assets are easier to see and understand. Ben Graham focused more on assets for stocks that are obscure and undesirable; if something goes wrong, investors can always sell the assets. Buffett focuses more on cash flows—it is easier for investors to understand future cash flows that the assets produce for companies with barriers to entry in their businesses and competitive advantages. No matter what, though, value investors would rather minimize risk than maximize returns. They adhere to Aristotle's dictum: "The aim of the wise is not to secure pleasure but to avoid pain."

Proper analysis and the right process are key. Experience and intuition are essential, too. Value investors tend to follow a holistic approach and understand:

- Accounting (how to read historical financial statements and associated notes)

- Finance (how to assess businesses, proper valuation approach, and understanding value creation and how future developments may affect the financials of the company)

- Economics (how markets are structured, implications of perfect and oligopolistic competition, and the drivers of interest rates)

- Strategy (drivers of barriers to entry, competitive advantage and sustainability, possible catalysts, and game theory)

- Psychology (how weaknesses of human nature and institutional conflicts of interest affect stock prices)

Character and the right frame of mind in making decisions are paramount if you want to become a successful value investor. Humility, patience, discipline, and a long-term perspective are essential. Intelligence has comparatively little to do with it. Successful people are intelligent, but intelligence does not ensure their success.

Emotions cloud judgement and lead to illogical conclusions. Humans are not rational; they overact, are overly optimistic, and tend to have a herd mentality. Such behaviour pushes stock prices away from value. Institutional behaviour introduces biases in stock prices due to the conflicts portfolio managers encounter when they manage other people's money. You can be the best valuator and screener, but you will never be a good investor if you panic, get greedy, or are impatient. Also, you will never be a good value investor if you do not do your homework and are not independent.

TA: Is it fair to observe that value investing capitalizes on the many irrationalities of human nature?

GA: Yes. The best investors understand human nature and institutional biases. My advice for investing success consists of several elements. Firstly, you need to have reasonable intelligence, but there is no need to be Einstein. As Buffett says, "What we do is simple but not easy." Secondly, you need to have sound principles of operation and a passion in an area that fits your character or personality, as well as a process and a system that leads to success. An investor needs to understand businesses from the bottom up, develop intuition, have a proper valuation model, and deal with simple companies and business structures. You need to get outside the narrow areas of your expertise and understand other areas too, read the history of financial markets, do your homework, be independent, and have long-term perspective. Generally, you should be willing to put a lot of an investment portfolio in your best ideas, i.e., have a concentrated portfolio without compromising the risk-reduction goal through diversification. A person must develop and work on their character and temperament. Most investors must develop strategies to deal with the weaknesses of human nature. For example, never make impulsive decisions—look before you jump. Have an analytical process in place that tells you when to buy and when to sell so that you overcome your emotions.

My research, using US data for the period of 1980 to 2018, shows that markets tend to be overly optimistic about growth for high-multiple firms and overly pessimistic about low-multiple firms. Value (low P/E stocks) beats growth (high P/E stocks) in the long run because investors tend to be overly pessimistic about value stocks. Some of these stocks go bankrupt, but most do not, and these stocks tend to do better in the future as investors are often seen to have been excessively pessimistic. Moreover, since investors are overly optimistic about growth stocks and overly pessimistic about value stocks, growth stocks react much more negatively than value stocks to bad news. As a result, value tends to beat growth, not because value does so well, but because growth does so poorly in the long run. The demise of growth stocks over the last year is an excellent example.

TA: We have seen value stocks starting to outperform the market in recent months after a period of outperformance by growth stocks. Why do you think this has been happening, and how long will it last?

GA: We are facing a future of deglobalization and an environment of higher inflation and interest rates. In this environment, bonds and real estate are not likely to do well. High-quality, Buffett-favoured value stocks, which have competitive advantages and can pass on cost increases to customers, are likely to do well. The outlook is unfavourable for growth stocks, which will be hurt the most by deglobalization and higher inflation. For example, during the Cold War years between 1966 and 1991—when US inflation averaged 4.3 percent annually—value stocks outperformed growth stocks by 10.8 percent per annum, whereas during globalization years between 2008 and 2020—when inflation averaged only 1.7 percent—growth outperformed value by 4.2 percent. Their underperformance will also adversely affect the whole market, as the share of the technology sector (mostly growth stocks) in market indexes has increased steeply in recent years.

TA: The value investors we have met over many years, from John Templeton to Warren Buffett, have tended to be very calm and level-headed, living long and highly productive lives. Is there a connection between their personal and investment philosophies?

GA: If you practice value investing, you will tend to do well as an investor and in life. Patience, discipline, humility and a long-term perspective are traits that define value investors' characters and help them achieve investing success and a balanced and long life. That is another benefit of value investing!

TA: And another excellent reason to read your book! Thank you for sharing your thoughts with us.

This article has been edited for length and clarity.

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