Alley Company Quarterly Letter
The Value of Growth

July 14, 2017

The investment community has created a distinction between "growth" and "value" investing. In short, value investors select stocks that are cheap statistically on valuation metrics such as price-to-earnings ratio, price-to-book ratio, dividend yield, etc. Typically there is a reason for these companies to be selling at low valuations, such as lack of organic growth, inconsistent track records, or competitive problems of one kind or another. Value investors hope that these companies' fortunes will improve and that the valuation risk is sufficiently low to make it worthwhile to wait for the turn in fundamentals.

Growth investors, on the other hand, select stocks of companies whose track record of revenue, earnings, and dividend growth has been consistent in the past and continues to look promising in the future. While the valuation metrics tend to be higher, growth investors feel they are justified by the consistency of earnings growth and leadership positions these companies exhibit. They expect to pay a reasonable price for a unit of growth, and that continued growth will bail them out of possible valuation concerns over time.

There need not be a debate between "growth" and "value" as most investors don't knowingly buy "overvalued" stocks. The relevant question should be: "what price for a given level of growth?" If one can buy consistent growth at a fair price, then, hooray, it's a value! This is our philosophy as we prefer companies that exhibit market power and consistency of financial results.

We know that future growth is most valuable when inflation and interest rates (which are generally correlated) are low. This value proposition is supported by the classic dividend discount model which states that the price of a stock is theoretically equal to the discounted stream of expected dividends.

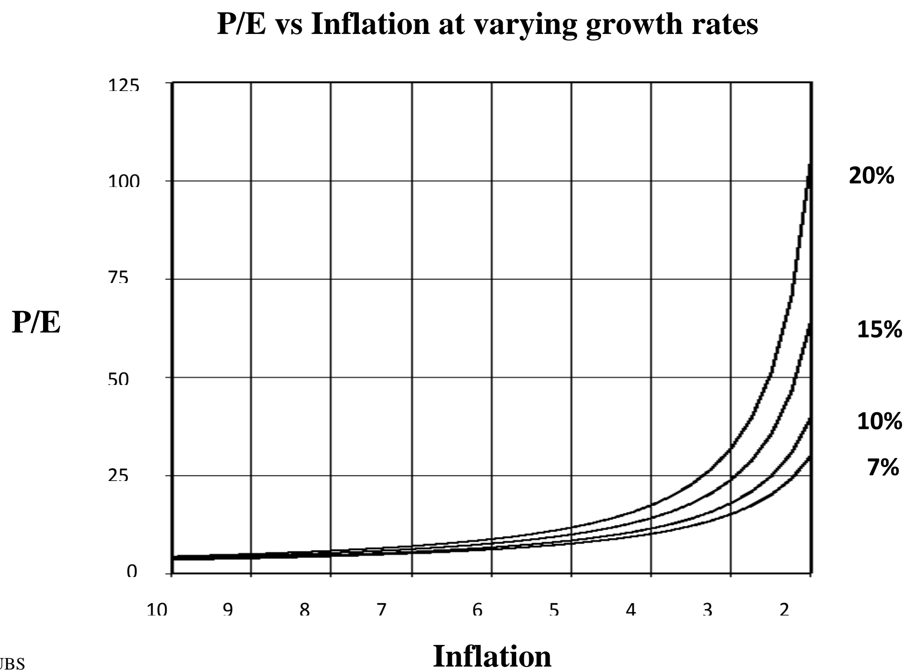
$$P = \sum \frac{D\ (1+g)^t}{(1+R)^t}$$

Where: P = price, D = current normalized dividend, g = secular long-term growth rate, R = equity discount rate, and t = time.

Alley Company LLC
585 Bank Lane, Suite 2400
Lake Forest, IL 60045
Phone 847-482-0938
Fax 847-482-1237
www.alleycompanyllc.com

The lower the discount rate, or R, in the equation, the higher the value of P, or price, of the stock, everything else being equal. This is important as a general rule, but even more so for companies that exhibit high growth in earnings and dividends, as the leverage in the equation is incrementally more favorable to the price of a stock with higher growth characteristics.

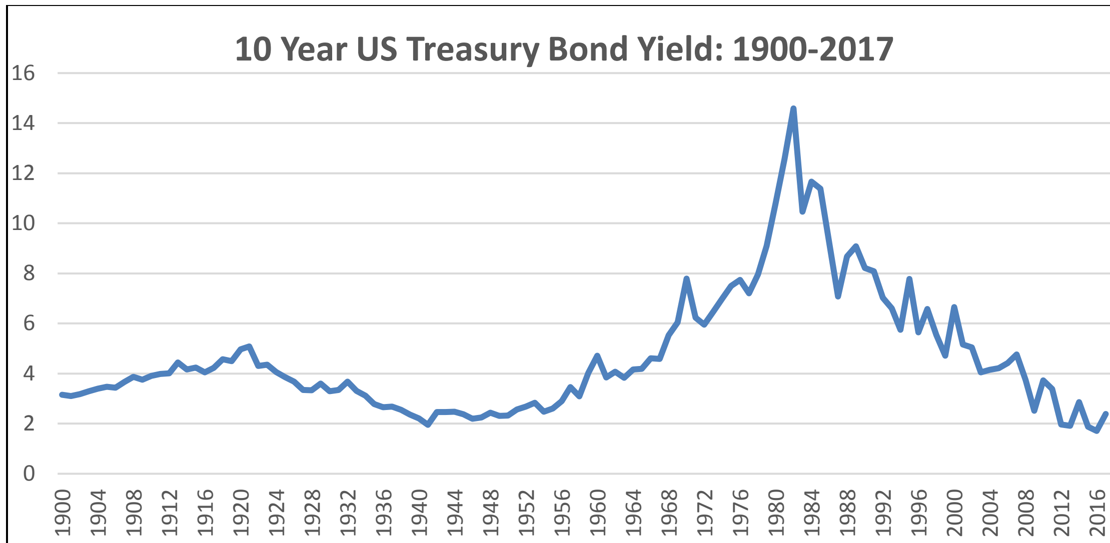
This is best illustrated by the graph below, which shows the theoretical relationship of P/E to inflation for stocks of various growth rates.



Source: UBS

As depicted, future growth becomes more valuable when inflation is low. Stocks that can consistently grow earnings and dividends have proven to be more valuable relative to the market in this environment.

Interest rates around the world, both short-term and long-term, are exceptionally low these days. Investors have been predicting higher interest rates for a number of years now, but for a variety of reasons, they remain low, and could very well remain relatively low for an extended period. The graph on the following page illustrates the history of the ten-year Treasury yield dating back to 1900.



Source: Robert Schiller (www.econ.yale.edu)

In our quarterly letter entitled "Déjà Vu?," published in July of 2015, we cited that from the low point in interest rates in the early 1940s it took *twenty years* to reach the long-term average interest rate of 4.7%. When we look back at the interest rate normalization process that occurred during 1941-1960, the annualized total return of the S&P 500 was a very attractive 14.50%. The annualized return for the ten-year U.S. Treasury bond was just 1.93% during the same period.[1] Historically, when yields are below 5%, rising interest rates have been associated with rising stock prices.[2]

We don't have a crystal ball on where inflation and interest rates are headed. However, continued low inflation globally caused by a number of well documented factors such as slow economic growth and deflationary price pressures driven by the internet and the likes of Amazon, coupled with the ongoing demand for U.S Treasuries from foreign sources given low and in some cases negative interest rates, augurs for a continuation of interest rates staying "lower for longer."

History would suggest that the interest normalization process is lengthy and gradual, and in this context, companies that are able to demonstrate consistent earnings and dividend growth are very valuable.

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[1] Annual return figures were taken from Aswath Damodaran's "Historical Returns of Stocks, Treasury Bonds, and TBills: 1928-2014", New York University.
[2] "Correlations between weekly stock returns and interest rate movements", J.P. Morgan Guide to the Markets – Q3 2017, p. 15.