Alley Company Commentary
The Value of Growth

The investment community has created a distinction between "growth investing" 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 and earnings growth has been consistent in the past and continues to look promising in the future. While the valuation metrics are 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 valuation concerns over time.

This debate need not be. The conflict is not between "value" and "growth" because no one knowingly buys "overvalued" stocks. The question is "what price for growth?". If one can buy growth at a cheap price, then it is a value. Who wouldn't buy growth if it is valuable?

We know that future growth is most valuable when inflation and interest rates are low, as is the case now. This 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.

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

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

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 growth stocks, as the leverage in the equation is incrementally more favorable to the price of high-growth stocks.

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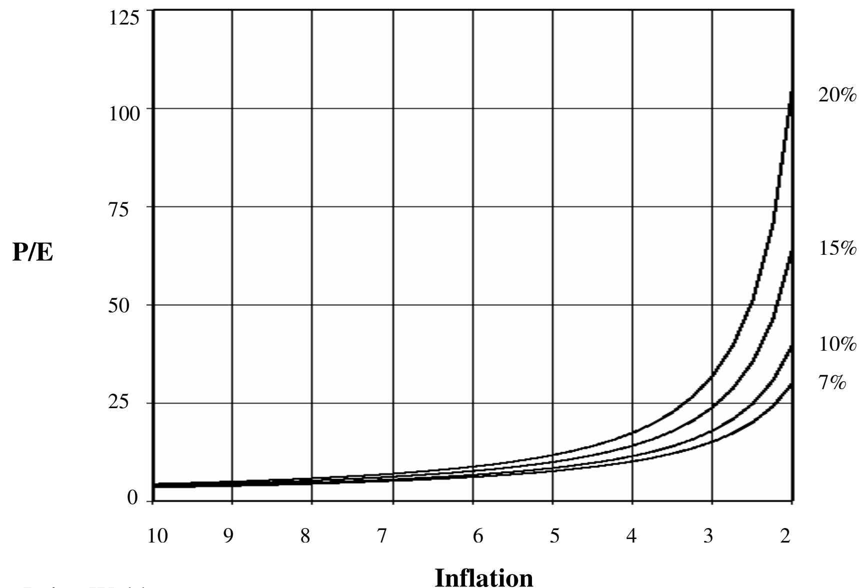
This is best illustrated by the graph below, which shows the relationship of P/E to inflation for stocks of various growth rates.



Source: Paine Webber

As depicted above, "future growth becomes more valuable" when inflation and interest rates are low. Growth stocks have proven to be more valuable relative to the market in this environment.

The environment we are living in at a given point in time is rarely perfect for any philosophy or style of investing. In periods of stable economic growth, the visibility of earnings growth tends to be highest, and correspondingly, P/Es of growth stocks also tend to be high, assuming interest rates are at reasonable levels.

When this visibility is impaired during an economic slowdown, confidence in growth rates wane, and P/Es of growth stocks get marked down. This is an important time to do homework on the true growth prospects of companies. If the future growth of these companies continues to look promising, the intermittent slowing of growth usually provides an excellent buying opportunity in the stocks. Once earnings visibility resurfaces, and the earnings growth rate is revalidated, the stocks' P/Es will rise again to reflect that growth.

Whether the environment is one of continuing growth, or a temporary interruption of the trend, growth is always valuable when inflation and interest rates are low. Think how valuable the earnings stream is for a company that consistently generates 15% earnings growth in a 2% inflation environment vs. 15% growth in a 10% inflation environment! This is why the stock market trades at less than 10 times earnings in a 10% inflation environment, and 25 times when inflation is 2%.

The point once again is that "growth is valuable" when inflation and interest rates are low. Investors should pay as low a price per unit of growth as possible with the knowledge that consistent growth is the recipe for successful compounding of money over time.

We at Alley Company believe that the U.S. economy is fundamentally solid, and that we will continue to operate in a low inflation environment that will strongly support predictable growth stocks. We are committed to the concept of compounding money with growth stocks that will allow the positive affects of compounding to flourish.

In periods of poor visibility for growth, more patience is required in achieving investment returns. Remember that over the long haul, the stock market reflects the moderate but consistent growth of wealth in America. Our job is to continually monitor the future growth prospects of our holdings to make sure they are intact. This is the challenge that we get up for everyday.

Website

Alley Company is pleased to announce the establishment of a website at ***www.alleycompanyllc.com***. The purpose is to familiarize you with our investment philosophy both generally, and through our periodic commentaries that are published on the site. Please take a look.

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