

## The Case for Growth Stock Investing

Value stocks have outperformed growth stocks for nearly four decades, while exhibiting less standard deviation risk and a very high short-term correlation with growth stocks. Conventional wisdom is that long term investors will achieve superior risk-adjusted returns with value stock portfolios. But this view has been recently challenged in academic circles, where studies have shown that the riskiness of stock returns comes in two flavors – discount risk and cash flow risk. Because these two forms of risk have



Luis Viceira

strikingly different characteristics, and they affect value and growth stocks in measurably different ways, advisors may want to rethink their allocations to growth and value stocks.

We recently interviewed Luis M. Viceira, a Professor of Finance at Harvard Business School, and Jakub W. Jurek, a PhD candidate there, who have co-authored a [paper](#) on this topic.



Jakub Jurek

### Understanding and Measuring Discount and Cash Flow Risk

Viceira believes the best way to understand these two types of risk is to consider an investor who holds a junk bond. There are two adverse outcomes that might affect the value of such a bond – a steep increase in interest rates (the discount risk) and a credit problem with the issuer (the cash flow risk) – each of which will cause precipitous declines in the value of the principal. If the investor has a short horizon, he might be indifferent as to what might have produced the fall in the value of the bond. After all, he is about to liquidate the investment and lock in the loss. However, if the investor has a long horizon, he will see a fall in value caused by rising interest rates as less risky than a fall caused by a default. Why? Because a decline in interest rates might eventually self-correct, through a reversion to the mean, while a credit problem related to default is permanent.

In recent [research](#) John Campbell, a Professor of Economics at Harvard, and Tuomo Vuolteenaho, a partner at Arrowstreet Capital L.P., have shown that equities exhibit the same forms of transitory (discount) and permanent (cash flow) risk. Discount risk, which they call “good beta” (in reference to the two types of cholesterol, “good” and “bad”) is typically associated with changes in the risk aversion of investors or changes in investor sentiment. Cash flow risk, or “bad beta,” relates to the stability and growth of the business and the earnings it will generate. Campbell and Vuolteenaho, and Viceira and Jurek in subsequent research, have measured both forms of risk, using techniques which they describe as ‘tricky’ but not overly technical. Discount risk is measured by observing how returns covary with observable factors known to forecast aggregate



stock returns, such as P/E ratios, and then attributing the remaining risk to cash flow risk. Viceira and Jurek caution that this model hinges on the assumption that prices are dependent only on changes to the factors they have identified (risk aversion, market sentiment, or growth rates). But these concerns are fundamentally the same as with measuring the riskiness of stocks using beta, which calibrates the degree to which a stock covaries with a known index. In both cases, there is a lot of 'noise' that must be filtered out before the meaningful elements of the model can be identified.

### **The Riskiness of Value and Growth Stocks**

Viceira and Jurek studied portfolios of value and growth stocks and found that discount rate risk dominates their short term (one or two years) return dynamics, resulting in a high (95%) correlation. Given the higher historical returns of value stocks, a short-horizon investor will be better off (on a risk-adjusted basis) with value stocks. But over longer time horizons (five to ten years), the correlation between value and growth returns drops to 70%, as the effect of cash flow risk dominates. This increases the diversification benefit of growth stocks, making them more attractive to the long term, risk averse investor. Although at short time horizons value stocks provide excess returns vis a vis growth stocks, growth stocks provide useful diversification at long time horizons.

Benjamin Graham described the stock market as a voting machine in the short term and a weighing machine in the long term. In the long term, cash flow risk is what matters, and growth stocks appear to have less of this risk than value stocks.

Viceira and Jurek looked at the universe of equities and their price-to-book ratios, in order to segregate value from growth stocks. Stocks above the median price-to-book are classified as growth and those below as value. An interesting observation is that roughly 70% the total market capitalization is attributable to stocks with a price-to-book ratio above the median value (growth stocks), with the balance being accounted for by value stocks. This ratio has been very stable over time during the period 1926 to the present, suggesting that, from the perspective of traditional value metrics, a neutral allocation between growth and value is approximately 70% growth and 30% value.

### **Value and Growth in Today's Markets**

In the first week of August portfolios with strong value tilts, especially leveraged quantitative funds, experienced large losses (as was the case with a big Goldman Sachs hedge fund). Viceira and Jurek cite this as an example of the cash flow risk inherent in value stocks kicking in, and doing so at the worst possible time – a time of crisis. On average value stocks will do better, but investors will have to weather some severe storms.



So, is there honestly a good reason for investing in value over growth? To outperform consistently for such a long stretch, value stocks have to be riskier inherently. Although the extra risk is hard to detect in the short term, it is observable in the long term. And it may not be the kind of risk that creeps gradually into a portfolio; it may strike suddenly, as it did earlier this month.

The debate between fundamental and cap-weighted indices plays into this discussion. Viceira and Jurek argue, as have others [Ed. note – see our [interview](#) with Burton Malkiel], that fundamentally weighted indices are a way of introducing a value bias into a portfolio. They have nothing against this approach, and argue that the key issue is investor awareness. Investors should know that fundamental indexing introduces a value tilt in their portfolio, and that they are being exposed to greater levels of cash flow risk. History shows that this risk is compensated, but ultimately investors need to determine whether they feel comfortable holding that risk in their portfolios. As an alternative to fundamental indexing, investors who want to tilt their stock portfolios toward value beyond the neutral market 70/30 growth/value market allocation might want to consider combining a traditional cap-weighted index with an actively managed value fund or with an ETF tied to a value index, and the allocation to the value fund or ETF should be reflective of the investor's time horizon. In this way, overall portfolio returns are likely to be very similar to the returns on a fundamental index. Whether they want to adopt one or the other should then depend on the cost (fees) of each alternative.

### **Current Areas of Research**

Viceira's current area of research centers on perhaps the key issue faced by investment advisors – how to incorporate an investor's age and risk tolerance into portfolio asset allocation. Viceira has looked at the composition of life cycle funds (those based on the age of the investor) and life style funds (based on the risk tolerance of the investor) to determine the optimal mix of stocks, bonds, and cash. His [research](#) shows that CDs and money markets can be very risky at long time horizons, because the real return of these investments (after inflation) can change significantly over time. The safest investments are inflation-protected bonds, such as TIPS, that will have short term volatility but will achieve the investor's long term goal, which is a predictable annuity after inflation. Viceira argues that modern portfolio support offers "qualified" support for life cycle and life style funds, and that (if properly constructed) they are better choices than money market funds, which are often the default choice in defined contribution plans.

Lastly, we spoke more generally about Viceira and Jurek's views on the market and global diversification. They caution that we may be moving into an era of reduced



returns from the equity markets, and this reinforces the importance of incremental improvements to returns and the benefits of compounding. Viceira noted that many students are surprised to see the difference an improvement from 6% to 7% makes in total returns, when compounded over a long time horizon. “The way to be smart about investing is to worry about costs and tax efficiencies,” Viceira explained. They are strong believers in international diversification, but noted that investors should be careful about overweighting emerging markets, since considerable exposure to these markets is also obtained by investing in the developed economies, which are the emerging world’s main trading partners. As with the issues surrounding the growth versus value debate, and the case for fundamental indexing, Viceira and Jurek warn that, with international diversification, investors must always be aware of the bets they are placing, noting that “statistics will take you only so far; economic thought, intuition, and common sense are the real ingredients to successful investing.”

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