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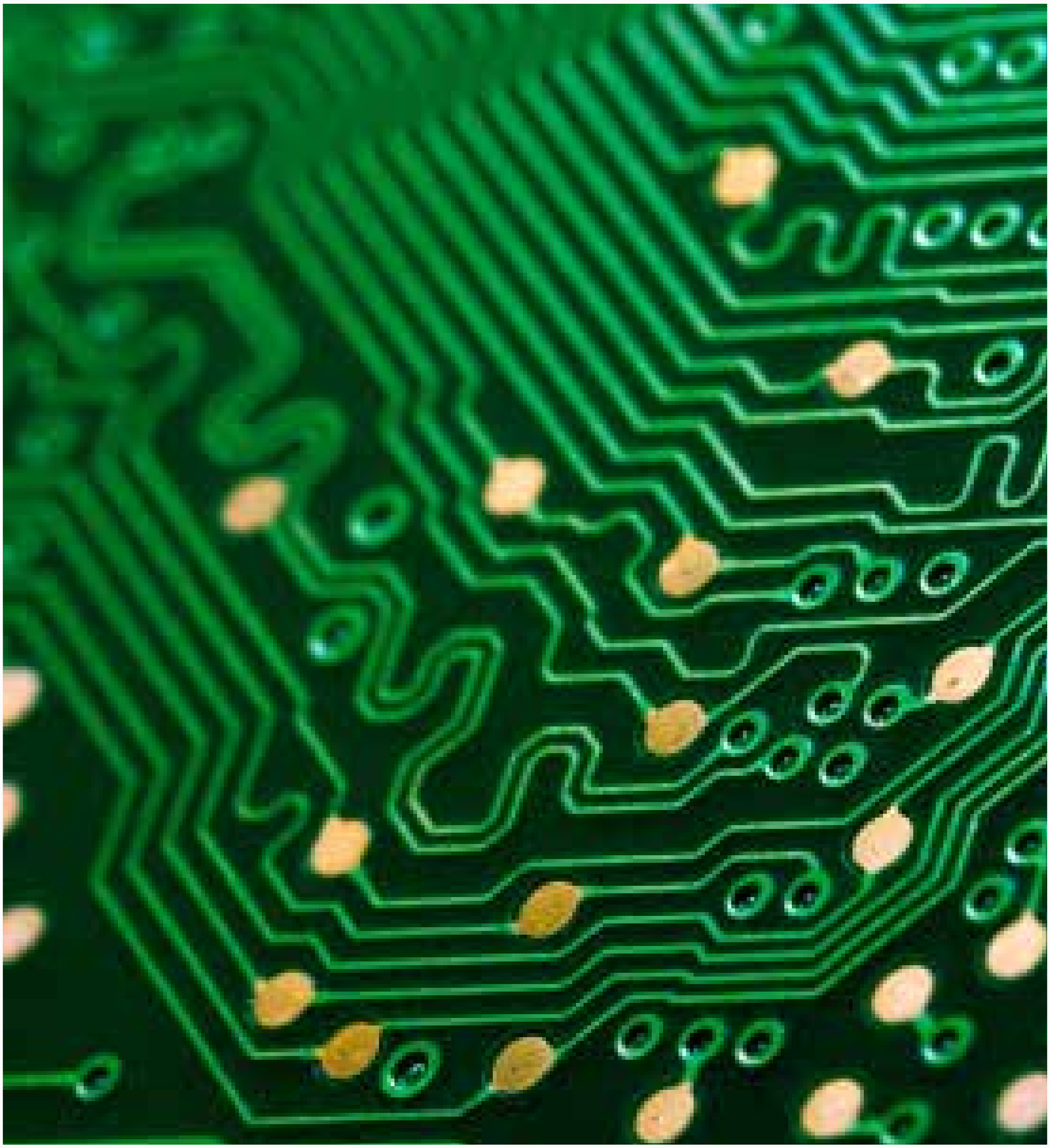

Another Golden Age of Growth Investing

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One of the landmark events on the calendar of investors takes place this week — the Value Investing Congress in New York. But it behooves us to remember that an alternative yet equally tenable approach also exists — that of growth investing. While the two styles share many common principles, growth investing focuses on identifying companies with above-average growth rates, whose share prices today are considered inexpensive relative to their intrinsic value over the long term.

The dearth of investors who publicly tout the principles of growth investing is one sign that its golden age may now be upon us. The Wikipedia entry on "Value investing" lists more than a dozen current well-known value investors including Berkshire Hathaway chairman Warren Buffett. Value investing is a sensible discipline, and its success has attracted many acolytes. When too many people are performing the same analysis and arrive at the same conclusion, however, it becomes the crowded trade. By contrast, the only investor listed in the Wikipedia entry for "Growth investing" is Thomas Rowe Price, Jr., who died many years ago. Philip Fisher, another legend whose Common Stocks and Uncommon Profits is generally considered to be the reference work on growth investing, goes entirely unmentioned.

Indeed, T. Rowe Price launched the field of growth investing in 1939 during an environment not too dissimilar than the one we are in today. Following a period of mass speculation, the stock market had crashed in 1929, and the investing world was looking for a better way.

Benjamin Graham and David Dodd wrote Security Analysis in 1934 to bring value investing to the mainstream. There was looming social unrest everywhere, prospects for growth appeared low, and investors were concerned about the future. Value investing seemed to provide the perfect salve for the time, and attracted a legion of followers.

Mr. Price saw something different. He saw that some segments of the economy — and some companies — were experiencing rapid growth despite the low or uncertain growth in the overall economy. He noted that these companies did not look inexpensive based on typical value analysis. These bargains became apparent only when factoring in high business growth over the long-term. He was proven right.

Growth and value investing could be seen as comprising two sides of the same coin. In theory a value investor could plug in high growth numbers and look out over the long-term just as well as a growth investor can. The reality, however, is that value investors are reluctant to insert such assumptions into their financial models; and if they do, they often fail to do so with conviction. As a result, value investors tend to shun early stage companies with negative earnings and high growth companies with current year price-to-earnings (P/E) ratios that are higher than average market multiples. To many value investors, a high P/E ratio automatically means a company is expensive, but P/E ratios have to be understood in the context of a company's future growth potential

Why can some investors see growth with better conviction than others? One possibility is that mathematical expertise, a character trait possessed by many investors and typically seen as a desirable feature for that vocation, promotes linear thinking. Yet growth occurs non-linearly through the compounding power that comes with recursion. It takes a compound thinker to see growth, but studies have shown that the human mind underestimates the power of compounding.

Another factor is the tendency of humans to not see the facts that are in front of them. When investors see a low stock price relative to growth prospects, they often ignore the growth prospects and assume the low stock price is justified. The human mind simply tends to work this way for most people. It is not easy to be intellectually honest.

Fear represents still another factor. Compounding forces promote more growth the further out you look. Yet today investors are shortening, not lengthening, their horizons—which can obscure how cheap a growth stock is. Investors generally believe that the future of the world is more uncertain today than ever. In reality, the future has always been uncertain, but the perception of uncertainty is what is greater today. Therefore, investors may be discounting growth today more than any time since the 1930s.

Thanks to the technology age and globalization of markets, there are many industries and companies that are experiencing above-average growth rates. Many industries also enjoy a higher degree of visibility than the broader economy, such as healthcare where innovative products and inelastic demand can create monopolistic market positions which persist for a decade or more.

High growth companies are particularly discounted if an investor is willing to look out several years. The good — and the bad for those of us keeping track for sentimental reasons — news is that the years will pass. The future will become the present, and growth investors will harvest its bounty.

We may indeed be in the golden age of sowing those growth investments. Many stocks with 25%+ compounded annual growth rates can be bought at price-to-earnings ratios of 15 or less. The media silence on the subject of growth investing today should be music to the ears of the next T. Rowe Price.

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