Value vs. Growth Debate Misses the Point

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For the past five years, growth stocks, especially technology-sector equities, have significantly outperformed value stocks, which has some investors debating the merits of the two styles.

According to research firm Factset, between Dec. 21, 2016 and Nov. 30, 2020, iShares Russell 1000 Growth ETF (IWF) saw a total return of 134.67%, while the iShares Russell 1000 Value Index ETF (IWD) gained 33.02%. That's a significant return spread between the two ETFs, translating to a full 16.43% annualized relative outperformance.

Lately, however, value stocks are showing signs of life. From Aug. 31, 2020 to Nov. 30, 2020, value beat growth, according to a story in ETF Database. Comparing Vanguard Value ETF (VTV) to Vanguard Growth ETF (VUG), VTV outperformed VUG, 6.4% to 2.1%. This value rebound has some investors questioning if a rotation out of pricey growth stocks and into cheap value equities may be happening.

The discussion between value and growth stocks misses the point. This matters because investors need to rethink their views about the two styles as technological innovation changes the economy and the market. We believe growth stocks can be worth the premium prices paid for them; here are some metrics to consider.

HOW GROWTH CAN BE WORTH THE PRICE

Traditional value metrics include measurements such as price-to-earnings, but in our view traditional value metrics aren't suitable when researching growth stocks. Let's use Amazon.com (AMZN) as an example. During the most recent five-year period, the online retailer's PE ratio averaged 219. That's 11.37 times the S&P 500 valuation. During those five years, Amazon minimized reported profits and instead reinvested nearly all cash flow into adding capacity and modernization. The firm's action didn't harm share prices as the stock rose from a low of $502 to over $3,400.

Instead of PE ratios, investors could use other traditional metrics in their research, such as earnings growth and cash flow, or new-customer growth and sales. Using these metrics, look at the difference between chipmaker Intel (INTC) and graphics processor NVIDIA (NVDA).

For the most-recent five years, Intel's sales grew an average 5.2% annually, while profits grew 12.5%. Meanwhile, NVIDIA saw 18.5% annual sales increase, spurred by its fast-growing gaming, video, and advanced-sensors business. Based on the market served by NVIDIA's products, the firm's profits are forecasted to grow 18.3%, which is reflected in its current lofty share price.

FINDING VALUE IN GROWTH COMPANIES

Technology is not limited to "tech" companies; rather it's changing every company, every facet of business. Here are just a few examples:

- **Entertainment:** Netflix (NFLX) first disrupted the movie-rental company space through video compression and taking advantage of faster home-internet connections. Now it uses artificial intelligence to analyze subscriber viewing preferences, competing with Hollywood's movie studios by producing its own content.

- **Medical:** Align Technologies (ALGN) makes 3D digital scanners to create clear teeth aligners for people who want straighter teeth at a low price. Their technology has a global reach and is taking business from traditional orthodontic practices and providers.

- **Industrial/Consumer:** TREX (TREX) combines technology and sustainability for the outdoor residential market by creating a wood alternative to traditional lumber. Made of recycled plastic bags, its engineered lumber-alternative is colorfast and termite-proof. Sales are forecast to be $867 million this year, nearly double the $440 million it sold in 2015.

While some traditional valuation metrics may not properly measure today's growth companies, that doesn't mean investors should buy growth stocks blindly. Scrutinize their paths to profitability. If a fast-growing company is generating cash and choosing to reinvest into research and expansion, it is investing in its future. Beware the company that's growing quickly by spending investor cash while losing dollars for each sale. That's a red flag for investors.

The debate over growth and value will continue, but investors may want to reconsider how these styles may evolve as innovation's influence on the economy is rapidly changing businesses.

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