OPINION

The truth about long-term returns of growth and value stocks

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There is plenty of academic research showing that, on average in the long run, value stocks – defined by academics as stocks with low price-to-earnings (P/E), or price-to-book ratios (P/B) – beat growth stocks – defined as stocks with high P/E or P/B ratios. For example, in recent research I carried out using U.S. data over the period

from August, 1966, to October, 2019, I found that value stocks beat growth stocks by about 7 per cent. The results are similar for Canadian and international markets.

But do value stocks deserve an award for being such an outstandingly preforming group of stocks? My research suggests no, at least the way academics define value stocks. I find that value stocks beat growth stocks not because value stocks produce such an outstanding long-run performance but because growth stocks earn terrible long-term returns.

Let me explain. The P/E or P/B multiple is a function of the growth rate of earnings going forward. Companies have low multiples because markets expect low earnings growth. Companies have high multiples because markets expect high earnings growth. The markets tend to be overoptimistic about growth for the high-multiple firms and overpessimistic about growth for the low-multiple firms. As a result, investors bid up (overvalue) high-multiple firms and bid down low-multiple firms. And buying overvalued stocks leads to poor long-term performance.

I examined three pieces of evidence to support this.

First, let's see what happens when companies announce positive and negative earnings surprises. A positive surprise is when the company reports earnings that exceed expectations by at least 10 per cent. A negative surprise is when the company announces earnings that fall short of expectations by at least 10 per cent.

For the period 1980-2018, I found that when U.S. companies announce positive surprises the value premium (defined as the difference between value and growth stock returns) is 2.34 per cent based on value and growth stock returns three months after the earnings announcement and 6.69 per cent over the following year. When companies announce negative surprises the value premium is 6.04 per cent based on value and growth stock returns three months after the earnings announcement and 21.51 per cent over the following year.

What could be the reason? As I indicated earlier, a high P/E (or P/B) ratio implies a high expectation of growth. Low P/E implies a low-growth expectation. If we are pessimistic about growth and we get bad numbers, in some way we expected it. But if we are optimistic about growth and we get bad numbers, we are very disappointed

and react negatively. An analogous explanation can be given in the case when there are positive earnings surprises. If we are pessimistic about earnings for value stocks and we get better numbers, we are exuberant, and this is reflected in stock prices. For growth stocks, the good numbers are already baked into stock prices and so there is little reaction to the good news. As one can see, growth stocks react much more negatively than value stocks when the news is bad than when the news is good.

Second, researchers at the Darden School of Business examined the stock performance of high-asset-growth U.S. firms and compared it with that of low-asset-growth firms over the past 40 years. They found that low-growth firms outperformed the high-growth firms by a whopping 22 per cent on average per year, over the 40-year period. High-growth stocks tend to attract a lot of attention and a lot of trading by investors and thus they tend to become overvalued, leading to low returns going forward.

Third, I examined returns for value and growth stocks across different earnings-quality portfolios, determined by net income volatility over a five-year period – the higher the volatility, the lower the earnings quality.

I found that while the value premium was evident in the total sample (7 per cent), the premium appears to be driven primarily by firms in the poorly earning quality portfolios. The intuition is that as growth firms, on average, tend to be bid up by investors, the less-visible ones – which tend to have poorer earnings quality – are bid up the most and end up having lower returns than better-quality growth stocks. For value stocks, there is no evidence that poorer earnings quality exerts a discernible effect.

However, there is a silver lining to the story as far as value investors are concerned. It has to do with the fact that academics do not look at (as they do not know) the actual stocks that value investors buy, they only look at stocks value investors consider as a potential buy. Value investors sort stocks by P/E or P/B to find possibly undervalued stocks. They then value these stocks to determine their intrinsic value and only buy the stocks that meet a predetermined margin of safety.

In other words, the stocks actually chosen by value investors may have a great performance even if, on average, all low P/E and P/B stocks do not.

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