Growth Style Investing

By Crescent MFD

One of the most popular and potentially rewarding strategies is "growth investing." This article delves into what growth investing is, its key advantages and disadvantages, and how it performs across different market cycles.

What is Growth Investing?

Growth investing is an investment strategy that focuses on capital appreciation. Rather than seeking out undervalued companies, growth investors look for businesses that are expected to grow at a faster rate than the overall market or their industry. These companies, often in innovative and dynamic sectors like technology, healthcare, and consumer goods, tend to reinvest their earnings back into the business to fund research and development, expand operations, or enter new markets. As a result, they often have high price-to-earnings (P/E) ratios and may not pay regular dividends. The core bet is that their rapid future expansion will lead to a substantial increase in their stock price.

Advantages of Growth Investing

- Higher Potential Returns: When a growth company's vision materializes, it can generate significant capital gains that far exceed the broader market's performance.
- Innovation and Transformation: Investing in growth companies allows you to participate in cutting-edge industries and emerging trends that are reshaping the economy.
- Compounding Growth: By reinvesting profits, these companies can experience a compounding effect, leading to exponential growth in their value over time.
- Portfolio Diversification: Growth stocks can be a valuable addition to a portfolio, complementing value-oriented or income-generating investments and providing a balance between long-term capital appreciation and stability.

Disadvantages of Growth Investing

- Higher Risk and Volatility: Growth stocks are often more susceptible to significant price swings. If a company fails to meet its ambitious growth targets, the stock price can plummet. This makes them more suitable for investors with a higher risk tolerance.
- Limited Income: As growth companies prioritize reinvestment over dividends, they are not ideal for investors who rely on a steady stream of income from their investments.
- Market Sensitivity: Growth stocks can be particularly vulnerable during economic downturns or periods of rising interest rates, as higher borrowing costs can hinder their expansion plans.

Growth Investing and Market Cycles

The performance of growth stocks is not static; it is heavily influenced by the prevailing market cycle. Understanding these cycles is crucial for a growth investor.

- Recession/Early Expansion: During a recession, growth stocks often underperform as investor confidence is low and companies may struggle with limited capital. However, during the early stages of an expansion, as the economy begins to recover and interest rates remain low, growth stocks can experience a strong rebound, benefiting from renewed optimism and a conducive environment for expansion.

- Mid-to-Late Expansion: This is often the sweet spot for growth investing. As the economy strengthens, corporate profits rise, and investor sentiment is positive, growth stocks tend to flourish. The "herd mentality" often drives their prices to new highs.
- Contraction/Peak: As the market reaches its peak and the economy starts to cool down, growth stocks can become volatile. Investors may begin to shift from riskier assets to more stable, value-oriented companies.

At Crescent MFD, we emphasize the importance of a long-term perspective, especially with growth investing. While market cycles are a reality, focusing on a company's strong fundamentals, leadership, and long-term potential can help you navigate short-term volatility and build a resilient portfolio.

A variety of renowned investors, economists, and fund managers have offered their perspectives on the growth style of investing. Their insights provide key pointers that go beyond the basic definition, offering a deeper understanding of this approach. Here are some key takeaways from various sources:

1. **Peter Lynch : "Invest in what you know" and the Power of the PEG Ratio**

Peter Lynch, a legendary fund manager at Fidelity Investments, is famous for popularizing the concept of "Growth at a Reasonable Price" (GARP) . He believed that individual investors had an advantage over Wall Street professionals because they could spot promising companies in their daily lives.

"Invest in what you know." Lynch's most famous mantra encourages investors to find companies whose products or services they understand and use. By doing this, you can identify a company's success or failure long before the financial reports reveal it.

The Power of the PEG Ratio. Lynch popularized the use of the Price-to-Earnings Growth (PEG) ratio. He argued that a company's P/E ratio should not be viewed in isolation. By dividing the P/E ratio by the company's annual earnings growth rate, you can assess whether a growth stock is reasonably priced. A PEG ratio of 1.0 or less is generally considered attractive.

"Behind every stock is a company. Find out what it's doing." He stressed the importance of fundamental research and understanding the business itself, rather than just focusing on the stock price.

2. Philip Fisher: The "Scuttlebutt" Method and Qualitative Analysis

Philip Fisher , an American stock investor and author, is considered one of the pioneers of growth investing. He placed a great deal of emphasis on qualitative factors and a company's management.

The "Scuttlebutt" Method. Fisher is famous for this method, which involves gathering information about a company from its competitors, customers, suppliers, and even former employees. This hands-on, grassroots research provides insights that are not available in financial statements.

Focus on Long-Term Growth Potential. Fisher believed that the greatest returns came from investing in companies with the potential for massive, long-term sales growth, not just short-term, cyclical gains.

The 15 Points. In his influential book, Common Stocks and Uncommon Profits, Fisher outlined a checklist of 15 points for evaluating a company. These points cover a wide range of factors, including a company's competitive advantage, its commitment to R&D, the quality of its management, and its profit margins.

3. **Warren Buffett: Growth as a Component of Value**

While often labeled a value investor, Warren Buffett has frequently stated that the distinction between "growth" and "value" investing is a false one.

"Growth and value are joined at the hip." Buffett argues that a company's future growth prospects are a critical component of its intrinsic value. A company that can grow its earnings substantially over time is inherently more valuable than one that cannot.

"The most important quality for an investor is temperament, not intellect." This pointer applies to all forms of investing, but it is especially relevant to growth investing. Growth stocks can be volatile, and a strong temperament is needed to resist the urge to panic-sell during market corrections.

Other Notable Pointers

- "In investing, what is comfortable is rarely profitable." This quote, often attributed to Robert Arnott, captures the essence of growth investing. High-growth, innovative companies are often in uncharted territory, which can feel uncomfortable, but this is where the potential for outsized returns lies.
- "Time in the market beats timing the market." This popular quote from Ken Fisher and others applies universally to investing, but it is particularly important for growth stocks, which are often best held for the long term to allow their growth story to play out.
- "A market downturn doesn't bother us. It is an opportunity to increase our ownership of great companies with great management at good prices." This quote from Warren Buffett highlights the fact that market corrections can be an excellent time for growth investors to acquire shares in high-quality companies at a discount.