Why I Prefer Value Investing to Growth Investing- *John Dorfman*

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Boston, June 24, 2004 (Bloomberg) -- Growth and value are the two major ``religions'' of the stock market.

There are dozens of investing methods, but probably 80 percent of investors subscribe to some variant of these two major belief systems.

Growth investors look for companies with rapidly growing earnings. Some growth devotees focus on historical growth, others on projected growth. Many use a combination of the two.

A growth investor might, for example, have purchased Microsoft Corp. or Cisco Systems Inc. in 1990. Through the end of 2003, a $100,000 investment in Microsoft would have grown to $2.6 million, and a similar investment in Cisco to $15.4 million.

By contrast, investing in the Standard & Poor's 500 Index would have netted you a ``mere'' $333,820.

Such triumphs are wonderfully gratifying. It's quite difficult, however, to identify ``the next Cisco'' or ``the next Microsoft.'' To be a good growth investor, you need considerable ability to predict the future.

Value Investors

Most growth investors are willing to pay a fairly high price for a stock whose earnings they expect to explode. They aren't completely insensitive to price, but the question of whether a stock is cheap or expensive isn't the paramount question for them. The crucial question is what earnings will be in two to five years.

Value investors like me, on the other hand, view cheapness as a major virtue. We're skeptical of anyone's ability, no matter how expert they are, to predict the future. That's why we focus on stocks that are cheap.

Just as growth investors aren't totally insensitive to price, we aren't completely indifferent to earnings progress. But let's face it, a stock rarely gets cheap when earnings are zooming ahead.

While we would prefer to own cheap stock in a company with booming earnings, we're willing to sacrifice some earnings growth for the sake of cheapness.

Once we have accumulated a collection of cheap stocks in companies we believe are sound, we figure the odds favor us. If we were brutally honest, we would admit that we don't know for sure which of our companies will post robust earnings and which ones will continue to struggle.

Which Approach?

We can live with that uncertainty because experience tells us that success in business is somewhat cyclical. We can be pretty sure that some of our cheapies will go on to better things.

Which approach works better? That's a never-ending debate. But let me at least throw a little data on the fire.

Numerous studies, including ones by David Dreman, Sanjoy Basu, Josef Lakonishok and others, indicate that value stocks outperform the overall stock market by about 3 percentage points a year over long periods of time. Expensive stocks -- those with high price-earnings ratios -- have underperformed the market by a roughly equal amount.

In the years 1980-2003, the Russell 3000 Value Index has beaten the Russell 3000 Growth Index by about 1.5 percentage points a year. Russell Investment Group, an investment-consulting firm in Tacoma, Washington, publishes these indexes.

Growth vs. Value

The Russell 3000 contains the largest 3000 stocks in the U.S. market. The firm divides the index into a growth half and a value half. The growth index has returned 13.73 percent per year on average from 1980 through 2003, the value index 15.24 percent.

That may not seem like a big difference, but with compounding it adds up over time. Had you put $100,000 into the value stocks in 1980 you would now have $3 million. In the growth stocks you would have $2.2 million.

The Russell 3000 Value beat the corresponding growth index in 14 of those 24 years.

Over the past eight years (1996-2003) the S&P Barra Value Index has returned an average of 11.6 percent annually, while the S&P Barra Growth Index has returned 6.28 percent. The value index has beaten the growth index in six of the eight years.

In his books, Dreman (my mentor and former employer) presents a cogent theory on the mechanism by which value stocks outperform growth stocks. It has to do with the ways these two groups of stocks respond to earnings surprises.

Value Stocks

Value stocks are out of favor, and investors don't expect too much from them. Consequently they don't decline much on earnings disappointments.

These downtrodden stocks do, however, respond well to positive earnings surprises. When investors aren't expecting much, it is easier to beat expectations, and a favorable earnings surprise may change the psychological aura around a stock.

Growth stocks are expected to do well. As a result, they respond less dramatically to positive earnings surprises. And they are more likely to fall hard on negative surprises.

Finally, Dreman notes that surprises aren't rare events; they are frequent. This again relates to the inability of people, including experts, to foretell the future.

Some large stocks that have value characteristics today include AT&T Corp. (T), Devon Energy Co. (DVN), Allstate Corp. (ALL), Marathon Oil Corp. (MRO) and Archer-Daniels-Midland Co. (ADM). I own Devon for most clients and AT&T for a few.

People often ask why I don't switch back and forth between growth and value depending on my outlook for a particular year. The answer is that I think it's impossible to tell in advance which will do better in the short-term. In the long haul, I'm confident that value will outperform.

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