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Growth versus Value Research

*Article Provided by Integrity Research Associates for Fidelity Investments**

Growth versus value is an overused, and sometimes artificial, dichotomy. Yet there are genuine distinctions in how growth-oriented investors utilize research when compared to value investors.

Growth Research

Growth comes in many forms. The classic definition of growth investing relates to identifying companies whose profits and share price will beat the market over a long period. Traditional growth investing focuses on earnings growth, price/earnings and the Price/Earnings to Growth (PEG) ratios.

Fundamental analyst-driven research, which also focuses on earnings and price/earnings, is a natural fit. Understanding the factors behind growth is a key step in determining whether the growth is sustainable. Analyst-driven research, such as the research offered by Standard & Poor's or Lehman (Barclay's Capital), is important to assessing the causes of growth.

Growth often originates either from companies benefiting from technology advances (think Apple) or companies which dominate a niche (think Service Corp International which dominates the funeral home business). From a research perspective, growth investors place a premium on understanding industry trends. Analyst-driven research typically includes industry level analysis—at the very least comparative information on competing firms. Growth-oriented investors will draw on multiple sources, including the news media or the internet, to get insights into industry trends, and how they may impact growth companies.

Model-driven research which focuses on growth-oriented factors is also relevant. For example, Columbine Capital Services evaluates stocks based on multiple factors which vary depending on the industry sector. Not all of the factors Columbine tracks are growth-oriented, but an important part of Columbine's methodology is assessing the long-term growth characteristics of a stock. Long term earnings growth is an important factor that Columbine uses, in addition to analysis of earnings and earnings expectations.

Momentum investing, although not strictly speaking a growth discipline, often gravitates toward growth firms when market conditions are favorable. Technical analysis is a tool often used by momentum investors to interpret market trends and assist in trading decisions. Research firms such as Channel Trend and Market Edge include technical analysis in their research process and Recognia offers explicit technical analysis.

Value Research

Value oriented investors trace their roots to Benjamin Graham, who first popularized the discipline of valuation analysis. Graham's investment philosophy was to buy good assets cheaply, when they are out of favor. Or, as Warren Buffet puts it, 'finding an outstanding company at a sensible price.'

Modern securities analysis is built on valuation analysis designed to determine what a stock is worth. Once you have calculated the value, you can then determine whether the market is under-valuing or over-valuing the stock. Both analyst driven and model-driven research determine valuations of stocks. Generally, stocks with calculated valuations above their current market price receive buy recommendations, and vice versa.

Does this mean that most research is value-oriented? Yes, in the sense that valuation analysis is a critical component of fundamental research, whether analyst-driven or model-driven. The problem is that since most investors, whether institutional or individual, are relying on fundamental analysis, it quickly becomes the consensus. In its purest form, value investing goes against the grain (or at least that was the original intent.)

Some of the research firms offered through Fidelity.com have strong value-oriented characteristics. For example, Ativo Research produces model-driven research which relies heavily on cash flow analysis drawn from each company's income statement and balance sheet. Based on the cash flow analysis, Ativo calculates the 'fair value' for each stock it follows which drives its buy and sell recommendations.

Value investors also gravitate toward more specialized forms of research such as forensic accounting, to help avoid those stocks which are correctly undervalued. Using our earlier example, Ativo describes its methodology as including forensic analysis. Direct insight into the quality of a company's accounting practices, and its governance in general, can be obtained through Audit Integrity's reports. Audit Integrity is model-driven analysis focused on factors which increase the likelihood of accounting restatements and other risks

Which to Choose?

Although there is a difference between growth stocks and value stocks, the growth/value distinction for research is not as clear cut. Research providers tend to incorporate elements of each in their analysis. Research firms use growth-oriented analysis to project future revenue and profit streams and assess their sustainability. They may also look at industry dynamics, new products, and regulatory or economic trends to model growth prospects. At the same time, valuation analysis is critical to fundamental research, which may include both analyst-driven and model-driven research. Fundamental research makes stock recommendations based on the valuations it calculates, issuing buy recommendations when values exceed the stock price and sell recommendations when the stock price exceeds the valuation.

The distinction between growth and value is more pronounced in how investors use research. Growth-oriented investors are more focused on research which analyzes whether multiples are reasonable and the prospects for future growth. Value investors are interested in understanding 'cheap' stocks to determine whether they are cheap for a good reason, or whether they are simply out of fashion. Fortunately, users of Fidelity.com can find good research to assist them in assessing both growth and value.