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Equity Investing

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Chapter 14: Growth Stocks vs. Value Stocks

When I entered the investment business in 1969, I endorsed the view that one should always adhere to the same equity investment style -- that is, a style with which one is comfortable. On becoming more confident that I understand the factors that bring a style into and out of vogue, I now feel that to adhere to one style for all times is not the most productive approach. The Growth style and the Value style are well defined and different in a major and very fundamental way. History teaches us that when fundamental conditions are right to bring one style into favor, the conditions tend to persist for quite a long time -- say 10-15 years.

You should be very wary of those who attach almost supernatural powers to a portfolio manager primarily because his style is in favor. But, human nature will never change. Investors glorified the prominent growth stock investors in the 1960's and on into the early 1970's far out of proportion to their money management skills once the fact that their style was simply doing great was factored out. Investors did the same thing by glorifying value style investors in the 1970's and into the mid 1980's. In both cases, if the portfolio managers had had their results "style adjusted" (that is, adjust the performance returns caused by the fact that the style was in vogue), they would have appeared more mortal than the immortal powers attributed to them. How bright are they when they proceed to spend the decade following their deification wallowing in sub-par investment results?

One might argue that if your investment time horizon is, say, 30 years, it does not matter which investment style you use. Both will likely lead to a similar result albeit by very different routes along the way. Unfortunately, I have never met any clients so forgiving as to give me 30 years in which to prove myself. So, if your focus is on performing well over 3-5-10 years, you had better have a very definite opinion about which investment style is going to do well and apply that style. Also, beware that style shift junctions can be up to five years in duration. There will not be a neat instantaneous division between the end of one style and the beginning of the new style. It will be a messy and confusing transition filled with doubt. You will need conviction and staying power to adhere to your convictions that a style shift is taking place.

We were in an era where the many investment firms that did so very well from 1972 through 1988 using the value style went into a period of apologizing and predicting that the value style would certainly cycle back into favor "very soon." After all, it was generally not the preferred style for the next 10 years. Some investment firms that use a loose combination of value and growth (that is, the weak form of both) and place tremendous weight on client service can continue to prosper. That is, their investment results are always tolerable as "middle of the road" and they go the extra mile with client service.

Over the years, two major stock investment styles have emerged. The growth stock style focuses on those stocks growing their earnings meaningfully faster than the overall economy and with some degree of consistency. The

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PE's tend to be higher than the average PE of all stocks and the dividend yields tend to be lower. Debt load tends to be low. The ratio of stock price to book value is generally high. Generally, the companies are in new, vibrant industries and are on the cutting edge of improving the quality of life.

The value stock style uses companies that may be older and somewhat out of favor in the stock market. They tend to pay a dividend yield higher than the norm. A meaningful part of their worth may be in bricks/mortar and real estate. Thus, the ratio of stock price to book value is usually lower than for growth stocks. They tend not to be purchased for their earnings growth rates (unless viewed as a turnaround situation), but for their inherent book value, dividend yield and current low price of the stock. Debt may be a significant part of the total capitalization.

Investors that specialize in buying value stocks may initially screen candidates by looking for those stocks where the projected earnings growth rate plus the dividend yield is greater than two when divided by the PE. For example, a growth rate in earnings of 6% per year coupled with a dividend yield of 6% and a PE of 4 would result in a potentially good value buy. It would deserve some fundamental research to check it out.

Value stock (low PE) investors argue that their style is the best way to invest over the long-term. They say that by concentrating on low PE stocks that usually have a good book value, they seldom take much risk. Also, a significant portion of their total return comes from dividend yield so as to remove a lot of price uncertainty. Certainly, the long-term results for value investing are quite good. However, the long-term results from growth stock investing are also quite good. Which style should you use? Should you simply put half of your funds in each style?

I will argue that if your investment time horizon is 30-35 years, it probably does not matter which style you select. To feel diversified, you could put one half of your funds in each style. For an investor beginning a career-long investment program in his/her 20's or early 30's, a 30-35 year time horizon is not an unreasonable time period. This does not mean that you will not evaluate your results until after 30-35 years have passed. It simply means that the funds will generally not be withdrawn and spent until that period of time has passed.

Chart 1 shows year-by-year total return results from the Vanguard Windsor Fund and the Vanguard U.S. Growth Fund for the 50 years 1959-2008 inclusive. I use Windsor as a proxy for the value style and U.S. Growth as a proxy for the growth style. U.S. Growth fund has had some changes over the years involving international stocks. Here, I only use the domestic results over the entire time period.

The shading on the returns shows which of the two styles had the higher return in each year. The "Index" columns simply accumulate the wealth creation via each style having started with a unit value of 1.000.

You would have been a very smart investor if you had invested solely in growth over the 1959-1972 inclusive period, solely in value over the 1973-1988 inclusive period, growth over 1989-1999 inclusive and value over 2000-2008 inclusive. Your wealth index would have become 972.642 for a return of 14.8% per year over the 50 years. Some would argue that having made three style changes over 50 years would have been foolish and unproductive. Certainly, it would never have been completely clear when you should have made a change.

Charts 2, 3, 4 and 5 show the wealth accumulation for the same four sub-periods highlighted in Chart 1. Chart 6 shows the wealth accumulation over the entire 50 years. Chart 7 shows the same results in bar chart form for the four sub-periods and for the entire 50 years.

Let us consider the 30 year period 12/31/58 - 12/31/88 and examine the performance by styles. See Chart 8. The Windsor Fund returned 13.1% per year while the U.S. Growth Fund returned 12.0% per year. Now, let us consider the results if you had switched from growth (U.S. Growth Fund) to value (Windsor Fund) at the end of 1972. Chart 8 shows that your return over the 30 year period would have been 17.0% per year. Obviously, this is a very significant improvement in the 30 year results. Certainly, the chances of having made the switch at

exactly the perfect time would have been low. However, what if you had made the change anywhere from three years early to three years late? The chart displays all such results. The average of the seven possible results is 16.2% per year while the worst case is 15.1% per year if you had switched at the end of 1975. In all cases, your 30 year results would have improved markedly over holding either one style for the entire 30 years.

Is it a completely indecipherable mystery what causes the growth stock style to do very well for approximately 15 years and then what causes the value stock style to do very well for approximately 15 years? Is it just random chance and/or irrational investor preferences that cause this to occur? I think not on both counts.

Note in Chart 1 that you would have been even smarter if you had made the style switches so as to capture the best return in each and every year. I would argue that this is an unproductive pursuit and that the short-term style results are somewhat random chance. For example, I would argue that President Clinton came into office in the initial phase of a long growth stock market. However, the economic uncertainty he brought with him coupled with an assault on the health care industry (a paragon of modern growth stock investing) served to lower PE's generally and growth stock PE's in particular over 18-24 months.

I will put forth that the more productive style changes will only occur approximately every 15 or so years. The approximate 30 year cycle seems to appear over and over. The modern U.S. inflation and PE cycles are approximately 30 years. This leads me to suspect a relationship between stock style cycles and inflation/PE cycles.

Review Chapter 10 in regards to a determination of PE's based on inflation and earnings growth rates. In particular, see charts 2 and 4 in Chapter 10. These two charts are both reproduced here as Chart 9. When inflation is at 1% (good times) 16 years of earnings are discounted back to present value. At the other extreme, when inflation is at 10% (bad times), only 8 years of earnings are discounted back to present value. These are assumptions based on associating rising inflation with negative support for PE's and declining inflation with positive support for PE's.

Let's assume that value stocks are generally purchased by more conservative investors who place great value on a meaningful and consistent return from dividend yield. The companies, in turn, appreciate this loyal investor support and want to keep paying a good dividend so long as possible.

On the other hand, assume that growth stocks are typically purchased by investors who seek superior returns through growing the company via reinvesting earnings as opposed to paying a meaningful dividend. So, historically, a meaningful portion of the total return from a "value" stock was from dividend yield. That is, a dividend yield that the companies wanted to avoid cutting if at all possible. Contrarily, a "growth" stock could have almost all of the return from earnings growth and very little, if any, from dividend yield. The result would be that in periods of higher inflation the "value" stock would have a meaningful portion of its total future return (i.e. the dividend yield portion) somewhat insulated from being reduced away.

The essence of my basic model to determine PE's as a function of inflation and earnings growth rates is quite simple. A unitized initial EPS of \$1.00 is grown at the earnings growth rate and then each year's EPS is discounted back to present value using the inflation rate. The number of years to sum up (that is, how far out into the future to discount earnings) is a function of inflation. The higher the level of inflation the shorter the discounting. For inflation at 1% I discount out 16 years. For inflation at 10% I discount out 8 years. It is somewhat of a non-linear function of years vs. inflation between 1% and 10% inflation. Since you begin with unitized earnings of \$1.00, the sum of the discounted present value (the "price") is the ratio of price/earnings or PE.

Let us use our model governing the PE determination work discussed already that involves inflation, earnings growth rate and discounting future earnings back to present value. We will compare how the PE compresses as inflation goes from 1% to 10% for both a company with 15% earnings growth and one with a 7% earnings

growth. In short, generally, when PE's compress they will compress more for faster growing companies and when PE's expand they will expand more for faster growing companies. Using our model:

PE's and PE CHANGES

	<u>Inflation</u>		<u>% Change in PE</u>
	1%	10%	
EPS Growth = 15%	57.3	9.8	-83%
EPS Growth = 7%	27.1	7.1	-74%

Now, let us hypothesize two stocks with each having expected 12% total returns. The value stock has 6% earnings growth and a 6% dividend yield. The growth stock has 10% earnings growth and a 2% dividend yield. The perception of inflation goes from 1% to 10% over 5 years. The value stock PE goes from 24.7 to 6.8 over 5 years which is -23% per year. The growth stock PE goes from 35.7 to 8.0 over five years which is -26% per year. The total average annual return for each stock is:

$$\text{Value Return} = (((1 + 6/100)*(1 + -23/100)) - 1)*100 + 6)$$

$$= -12.4\% \text{ per year over five years}$$

$$\text{Growth Return} = (((1 + 10/100)*(1 + -26/100)) - 1)*100 + 2)$$

$$= -16.6\% \text{ per year over five years}$$

In short, the value style does better in a period of rising trend inflation because the PE is squashed less than for the growth style and less of the total return comes from price change. In a period of falling trend inflation, the growth style would do better. However, bear in mind that investors tend to fight the last battle. Thus, once trend inflation bottoms it may take 5-7 years before the value style takes over. Likewise, once trend inflation tops it may take 5-7 years before the growth style kicks in. Also, a period of rising inflation will tend to favor companies with a lot of real estate and debt on the books as opposed to the contrary. So, value stocks get an added boost in this regard when inflation picks up.

Now, let us use these same two stocks and assume that it takes 15 years for the perception of inflation to go from 1% to 10% and then another 15 years to go back to 1%. Chart 10 shows how the key numbers progress and change over this 30 year time period. Integral to this chart is our model that calculates PE using earnings growth rates and inflation.

Chart 11 plots inflation vs. PE for varying growth rates. The curves in this chart have proprietary adjustments downward from the strict outputs of Chart 9. Note that as inflation increases from very low rates the PE drops faster for higher growth rate stocks. This is why it was such a shock to own growth stocks from the late 1960's through the 1970's. Stocks with expected growth rates in the 15% to 20% or more range had dramatic PE corrections as the perceived world of very low inflation moved to a world of near 10% inflation.

There are different investment styles for different economic/market environments. The two primary styles we have discussed are the growth stock style and the value stock style. To reiterate, a growth stock is one whose earnings per share is growing at a rate meaningfully higher than that for the overall stock market, the dividend yield is generally lower than for the stock market and the price/earnings ratio can be two or more times the earnings growth rate. Ideally, the earnings growth will tend to be relatively stable and consistent over time.

The value stock style typically involves companies who are considered somewhat dull, are generally out-of-favor, sell at price/earnings ratios meaningfully below the overall stock market and usually have significant dividend yields (i.e., meaningfully higher than for the overall stock market). The value companies tend to have their stock prices determined by assets, net worth, value of natural resources and other balance sheet related items. An excellent rough formula to use for scouting out good value candidates is:

(Growth Rate of Earnings per Share + Dividend Yield) / PE

You want the resulting value from this equation to be as high as possible -- at least a value of 2 or more.

So, when you perceive that the economy is embarking on a long trend period of rising inflation (as in the early 1970's) you want to shift out of growth stock investing and move toward a value style emphasizing the above formula as a starting point. Of course, use of one simple formula does not negate the need to still do significant fundamental research on the stocks you purchase.

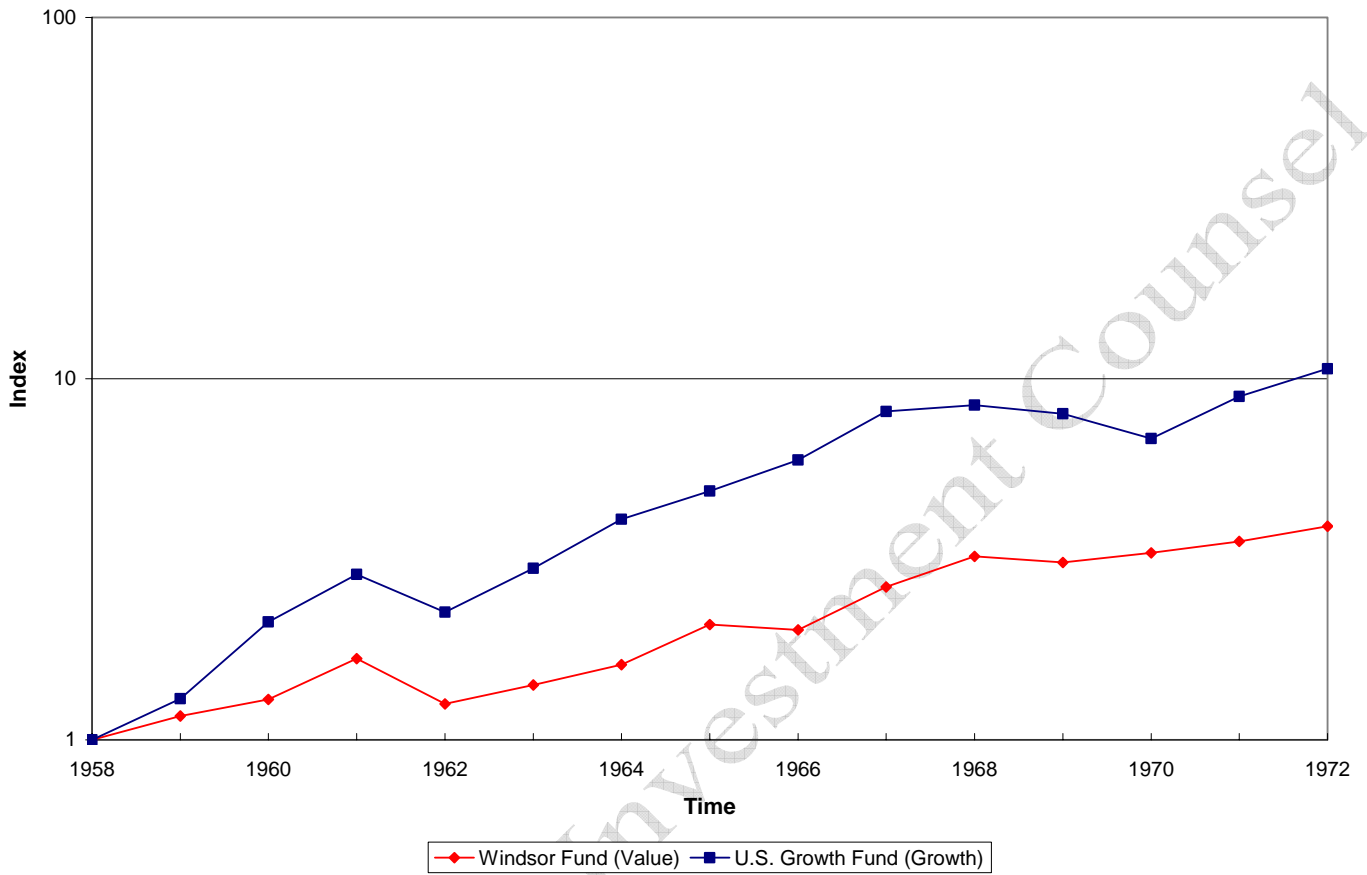
I want to stress that there is no magic formula for consistent success in equity investing. This is especially true over the short-term or even the intermediate-term. Still, the approach outlined above does utilize long-term empirical evidence to help one focus on the relationship of some key variables such as earnings growth rates, inflation, dividend yields and PE ratios. The average investor is bouncing off of the walls with no coherent approach to garnering long-term success. Still, good fundamental research on individual stocks is vital. Our goal is to help one focus energies on productive endeavors.

Year	"VALUE"		"GROWTH"			Return/year
	Windsor Fund	Windsor Index	US Growth Fund	US Growth Index		
		1.000		1.000		
1959	16.4	1.164	29.9	1.299		
1960	11.2	1.294	63.1	2.119		
1961	29.6	1.678	35.6	2.873		
1962	-25.0	1.258	-21.5	2.255		
1963	12.7	1.418	32.4	2.986		
1964	13.9	1.615	36.6	4.079	Growth	18.4%
1965	29.1	2.085	19.7	4.882		
1966	-3.3	2.016	22.0	5.956	Value	10.2%
1967	31.5	2.651	36.2	8.113		
1968	21.4	3.219	4.1	8.445		
1969	-3.8	3.096	-5.4	7.989		
1970	6.4	3.294	-14.5	6.831		
1971	7.5	3.542	30.6	8.921		
1972	10.2	3.903	19.4	10.652		
1973	-25.0	2.927	-32.3	7.211		
1974	-16.8	2.435	-33.4	4.803		
1975	54.5	3.763	30.7	6.277		
1976	46.4	5.508	14.5	7.187		
1977	1.0	5.564	1.2	7.273		
1978	8.8	6.053	16.2	8.452		
1979	22.6	7.421	18.1	9.982	Growth	6.7%
1980	22.6	9.098	33.6	13.335		
1981	16.8	10.627	-0.5	13.269	Value	15.7%
1982	21.7	12.933	19.7	15.883		
1983	30.1	16.826	23.9	19.679		
1984	19.5	20.107	1.2	19.915		
1985	28.0	25.737	36.5	27.184		
1986	20.3	30.961	7.8	29.304		
1987	1.2	31.333	-6.1	27.516		
1988	28.7	40.325	8.8	29.938		
1989	15.0	46.374	37.7	41.224		
1990	-15.5	39.186	4.6	43.121		
1991	28.6	50.393	46.8	63.301		
1992	16.5	58.708	2.8	65.074		
1993	19.4	70.097	-1.5	64.097	Growth	21.3%
1994	-0.2	69.957	3.9	66.597		
1995	30.2	91.084	38.4	92.171	Value	13.2%
1996	26.4	115.130	26.1	116.227		
1997	22.0	140.459	25.9	146.330		
1998	0.8	141.582	40.0	204.862		
1999	11.6	158.006	22.3	250.546		
2000	15.9	183.129	-20.2	199.936		
2001	5.7	193.567	-31.7	136.556		
2002	-22.3	150.402	-35.8	87.669	Growth	-10.6%
2003	37.0	206.050	26.1	110.551		
2004	13.4	233.661	7.0	118.289	Value	0.6%
2005	5.0	245.344	11.2	131.538		
2006	19.4	292.941	1.8	133.905		
2007	-3.3	283.274	10.2	147.564		
2008	-41.1	166.848	-37.8	91.785		
		10.8% per year		9.5% per year		

Chart 1
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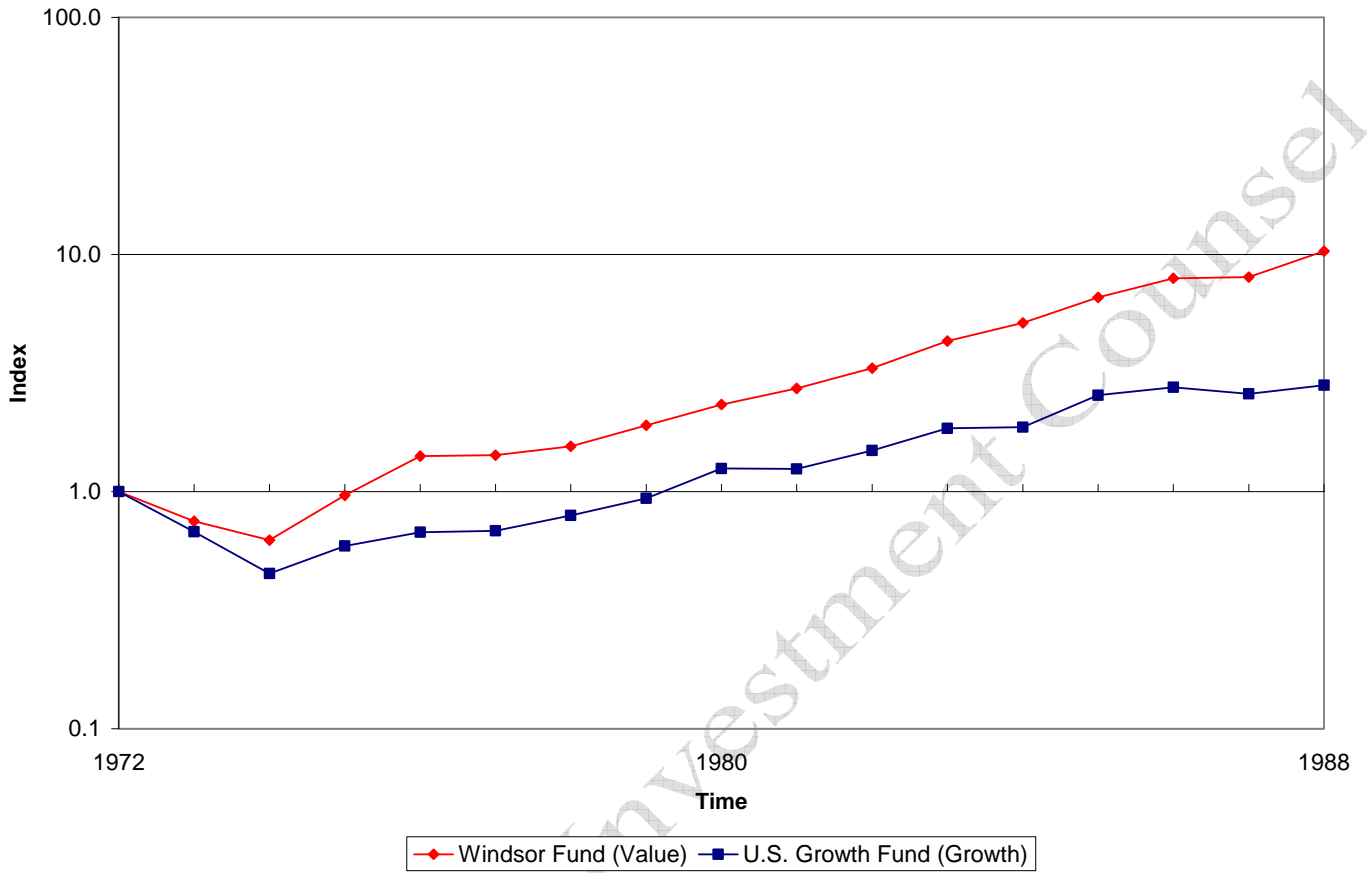
Styles: Value vs. Growth

Chart 2
Eads & Heald Investment Counsel



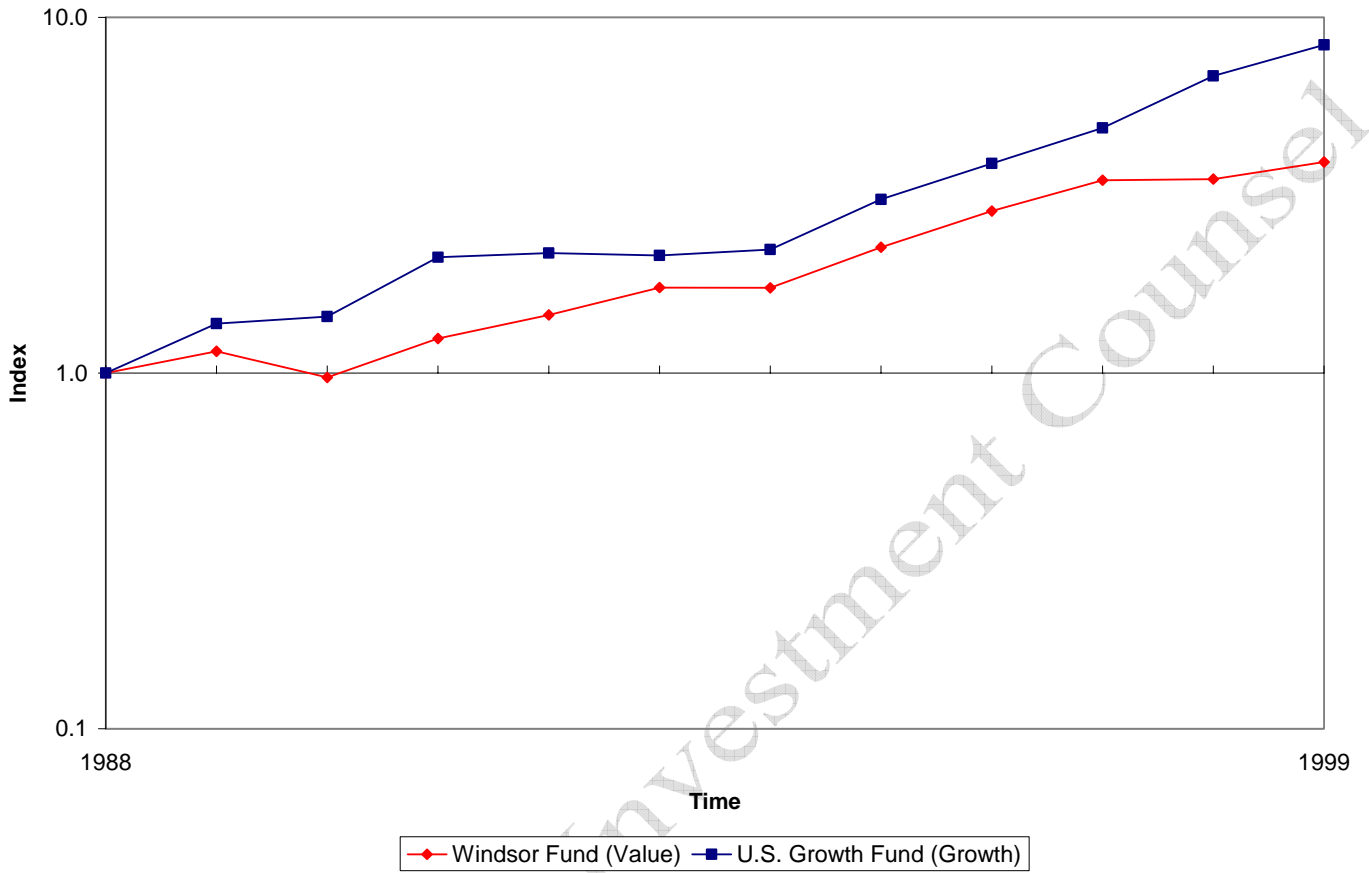
Styles: Value vs. Growth

Chart 3
Eads & Heald Investment Counsel



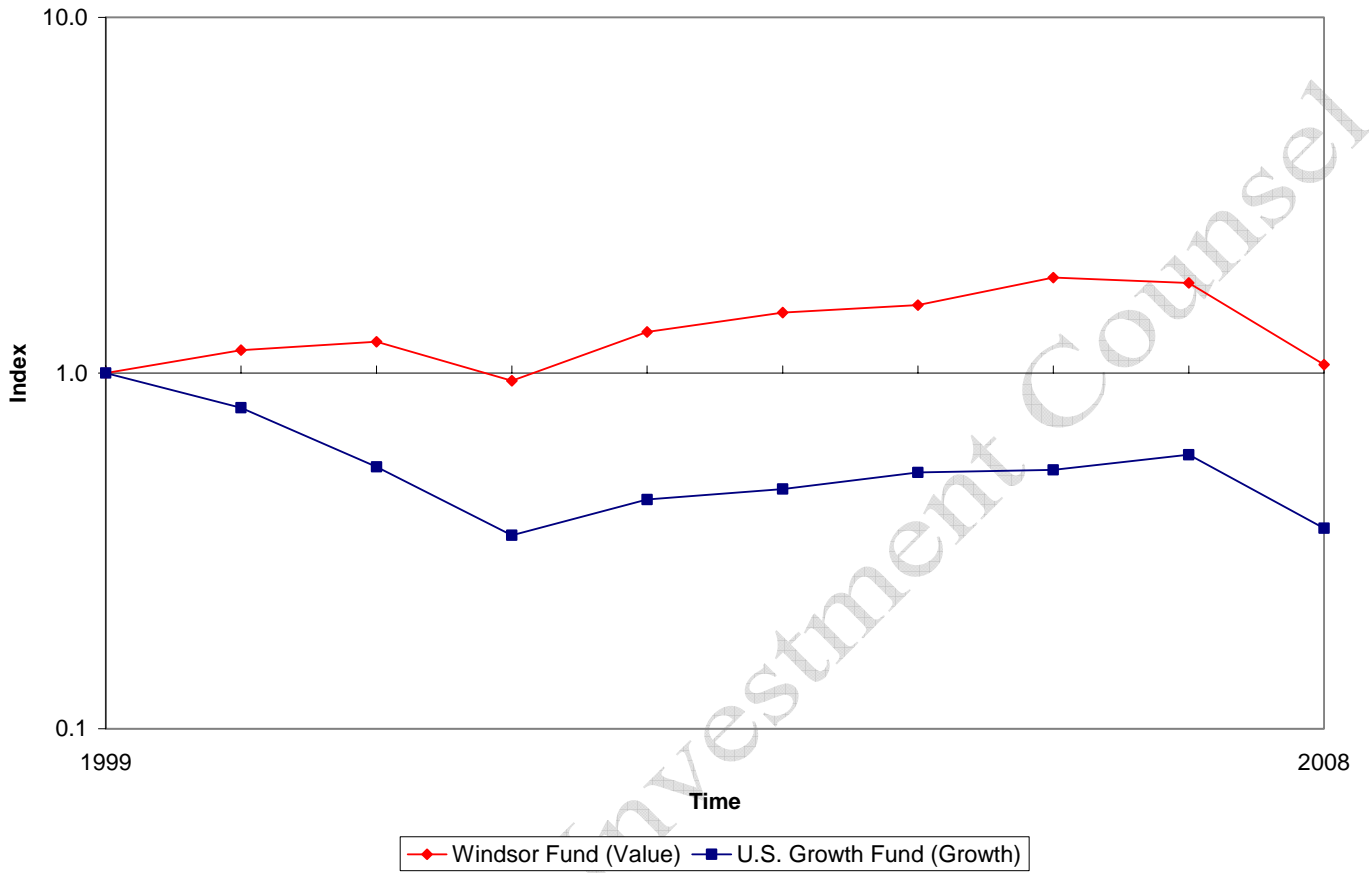
Styles: Value vs. Growth

Chart 4
Eads & Heald Investment Counsel



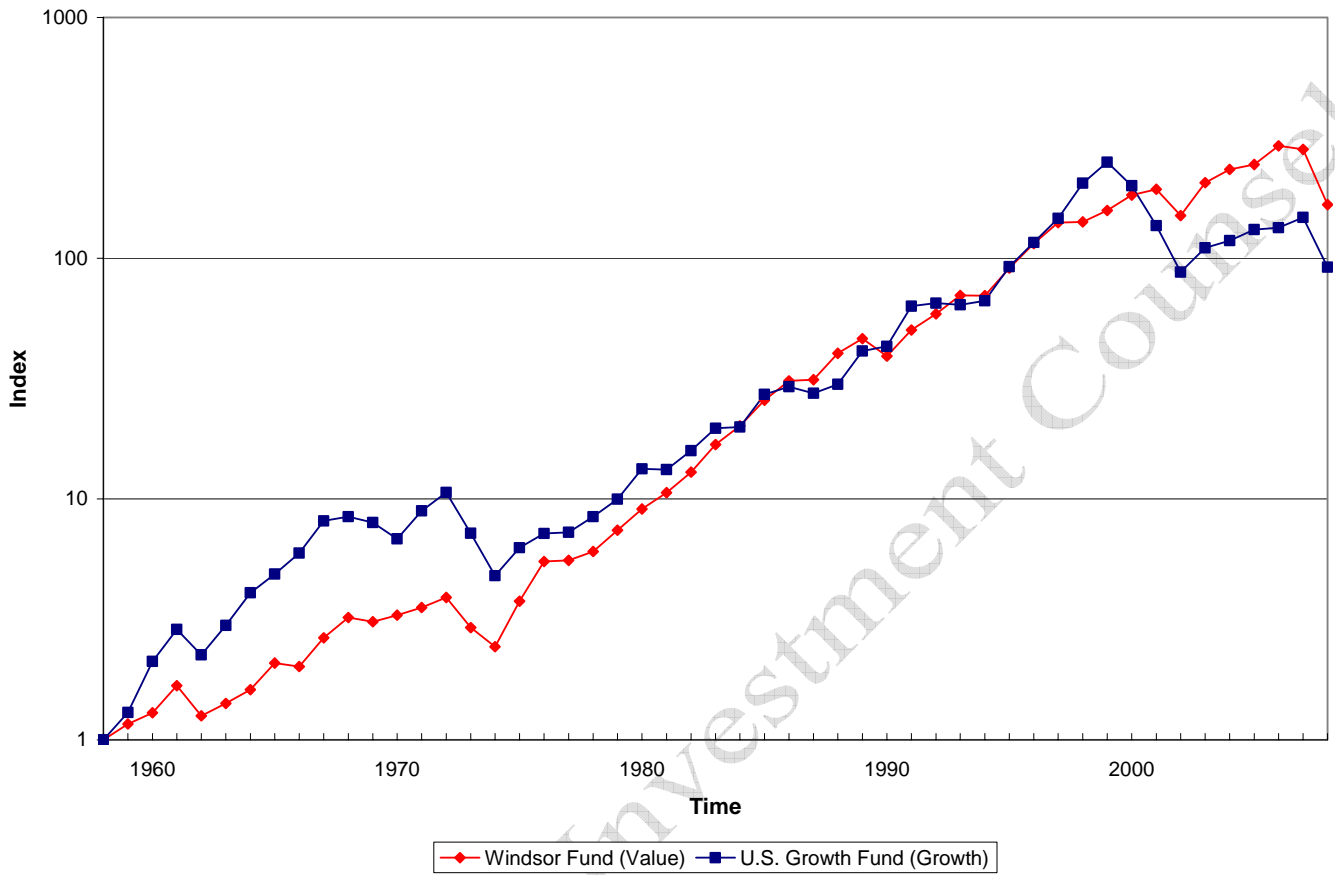
Styles: Value vs. Growth

Chart 5
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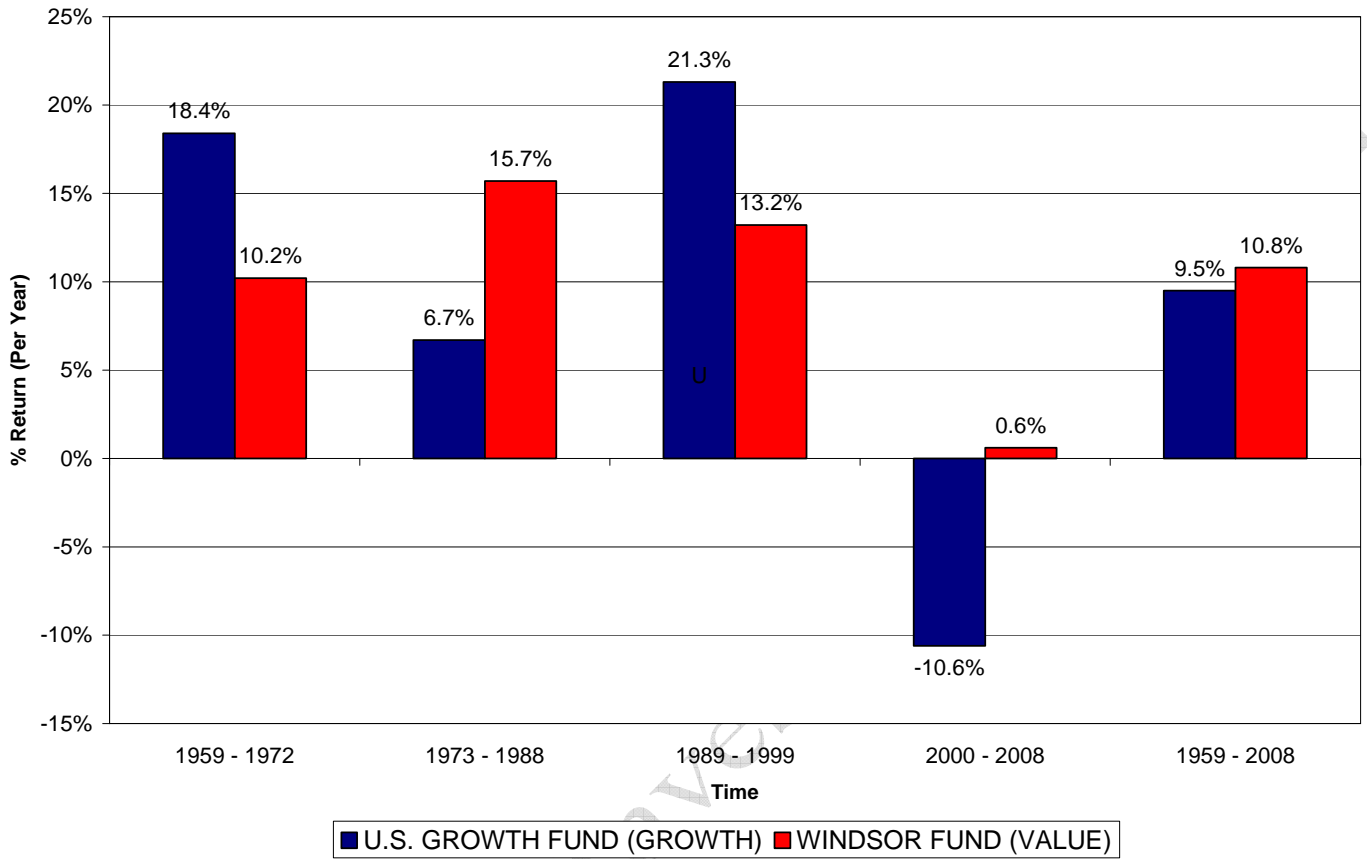
Styles: Value vs. Growth

Chart 6
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Styles: Growth vs. Value

Chart 7
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Eads & Heald INVESTMENT

12/31/58 – 12/31/88

Average Annual Returns Over 30 Years

Windsor Fund	13.1%/yr.
U.S. Growth Fund	12.0%/yr.

Start With U.S. Growth, Move To Windsor:

12/31/69	16.7%/yr.
12/31/70	15.9%/yr.
12/31/71	16.7%/yr.
12/31/72	17.0%/yr.
12/31/73	16.6%/yr.
12/31/74	15.7%/yr.
12/31/75	15.1%/yr.

INFLATION 1 %
GROWTH 15 %

INFLATION 10 %
GROWTH 15 %

Year	EPS Growth	
	15%	PV
0	1.00	1.00
1	1.15	1.14
2	1.32	1.30
3	1.52	1.48
4	1.75	1.68
5	2.01	1.91
6	2.31	2.18
7	2.66	2.48
8	3.06	2.82
9	3.52	3.22
10	4.05	3.66
11	4.65	4.17
12	5.35	4.75
13	6.15	5.41
14	7.08	6.16
15	8.14	7.01
16	9.36	7.98
17	10.76	9.09
18	12.38	10.35
19	14.23	11.78
20	16.37	13.41

Year	EPS Growth	
	15%	PV
0	1.00	1.00
1	1.15	1.05
2	1.32	1.09
3	1.52	1.14
4	1.75	1.19
5	2.01	1.25
6	2.31	1.31
7	2.66	1.37
8	3.06	1.43
9	3.52	1.49
10	4.05	1.56
11	4.65	1.63
12	5.35	1.70
13	6.15	1.78
14	7.08	1.86
15	8.14	1.95
16	9.36	2.04
17	10.76	2.13
18	12.38	2.23
19	14.23	2.33
20	16.37	2.43

	<u>PE</u>	<u>PE/g</u>
5 Yrs.	7.51	0.50
6 Yrs.	9.68	0.65
7 Yrs.	12.17	0.81
8 Yrs.	14.99	1.00
9 Yrs.	18.21	1.21
10 Yrs.	21.87	1.46
11 Yrs.	26.04	1.74
12 Yrs.	30.79	2.05
13 Yrs.	36.19	2.41
14 Yrs.	42.35	2.82
15 Yrs.	49.36	3.29
16 Yrs.	57.34	3.82
17 Yrs.	66.43	4.43
18 Yrs.	76.77	5.12
19 Yrs.	88.55	5.90
20 Yrs.	101.96	6.80

	<u>PE</u>	<u>PE/g</u>
5 Yrs.	5.72	0.38
6 Yrs.	7.03	0.47
7 Yrs.	8.40	0.56
8 Yrs.	9.82	0.65
9 Yrs.	11.31	0.75
10 Yrs.	12.87	0.86
11 Yrs.	14.50	0.97
12 Yrs.	16.21	1.08
13 Yrs.	17.99	1.20
14 Yrs.	19.85	1.32
15 Yrs.	21.80	1.45
16 Yrs.	23.84	1.59
17 Yrs.	25.97	1.73
18 Yrs.	28.19	1.88
19 Yrs.	30.52	2.03
20 Yrs.	32.95	2.20

30 YEAR INFLATION CYCLE

Inflation = 1%

	<u>EPS</u> <u>Growth</u>	<u>Dividend</u> <u>Yield</u>	<u>Long-Term</u> <u>Return</u>	<u>Fair</u> <u>PE</u>
Growth	10%/yr.	2%/yr.	12%/yr.	35.7
Value	6%/yr.	6%/yr.	12%/yr.	24.7

Over 15 Years

	<u>EPS</u> <u>Growth</u>	<u>PE</u>	<u>Price</u> <u>Yield</u>	<u>Yield</u>	<u>Total</u> <u>Return</u>
Growth	10%/yr.	-9.5%/yr.	-0.4%/yr.	2%/yr.	1.6%/yr.
Value	6%/yr.	-8.2%/yr.	-2.7%/yr.	6%/yr.	3.3%/yr.

Inflation = 10%

	<u>EPS</u> <u>Growth</u>	<u>Dividend</u> <u>Yield</u>	<u>Long-Term</u> <u>Return</u>	<u>Fair</u> <u>PE</u>
Growth	10%/yr.	2%/yr.	12%/yr.	8.0
Value	6%/yr.	6%/yr.	12%/yr.	6.8

Over 15 Years

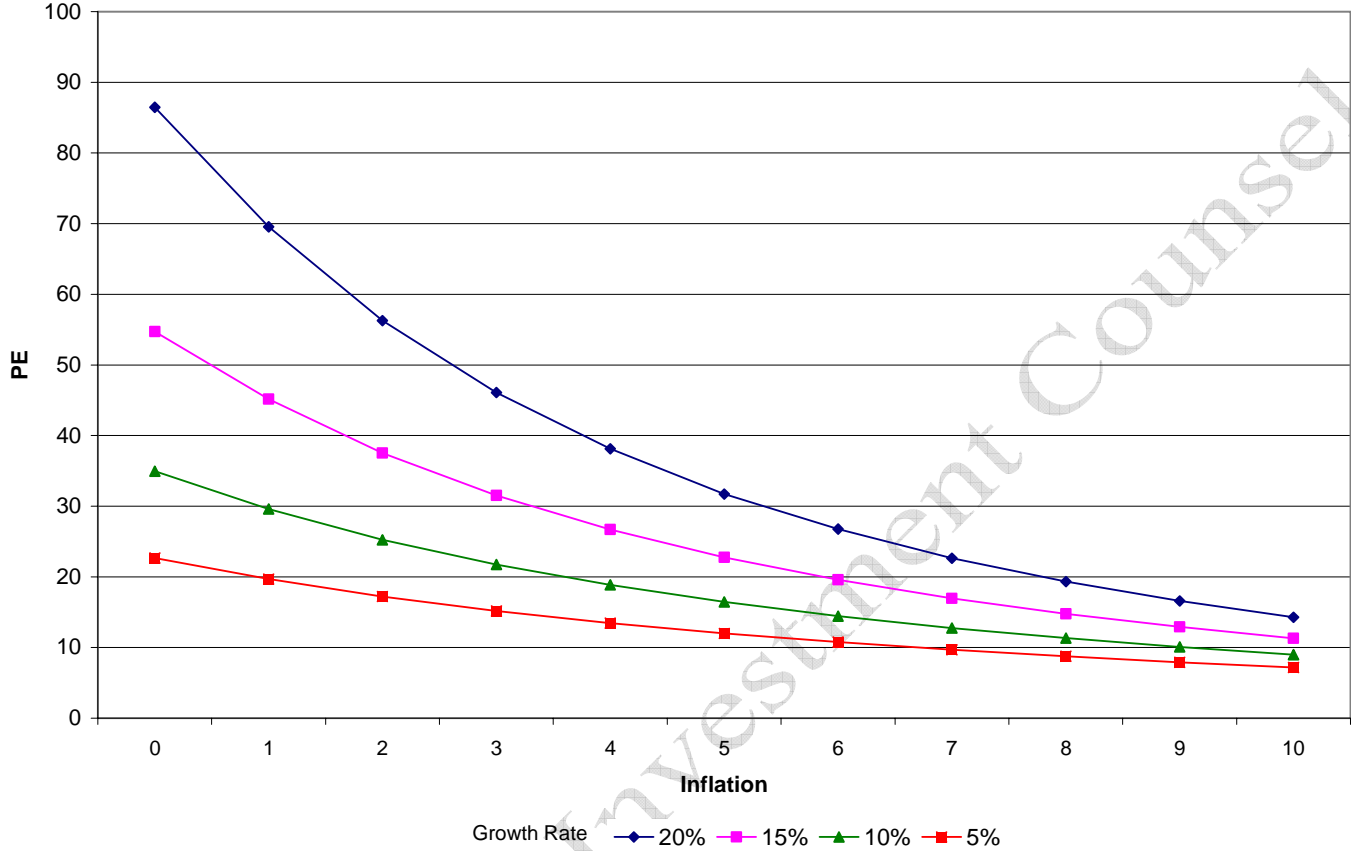
	<u>EPS</u> <u>Growth</u>	<u>PE</u>	<u>Price</u> <u>Yield</u>	<u>Yield</u>	<u>Total</u> <u>Return</u>
Growth	10%/yr.	10.5%/yr.	21.5%/yr.	2%/yr.	23.5%/yr.
Value	6%/yr.	9.0%/yr.	15.5%/yr.	6%/yr.	21.5%/yr.

Inflation = 1%

	<u>EPS</u> <u>Growth</u>	<u>Dividend</u> <u>Yield</u>	<u>Long-Term</u> <u>Return</u>	<u>Fair</u> <u>PE</u>
Growth	10%/yr.	2%/yr.	12%/yr.	35.7
Value	6%/yr.	6%/yr.	12%/yr.	24.7

PE vs. Inflation

Chart 11
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