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Resources Management Corp

MARKET COMMENTARY

GROWTH OR VALUE?

Are you a growth investor or a value investor? Do you only invest in companies with low P/E ratios or do you leverage "alternative valuation" metrics? The modern investing environment seems to be obsessed with classifying funds and securities into strict buckets based on a few characteristics that have become viewed as completely defining qualities. The most stark comparison that is often made is that of designating a stock as "growth" or "value". As stated by Fidelity Investments, "growth investors are attracted to companies that are expected to grow faster (either by revenues, cash flows, or definitely by profits in the future) than the rest. As growth is the priority, companies reinvest earnings in themselves in order to expand, in the form of new workers, equipment, or acquisitions." These securities are considered to be more expensive and riskier as much of the valuation is driven by events expected to happen in the future. Value investing, on the other hand, "is about finding diamonds in the rough – companies whose stock prices don't necessarily reflect their fundamental worth. Value investors seek businesses trading at a share price that's considered a bargain, and as time goes on the market will properly recognize the company's value." These stocks are generally viewed as less expensive and less risky.

Aesop, in 1884, relayed the story of *The Hawk and the Nightingale* that teaches us that "a bird in the hand is worth two in the bush." Today, Aesop would have been classified as a value investor because of his unwillingness to consider what the risk adjusted value of birds in bushes is once we take into account how sure we are they can be retrieved. The problem with dividing securities into groups that are effectively "birds in the hand" (value) or "birds in the bush" (growth) is that it requires the incorrect assumption that these buckets require different investment criteria. Investing, however, is simply the act of deploying capital now with the expectation of a sufficient risk adjusted return in the future. To evaluate the appropriate price to pay for a security, we must consider several factors: how much cash flow is produced today, how much that cash flow will grow over the investment horizon, and how certain are we that our projections will materialize. Based on these three factors, we can estimate a range of values for the security by discounting the cash flows by the return required in consideration of the level of risk.

While growth and value are consistently portrayed as opposites, we would argue that they are both actually just factors that need to be evaluated in the investment process. Understanding how fast the earnings available to owners will grow over time is critical to assessing what the proper valuation for a company should be. Similarly, ensuring that the price paid is less than the intrinsic value of a security is a critical strategy in managing risk over the long term. Buying a stock simply because it has a high expected revenue growth rate over the next five years, for example, is essentially gambling if no thought is given to the price that is being paid for this growth (and the market has a history of overpaying for expected growth). To the same end, purchasing a stock that looks "cheap" relative to last year's earnings is highly irresponsible if the future of the company has not been properly taken into account.

So, do we look for growth or value stocks when building our portfolios? The answer is yes. We aim to be disciplined investors who consider the bird we are holding, the number of birds in the bush and how certain we are the birds can be caught. In this way, we are able to become owners of the current and future leading companies without undue exposure to a permanent loss of capital over the long term.

Corporate Center West
433 South Main Street, Suite 200
West Hartford, CT 06110
860-561-1245 phone
860-561-1310 fax

866-383-4574 toll free
www.resourcesmanagementcorp.com

P.O. Box 348
9 Bryan Plaza
Washington Depot, CT 06794
860-868-1830 phone
860-868-1834 fax