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Growth Stock Investing Myth and Reality

It is widely believed that being a large capitalization growth stock investor is a buy and hold proposition. The implication is that there exists a large cadre of companies that stamp out above average earnings per share growth consistently year in and year out. Thus to be a successful growth stock investor, you would simply identify relatively faster growing industries and buy the leading companies in those industries. Over time, the magic will work and you should outperform the market. Not exactly!

We recently conducted a study to find out how large the universe of "growth" companies really is. We started with the current Russell 3000 Index companies and using Baseline, a computerized database, we screened for companies that had achieved at least 10% earnings per share growth each year for the last ten years ending with 2002. Out of 3000 companies, only 26 met the criteria. Less than 1% of the universe consistently grew EPS by at least 10% per year. Furthermore, only 4 of those would have been considered large capitalization companies ten years ago.

We then relaxed the criteria on our screen to include all companies that achieved compounded earnings per share growth of 10% over the entire period, but not necessarily each year. Since we were trying to identify "growth" stocks, we also required that the company have no years in which earnings per share actually declined from the prior year. This less restrictive screen yielded 111 companies. Less than 4% of the universe were able to compound earnings per share by at least 10% while having no down years. And only 17 of them would have been considered large capitalization stocks ten years ago. Of those 17, four were health care companies, three were retailers, and three were financial services companies. None were hardware or software technology companies even though the Russell 1000 Growth Index has been dominated by technology stocks for the last several years. We will discuss this list of great companies in a future letter as to what they have in common and how they performed over the ten- year period.

It is a myth that there are a large number of companies with consistent above-average earnings growth that you can buy and hold. In spite of this, analysts continue to extrapolate impossible growth rates for companies and incorporate unattainable expectations for EPS growth into valuations. Inevitably, when growth rates don't meet expectations the stocks get killed. More on this also in a future letter.

Two points come to mind. First, managers of growth stock portfolios must constantly assess the sustainability of the expected growth rates of their companies. These are high expectation stocks where the price of disappointment is invariably large. That is why this issue is the cornerstone of our fundamental research. If we believe growth rates are going to be below expectations, the stock must be sold.

Second, there is a higher likelihood of finding companies that can achieve consistent above- average earnings per share growth in the universe of midcap companies than in the large cap arena. Therefore, we direct a significant portion of our primary fundamental research in that area of the marketplace.

As for the current equity market environment, the headline risk related to the war will dominate the short term environment. Sentiment figures have unfortunately risen to 48% Bulls in the Investor Intelligence survey, reflecting an anticipated positive outcome. The recent rally may have already priced in a reasonably quick resolution. Therefore, in the near term, the market is risky and vulnerable to a correction.

Over the next twelve months, the market should do better, as earnings expectations have been ratcheted down to more realistic levels. Any uptick in the economy in the second half of 2003 or in 2004 should result in companies reporting better earnings than analysts expect. That is the necessary ingredient for higher stock prices.

-Robert C. Davis, CFA
April 9, 2003

A copy of our Form ADV, Part II is available upon request.
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