**TD Global Investment Solutions**

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*A Conversation With*

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# Traversing the Equity Style Spectrum

## Investors often think of the equity market as being divided into value stocks and growth stocks. Can you describe the difference between the two?

Value is essentially a price-driven characterization. A stock is considered a "value" stock when its price is low relative to either its book value, its annual earnings, or its dividend, compared to other companies. Implicitly, these three metrics – book value, earnings, and dividends – are viewed as being indicative of a company's intrinsic worth. The less you have to pay per dollar of book value (or earnings or dividends), the better "value" you are thought to be getting. Growth has nothing to do with price; it's all about how fast a company is growing its revenues and its earnings. "growth" stocks are simply stocks with high levels of revenue and/or earnings growth.

## Is it common for stocks to move from one of these buckets to the other?

Before I answer that, I should point out that growth and value, under the definitions I just outlined, are not really opposites. A company might have high revenue growth while also selling at a low multiple of its earnings, meeting the criteria for both designations. Or it might meet neither one! That is, a company might have a low growth rate while selling at high valuation multiples. So it's not quite accurate to think of stocks as always necessarily falling into one, and only one, of these two buckets. The companies that provide indices, like MSCI and Russell, acknowledge this, and will sometimes assign a stock partially to one index and partially to another, as odd as that might seem. So with that background, yes, sometimes a stock might move completely from one bucket to the other. At other times a stock might go from being completely in one bucket to being in both, or vice versa. Or sometimes it might stay in both buckets simultaneously but the proportions might change. A famous example from recent history is Meta. Between September of 2021 and October of 2022, the stock fell 75%. While Meta's earnings did fall in 2022, they did not fall nearly as much as the price, so the price/earnings ratio dropped significantly, and in mid-2022 the company got added to value indices after years of being classified as purely a growth stock. But by the middle of 2023 the stock had tripled off of its low, and was once again moved back into the growth bucket in the indices. One more thing to keep in mind is that the index providers like to keep the market capitalizations of the growth and value sub-indices within a broader index equal, and that will also affect how these weighting decisions are made.

## Does it change your view on these companies when they move from one category to another?

In a word, no. Think about the Meta example I just mentioned. Did the company fundamentally change between 2021 and 2022, or between 2022 and 2023? Not really. What happened was that many investors panicked in 2022 about the impact that changes in the privacy settings on the Apple iPhone would have on Meta's ability to sell ads, then decided in 2023 that the panic had been mistaken. In other words, investors got it wrong, yet somehow we were supposed to believe that Meta had gone from being a growth company to a value company because of that error. This just highlights the limited usefulness of these two categories. As I said earlier, growth and value are not opposites, so what sense does it make to split the market evenly into these two buckets? Here's another thing: you would think that stocks that are "cheap" should outperform over time, shouldn't they? Otherwise, being a value stock has no real significance. But as we pointed out in our paper titled *What Do We Mean When We Talk About Value* a few years ago, the value indices have not outperformed the growth indices over the long term. So whether a stock is classified as value or growth is not something we focus on.

## What are some better ways of categorizing stocks and defining value and growth?

Ask yourself a question: what is the purpose of a company? It's to generate returns for the owners of the business. The problem with the usual valuation and growth metrics is that they literally tell you nothing about what kind of returns on invested capital (ROIC) the company is earning, when in the end that is all that should matter to the people who have put up that capital. Let's start with growth – a company is growing, hooray. Does that necessarily mean it is creating wealth for the shareholders? Maybe, but maybe not. Growth doesn't just fall from the sky – companies have to invest to generate growth, by building factories, hiring more people, and so on. Suppose a company invests a billion dollars and in the end they grow their earnings by $40 million. That represents a 4% return on their investment. Did that create wealth for the shareholders? If management had returned the capital to the shareholders instead of investing it, the shareholders could have invested their money in risk-free government bonds and earned a similar or higher return. Capital has an opportunity cost, and not all growth creates value for shareholders. Focusing on growth in isolation is not giving you a complete picture of whether a company is succeeding. And the same holds true for traditional value metrics. If I tell you one company is trading at 10 times earnings and another is trading at 15 times earnings, does that mean that the first company is cheaper than the second? Again, maybe, maybe not. As we demonstrated in another paper *The P/E Ratio: A User's Manual*, the "right" P/E ratio for a company depends on the ROIC that the company earns. A company trading at 15 times earnings can be undervalued, and a company trading at 10 times earnings can be overvalued, depending not on differences in their growth rates but on differences in their ROIC. Ultimately, we believe that ROIC is really the best metric for comparing and categorizing stocks.

Now, if you do still want to try to categorize stocks based on some kind of valuation metric, we would say that you should at least use a valuation metric that makes sense, and that has a record of success at identifying stocks that subsequently outperform. The metric that meets those criteria, in our minds, is the free cash flow (FCF) yield, which is in fact related to a company's ROIC, so it is a window into ROIC. Two companies may have the same earnings per share and the same growth rate, but if one has a higher ROIC than the other, it can achieve that growth with less reinvestment and hence more free cash flow than the other company. The P/E white paper showed why the company with the higher ROIC should trade at a higher P/E for this reason, meaning that P/E is of limited use in comparing the stocks. But if both stocks were fairly priced from a discounted cash flow perspective (i.e., the one with the higher ROIC selling at a higher P/E), they would actually trade at the same free cash flow yield. That's why FCF yield is a better measure of value. And over time, stocks with higher free cash flow yields have outperformed much more reliably than the popular value indices based on price/earnings and price/book ratios. (That was the subject of another of our white papers, *Free Cash Flow Works*.)

## As a Portfolio Manager, how do you prevent style drift in your portfolios?

Our strategy is based on some core principles centered on the importance of ROIC and sound capital allocation by management. Ultimately, whether a stock makes it into our portfolio is dependent on an exercise of judgement by our team on the question of how sustainable a company's competitive advantage is. But we do use some quantitative tools to help us narrow the universe down before we begin to exercise that judgement, tools that help us focus in on companies that have high ROIC, high margins, and opportunities to reinvest in their business. The tools are a kind of disciplined gating mechanism, and they help ensure that the portfolio always maintains a consistent quality profile. If you look at our style characteristics as measured by Style Analytics, you will see that we have a very consistent style profile over time as a result of our process.

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