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What public companies can learn from private equity 1

Public companies will need to raise their governance game if they are to compete with private firms.

Are companies getting better at M&A? 7

The latest boom in merger activity appears to be creating more value for the shareholders of the acquiring companies.

The truth about growth and value stocks 12

Investors and fund managers build entire portfolios around the premise that growth stocks grow faster than value stocks. The problem is that they don't.

Governing China's boards: An interview with John Thornton 16

The ex-president of Goldman Sachs talks about his experiences as a reformer of board governance in China.

Why accounting rules shouldn't drive strategy 23

When changes in accounting rules provide no new information, they don't register with investors. Nor should they lead managers to shift focus.



The truth about **growth and value stocks**

Investors and fund managers build entire portfolios around the premise that growth stocks grow faster than value stocks. The problem is that they don't.

**Bin Jiang and
Timothy Koller**

What's in a name? In the vernacular of equity markets, the words “growth” and “value” convey the specific characteristics of stock categories that are deeply embedded in the investment strategies of investors and fund managers. Leading US market indexes, such as the S&P 500, the Russell 1000, and the Dow Jones Wilshire 2500, all divide themselves into growth- and value-style indexes. Academics also use these categories as shorthand, arguing at length over which investment approach creates more value—a value strategy or a growth strategy. These names explicitly convey the expectation that growth stocks will have higher revenue growth prospects than value stocks.¹ And investors, even large institutional ones, often make investment decisions based largely on those expectations.²

It's not illogical that executives would often draw from this reality an assumption that having the label growth or value attached to a company's shares can actually drive prices up or push them lower. In our experience, many executives have expended considerable effort plotting to attract more growth investors, believing that an influx of growth investors leads to higher valuations of a stock. Some executives even turn this assumption into a rationale for using a high share price to defend risky acquisition programs—for example,

in deference to presumed shareholder expectations of growth.

The trouble is that such thinking is wrong in both cases. Evidence comes from a recent McKinsey analysis of the S&P/Barras indexes of S&P 500 companies.³ Although growth stocks are indeed valued at a higher level than value stocks on average, as measured by market-to-book ratios (M/Bs),⁴ their revenue growth rates are virtually indistinguishable from those of value stocks (Exhibit 1). The growth

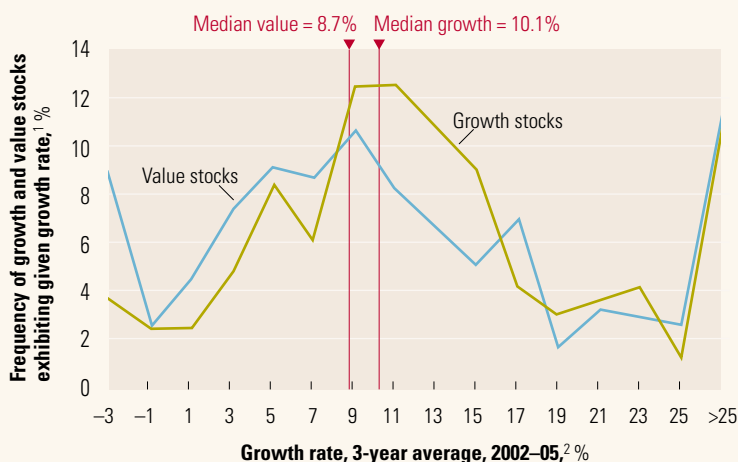
¹ Although there is no universal definition of growth and value stocks, most investors agree on the broad characteristics of companies in each category: growth stocks tend to have higher price-to-earnings ratios or market-to-book ratios, while value stocks have low P/Es and M/Bs and may have high dividend yields.

² Sophisticated investors do sometimes defy the growth and value stereotypes. Legg Mason Value Trust, one of the most successful mutual funds over the past 20 years and widely considered to rank among the leading value investors, includes in its top ten investments some companies that would definitely be classed as growth companies. As of October 2006, Legg Mason Value Trust holds more than 9 percent of its total assets (worth \$1.9 billion) in Amazon.com and Google, both clearly growth rather than value companies.

Exhibit 1

No advantage in growth

Companies that show up on growth indexes actually don't grow appreciably faster than those that show up on value indexes.



¹ S&P 500/Barra Growth Index and S&P 500/Barra Value Index as of Dec 2005.

² Excluding goodwill; does not include financial-sector stocks; 3-year average adjusts for annual volatility.

index's 10.1 percent median compounded revenue growth rate for 2002 to 2005 is not statistically different from the 8.7 percent median of the value index. Thus, the probability that a company designated as a growth stock will deliver a given growth rate is virtually indistinguishable from the probability that a value company will do so.

What *does* distinguish companies on growth indexes from those on value indexes is return on invested capital. For the value index, the median ROIC, averaged over three years, and excluding goodwill, is only 15 percent, compared with 35 percent for the growth index (Exhibit 2). In other words, the average growth stock is likely to deliver twice the average value stock's book return on capital. In fact, the correlation of M/Bs with ROIC in 2005 was 20 percent, versus 1 percent for growth rates.

The point is not that ROIC is a better filter for separating growth stocks from value

stocks; it is that the concepts of growth versus value are just not meaningful. Companies can have high price-to-earnings ratios (P/Es) and M/Bs because they have high growth and moderate ROICs, low growth and high ROICs, or high growth and high ROICs. Branded consumer products companies, for example, have high ROICs but modest growth, while hot retail companies have high growth and modest ROICs. This point may seem counterintuitive, but it is actually consistent with the conceptual drivers of value. Both a company's ability to grow and its ability to earn returns greater than its cost of capital generate higher cash flows—and hence higher valuations.⁵ Therefore, a high M/B or P/E for a company that is not growing fast is hardly surprising. At such companies, higher returns simply make up for slower growth.

Consider two otherwise similar companies, one with a higher ROIC. For these

³ Barra (which in 2004 merged with Morgan Stanley Capital International to form MSCI Barra) offers financial models and analytics intended to provide insight into the risks behind investment decisions. S&P and Barra collaborated from 1992 to 2005 to produce the official S&P 500/Barra Value and the S&P 500/Barra Growth indexes. Constituents for the S&P 500/Barra Value and Growth indexes studied in this article are as of the end of 2005.

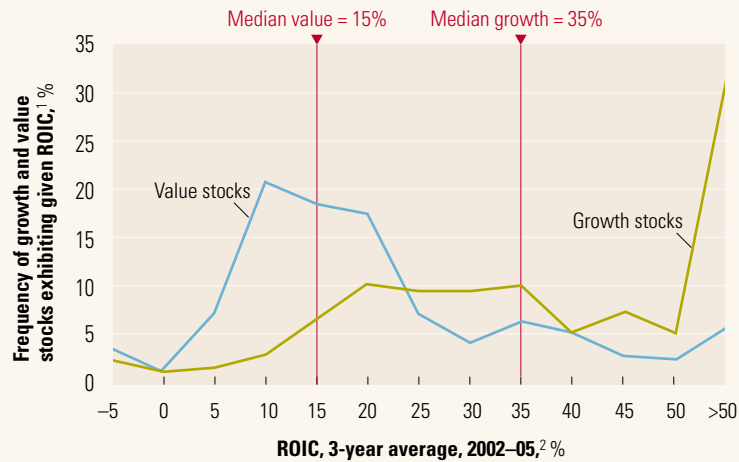
⁴ The median M/B for growth stocks was 4.8 at the end of 2005, while the median M/B for value stocks was 2.2. The medians are the same with or without financial-sector stocks.

⁵ See Bing Cao, Bin Jiang, and Timothy Koller, "Balancing ROIC and growth to build value," *McKinsey on Finance*, Number 19, Spring 2006, pp. 12–6.

Exhibit 2

Instead, better returns on capital

Growth stocks have much better returns on invested capital than do value stocks.



¹ S&P 500/Barra Growth Index and S&P 500/Barra Value Index as of Dec 2005; ROIC = return on invested capital.

² Excluding goodwill; does not include financial-sector stocks; 3-year average adjusts for annual volatility.

companies to generate the same growth in future cash flows, the higher-ROIC company needs to invest less capital back into its business than the lower-ROIC company. The excess cash at the higher-ROIC company can then be plowed into higher-return projects or given back to shareholders.⁶ Naturally, a company with a higher ROIC is valued at a higher level. In fact, any growth index includes many familiar names that enjoy high ROICs but actually have delivered limited growth relative to their industries from 2002 to 2005. Examples include Boeing (0.5 percent), Heinz (1.6 percent), Anheuser-Busch (3.5 percent), Altria (3.5 percent), DuPont (4.5 percent), Kimberly-Clark (5.4 percent), Hershey (5.5 percent), Coca-Cola (5.7 percent)—compared with a median growth rate of 9.6 percent for S&P 500 companies.⁷ Furthermore, executives who believe that attracting more growth investors will improve the value of businesses are bound to be disappointed. Our analysis of

companies whose stocks have been newly designated as growth stocks clearly shows that growth investors don't precipitate a change in valuation levels. Rather, they respond to it, moving into a stock only after the share price has already moved to a higher M/B or P/E. And while the number of growth investors does sometimes increase up to three months before a sustained increase in the M/B, it often takes them as long as 12 months *after* an increase in valuation.

Stocks downgraded from growth to value show a more striking pattern: when these stocks changed to value status, their M/Bs peaked and then headed into a sustained decline. Here again, growth investors hold onto a stock until they regard its revaluation as a trend. Sometimes they reach that conclusion fairly quickly, divesting within the first quarter after the stock's revaluation. Often they take much longer—as long as two and a half years.

⁶This comparison can be reduced to a simple formula: growth = ROIC × reinvestment rate.

⁷We compared the companies in the S&P 500/Barra Growth and Value indexes at the end of 1995 with the companies in those indexes at the end of 2005. The comparison yielded a list of 84 companies that have switched at least once from one classification to another during that ten-year period. Of these, we identified companies that made a clear one-way switch from value to growth or growth to value and then examined the change in their investor base in relation to the market valuation changes.

Simple attempts to discriminate between companies by a dimension or two will always fail to capture the variety of their characteristics, particularly in cyclical industries, where a company's ROIC may change radically from year to year. Even worse, simple classification attempts

may mislead investors. Many so-called value companies are distressed and in need of a turnaround. Companies and investors would be better off focusing on a company's fundamental performance and valuation rather than making arbitrary style comparisons. That's what the best investors do. 