



Value Vs Growth Stocks: A Literature Survey

Kanchan Koner

Research Scholar, Department of Commerce, The University of Burdwan

ABSTRACT: Over the years, investors have resorted to various strategies to beat the market and obtain superior gains. Value investing is one such strategy. The principal objective of value investing is to find undervalued stocks and invest in them with the hopes of them eventually rising to their potential value. The undervalued stocks can be identified by analysing the company's fundamentals. Moreover, a carefully carried out analysis of the company's fundamentals can lead to the investor ending up with two different types of stocks i.e. value stocks and growth stocks. This paper examines the literature on the comparative performance of value and growth stocks. Evidence suggests that though there is a consensus among the researchers regarding the outperformance of growth stocks by value stocks there remains controversy regarding its underlying reasons.

KEYWORDS: Growth Stocks, Trading Strategies, Value Stocks.

1. INTRODUCTION

From the existence of the stock exchange in 1602, investors tried to beat the market and obtain superior gains. In these years, investors were already characterised as value-driven in which risks and rewards were calculated unconsciously and implicitly (Sarna & Malik, 2006). Low et al., (2005), in this context, have opined that investing decisions are highly influenced by two opposite emotions, fear and greed. Fear drives an investor toward a negative or normal rate of return and greed drives to obtain a higher-than-average return on investment for the lowest compatible level of risk. Interestingly, from the viewpoint of market efficiency, it is impossible to obtain superior gains systematically, since all information is reflected in share price (Fama, 1970). This makes it impossible for investors to earn profits from buying and selling shares regardless of the investment strategies they adopt. But, keeping the perspective of Fama in view, some stocks are systematically outperforming other stocks in the market. This leads to market inefficiency. Various researchers have reported contradictory results regarding efficient market theory and provided evidence towards market inefficiency (Basu, 1977; Lakonishok et al, 1994; La Porte et al, 1997; Chan & Lakonishok, 2004; Athanassakos, 2009). The existence of market inefficiency offers investors the opportunity to obtain higher capital gains and acquire abnormal returns. As a result, investors over the years have resorted to several techniques and strategies to achieve these superior gains (Chan & Lakonishok, 2004).

Value investing is one such popular strategy adopted by investors. The objective of the value investing strategy is to find undervalued stocks and invest in them with the hopes of them eventually rising to their potential value. Arnold (2008) in this context argued that investors are always searching for stocks that potentially could create value, which involves searching the market and finding stocks that are undervalued and have the potential to generate capital gain. Value investing theories were coined by Graham & Dodd (1934), who argued that investors can analyse a firm's financial statements to find undervalued stocks to invest. The undervalued stocks can be identified by analysing different accounting ratios of firms or looking at their dividends relative to share price (Arnold, 2009). Moreover, such analysis of the company's fundamentals can lead to the investor ending up with two different types of stocks i.e. value stocks and growth stocks.

1.1 Value and Growth Stock:

The concept of value stocks can be traced back to 1934 and since then investors have sought value stocks for investment (Graham & Dodd, 1934). These stocks promise high returns and are often relatively inexpensive to acquire (Arnold, 2009). Typically the earnings for companies with value stocks are depressed in the past and their future is rather uncertain or the companies have reached maturity and presenting a stable performance (Chan & Zhang, 1998). According to Fama and French (1998), high returns on a value stock often arise since the market has undervalued distressed stocks and when the pricing errors are corrected the value stocks yield higher returns.



Growth stocks, on the other hand, have high expectations for their future earnings, their growth rate is high compared to the market average and they are expected to continuously rise further in future (Bourguignan & De Jong, 2003). Investors interested in this type of stock are referred to as growth investors. Growth stocks are rather often popular investment choices as the companies possessing these stocks tend to create innovative products with market opportunities (Bourguignan & De Jong, 2003). Investors anticipate that the market value of these innovative companies will increase quickly, leading to higher returns on growth stocks. According to Bauman and Millar (1997), investment in growth stock is especially popular and attractive during strong economic growth.

Now, the question that arises from the definition of value and growth stocks is how to determine whether a stock should be classified as value or growth. Various researchers have attempted to classify value and growth stocks by using different indicators. Typically, value stocks are characterized by relatively low market prices compared to a company's fundamental value, while growth stocks have relatively high market prices (Capaul et al., 1993; Bauman et al., 1998; Fama & French, 1998; Yen et al., 2004; Fama & French, 2007). Some researchers have advocated the use of multiple indicators for the identification of value stocks. However, Capaul et al., (1993) observed that the motive behind using multiple indicators to classify stock is not extraordinary, since a company's stock price represents the valuation made by investors regarding how a company will perform in the future. This is also acknowledged by Leledakis & Davidson (2001), O'Shaughnessy (2005) and Davis & Lee (2008).

While several indicators are available to classify stocks as value or growth, researchers commonly rely on three key indicators. These three indicators are price-to-earnings (P/E), price-to-book (P/B), and price-to-cash flow (P/C) or equivalents of these indicators, such as market-to-book, book-to-market, earnings-to-price, and cash flow-to-price. These indicators are commonly used since they produce stable results in returns. The reasons behind the importance and the constitution of the indicators are discussed below.

- **Price-to-earnings:**

The price-to-earnings (P/E) ratio is an indicator that compares the company's share price with earnings per share. The P/E is important since it compares earnings and share prices. According to Bragg (2007) it is the universal representation of investors' perception towards the firm's earnings. Lower (Higher) rates in P/E, give the perception that expectations of future earnings will also be lower (higher) (Bodie et al, 2009). Consequently, stocks with a low P/E ratio are characterised as value stocks and stocks with a high P/E ratio are characterised as growth stocks. A lower indication on the P/E ratio gives the investors the impression that they are paying less for earnings and could therefore be a sign of how expensive or cheap a firm's stock is compared to other stocks (O'Shaughnessy, 2005; Pinto et al, 2010). Besides, value portfolios classified on P/E tend to perform superior and consistently regarding the identification of value stocks and derive more consistent value premiums (i.e. the difference in returns between value and growth stocks) than those classified on P/B (Athanasakos, 2009).

- **Price-to-book:**

While P/E was adopted as the most appropriate measure to separate stocks, the price-to-book (P/B) ratio became popular after a study by Fama & French in the early 1990s. While Graham and Dodd (1934) explained this indicator as a measure of expected return on equity, Fama & French used it to separate value and growth stocks. The price-to-book ratio is equivalent to the market-to-book and book-to-market ratios (Fama & French 1998; Leledakis & Davidson, 2001). This P/B ratio is important since this indicator is used by investors to analyse whether the market price of a share is in excess or lower than a company's book value (Bragg, 2007). A higher (lower) price of a share indicates that investors have assigned additional (no) value to a company (Bodie, 2009). The stocks with a low P/B are characterised as value stocks, and stocks with a high P/B are characterised as growth stocks. A low P/B ratio may indicate that the company experiences problems regarding the fundamentals of the company, whereas a high P/B ratio may indicate that investors have high expectations regarding the future performance of the company (Bragg, 2007; Pinto et al, 2010). Fama & French (1998; 2007) reported that value portfolios classified on book-to-market (as an equivalent to P/B) provide significantly higher and more consistent returns than portfolios classified on other indicators. This view was also supported by Bauman et al (1998).

- **Price-to-cash flow:**

The amount of cash flow a particular company generates is another indicator investors use to value a firm's performance. According to Bauman et al (1998), P/C is not much used in previous studies to classify value and growth stocks, since it views a company's performance from a different point of cash in and outflows compared to earnings. The price-to-cash flow (P/C) is an indicator that



measures the prospects of the market regarding a company's future health from a financial point of view (Bragg, 2007). Therefore stocks with low P/C ratios are characterised as value stocks and stocks with high P/C ratios are characterised as growth stocks. The P/C ratio is considered an additional indicator of P/E since both ratios indicate firms' current and future performance (Yen et al, 2004).

In addition, some researchers also used dividend-to-price (D/P) as an indicator. However, D/P does not show consistency towards returns compared to other indicators. This was also acknowledged by Lakonishok et al (1994), Bauman et al (1998) and Davis and Lee (2008). On the contrary, Jeong et al (2009) documented that D/P provide sufficient consistency in relation towards returns. However such evidences were observed in only one of the three sample periods of the study. The authors have observed that in that particular sample period, more companies paid dividends than in the sample period of the previous or after, which explains consistency in D/P. However, in general, Fama & French (2007) and Davis & Lee (2008) have stated that using D/P as a classification indicator does not only produce insufficient consistency in return but rather limits the number of stocks that can be added to a portfolio since the number of companies paying dividend is significantly reduced over the years.

Now another question arises, when a stock is considered as either value or growth, does this suggest that value stocks can never become growth stocks and vice versa? According to O'Shaughnessy (2005) and Fama & French (2007), growth companies become value companies when aggressive competitors seek and accomplish to erode their extraordinary profitability and growth rates, hence growth companies become value companies. On the other hand, value companies become growth companies when value companies tend to increase profitability through product and market innovations and by restructuring organisational costs (O'Shaughnessy, 2005; Fama & French, 2007). When value companies create innovative products while reducing costs, their stock price should rise (Fama & French, 2007).

2. Value stocks Vs Growth stocks: Evidences from the past studies:

Since the 1960s various studies have documented evidence portraying value stocks outperforming growth stocks. Nicholson (1960), Mc Williams (1966), and Breen (1968) were among the first to do so. They have found that a portfolio with high E/P performed better than a portfolio with low E/P, taking the E/P effect on the absolute returns of stocks as an indicator. In a similar study, Basu (1977) found that a high E/P portfolio yielded a better average annual return than a low E/P portfolio when the returns of such portfolios adjusted for risk. However, Cook et al (1984) have argued that an E/P effect on stock returns could be just part of a size effect. Such views were dismissed by Jafee et al (1989). While observing both E/P and size effects on a sample of NYSE and AMEX stocks, the authors have found that the E/P effect overrides the size effect. However, in the context of the Indian stock market, Sehgal (2002) has found a strong size effect and a weak value effect. In another study, Fama et al (1992) provide evidence of the B/M effect on stock returns in US stock markets. They found that high B/M portfolios yielded higher average annual returns than low B/M portfolios. Further evidence of value premium in the US stock market is provided by Lakonishok et al., (1994). After constructing portfolios on E/P, B/M and C/P or GS (average growth rate of sales) ratios, the authors have found that value portfolios outperformed growth portfolios. Several studies on the major stock markets outside the US also documented the evidence of value premium. For example, Capaul et al (1993) observed the existence of value premiums in Japan, France, Germany, Switzerland and the UK stock markets. In a study conducted by Fama et al (1998) on stock markets across Europe, Australia and Asia between 1975 and 1995. They have found that in 12 out of 13 studied markets, high E/P, B/M and C/P stocks outperformed low E/P, B/M and C/P stocks. Even after sorting stocks on D/P, the authors have found evidence of value premium in 10 out of 13 markets. Arshanapalli et al (1998) further confirmed the overwhelming evidence of value premium on international markets. In a separate study, Chen et al (1991) on the Tokyo stock exchange found that high E/P and B/M portfolios outperformed low E/P and B/M portfolios. Evidence regarding the existence of value premiums was also witnessed in the Indian stock market (Deb, 2012; Saji, 2015). Interestingly, similar results were also observed even in the recession period (Saji, 2012). However, empirical evidence of value premium in emerging markets is mixed and less consistent. For instance, Fama et al (1998) compared the returns between value and growth stocks in 16 emerging stock markets between 1987 to 1995. The authors have documented evidence of value premium in at least 10 markets. However, they cautioned that due to high volatility, the evidence for a value premium in emerging markets should be interpreted carefully. Similar results were witnessed in a separate study by Chan et al (1998). In this study, the authors found that the value effect is almost non-existent in the highly volatile markets of Taiwan and Thailand. They also found a negative relationship between value effect and market growth indicating growth stocks are likely to perform better than value stocks in the fast-growing



markets. Some studies have indicated that value premiums increase over a longer holding period. Bird et al (2007) compared value premiums in 15 European countries over different portfolio rebalancing periods and found that value premium increases steadily as the investment horizon is extended. They suggested that many value stocks take a long time to reach a turning point in their market performance, and hence a relatively longer holding period is required to extract the full benefits of a value strategy.

While most international studies have shown that value stocks outperform growth stocks, some studies have reported opposite findings. In this context, Beneda (2002) found that growth stocks outperform value stocks. The author has also argued that to truly assess the performance of growth stocks, a long-term horizon assuming a buy-hold strategy must be examined and comparable portfolios of value stocks and growth stocks must be included in the study. In a similar study, Seigel (1995) analyzed the future returns of high-growth stock portfolios and suggested that long term investing in growth stocks may pay off. However, the study does not provide returns for a comparable portfolio of value stocks over the same period. Gonenc et al (2003) found in the Istanbul stock exchange, growth stocks have outperformed value stocks. They reported that growth stocks produce excess annual average returns over value stocks.

Reviewing the existing literature it has been observed that there is a consensus among the researchers that value strategies often outperform growth strategies. However, there are some controversies regarding the underlying reasons for such performance. Fama and French (1966) have argued that the higher return of value strategies is due to their increased risks. They explained that the value stock compensates the investors for bearing higher risks. Besides, cognitive biases in investor behaviour and agency cost have been identified as the major causes of high rewards to value investing (Lakonishok et al., 1994). Some researchers have argued that data selection bias is the reason for the superior performance of value stocks (Shanken & Solan, 1995). However such views were rebutted by Chan et al., (1995). Dreman & Berry (1995) found analysts' errors have an asymmetrical influence on high and low P/E stocks. Laporta (1996) stated that value stocks generated superior returns due to the behaviour attributes and expectation errors made by investors. There also exists strong disagreement among academic researchers as to the choice of a reliable indicator of the market valuation of firms. Basu (1977) and Campbell & Shiller (1998) found the Price to Earnings (P/E) ratio as a good predictor of equity returns. Chan et al (1991) suggested that Book to Market (B/M) value and Cash flows to Price (C/P) were significant in the variation of returns. Fama and French (1992) found the firm size and B/M as the factors explaining the cross-sectional variations in returns, while Lakonishok et al (1994) provided evidence only for the B/M effect. However, Athanassakos (2009) showed the P/E ratio as a better predictor of average equity returns than the Price-to-book (P/B) ratio. Leledakis and Davidson (2001) stood for better predictability of returns by ratios of sales to price and debt to equity.

3. Research Gap:

Value investing and the return differences between value and growth stocks have been extensively studied over several decades, with much of the research focusing on international markets, particularly the U.S. stock market. However, studies in the Indian context remain relatively scarce, highlighting a clear research gap.

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