

Monthly Letter to Our Clients and Friends

Point & Counterpoint: Value vs. Growth

Kendall J. Anderson, CFA
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The debate over which investment philosophy is best will continue with winners promoting their own style and losers rationalizing their losses. Passive vs. Active, Large vs. Small, Top Down vs. Bottom Up, Fundamental vs. Technical, International vs. Domestic, and the granddaddy of all, Value vs. Growth. In 1996 the now defunct Mutual Funds Magazine invited me to contribute my thoughts in this ongoing debate in a featured article titled "Speaking Out". The format was a Point: Counterpoint; with myself contributing the case for value. I jumped at the opportunity, knowing that Mutual Funds Magazine was carried throughout the country and available right here in Rock Hill, SC at the grocery store check-out lane! **Little did I know, the case for growth would be argued by John D. Gillespie, portfolio manager for the oldest and one of the most famous growth mutual funds in America, the T. Rowe Price Growth Stock Fund (PRGFX).** Of course, when I found this out, I thought to myself, should I try to buy up every available magazine? That way, I would not have to suffer the humiliation that surely would come upon me when my clients and friends read the debate.

A few years later, Mr. Gillespie left his duties with T. Rowe Price to become the managing member of Prospector Partners, LLC. **The lure of managing an open ended mutual fund must have been reignited in Mr. Gillespie, as they started and offered for investments the Prospector Capital Appreciation Fund (PCAFX) and the Prospector Opportunity Fund (POPFX) in 2007.** Gillespie's managing talent is evident— as of 6/30/11 Morningstar has awarded a 4-Star Rating to the Capital Appreciation Fund and a 5-Star Rating to the Opportunity Fund. Do yourself a favor and visit his web site www.prospectorfunds.com.

If personal wealth is the measure of success in the portfolio management business, then Mr. Gillespie has put me to shame. However, I do feel somewhat vindicated in regards to our battle of so many years ago. The reason is found in the fact sheets of his funds. They both use a value oriented strategy!

Since the debate between Value and Growth has continued to this day I am providing you, word for word, our Point and Counterpoint that originally appeared in the June 1996 edition of Mutual Funds Magazine.

Until next time,

Kendall J. Anderson, CFA

Point: The Case for Value Investing

By Kendall J. Anderson, Chartered Financial Analyst

The battle between growth and value is for your mind and your money. We all want to “get rich quick.” The growth school caters to this desire. And since investment providers need your money to create their own wealth, what better way to capture it than to create a picture of unlimited and quick rewards through growth funds. On the other hand, the value school seeks to appeal to your common sense, never promising immediate gratification.

So in making our case for value, let’s apply a test of long-term results. My test is simple, not an academic study using 50 years of data and a large number-crunching computer.

First, name five value investors who have made themselves and others rich over a long period of time. Here’s my list: Bernard Baruch, Benjamin Graham, Sir John Templeton, Warren Buffet, and John Neff. Too easy for you? Here are a few more: Roy Neuberger, Max Heine, and Michael Price...and two more, not in the classic sense, but value-motivated nonetheless; Peter Lynch and Jimmy Rogers.

Secondly, name five investors who have made themselves and others rich over a long period of time by investing in growth companies, buying them at any price. I’ll give you one—T. Rowe Price, founder of the Price mutual fund family.

Some of you may think a few of these rich and famous “value investors” are really growth investors. But if you study their work, you will find one underlying principle that all of them applied in investing: determining a worth or present value of whatever is being bought or sold, and then comparing this value to the current market price. This is the essence of value investing.

I can think of no one better to define what a growth company is than T. Rowe Price, who established the growth school over 50 years ago. His definition was, “a company with a long-term growth of earnings, reaching a new high level per-share at the peak of each succeeding major business cycle, and which gives indications of reaching new high earnings at the peak of future business cycles”.

Under Price’s definition, in order for us to succeed in our quest to pick profitable stocks, we must first believe that the past will predict the future. Then we must estimate accurately the future earnings of the company. I don’t have to remind you of the analytical community’s dismal track record of predicting future earnings. Accurately estimating the next quarter is almost impossible, let alone the next business cycle.

Let’s contrast that idea with what you must believe in order to successfully apply the value process. You have to believe that a business or any other asset has a monetary value that can be measured today. If you can believe that an asset’s current value can be established, then it is very simple to go to an auction (the market) and see how much someone will pay for it. The great thing about an

auction is that on one day very few buyers are present, and the sellers are giving everything away. The next day the auction is full of buyers, and sellers can set their own prices.

And that, my friends, is why value investing will continue to provide excellent results. No guessing on the future and no extrapolation of the past; just plain old buying at a bargain and selling at a higher price.

By the way, did you come up with four more rich and famous growth investors? Maybe you should look for five. You see, Price closed his New Horizons Fund in October 1967 and reopened it in June 1970, only to shut it down again in March 1972. His reason—the general level of prices was too high. I guess even Price realized that there is a price too high to pay.

Counterpoint: Growth Offers Greater Potential

By John D. Gillespie is portfolio manager of T. Rowe Price Growth Stock Fund, first introduced by Thomas Rowe Price in 1950.

Thomas Rowe Price developed his growth philosophy in the 1930s when the conventional strategy was to jump in and out of stock with each turn of the market cycle. Uncomfortable with this approach, he believed investors should act more like business owners who try to maintain their stake in the company through both economic booms and busts. Price's growth philosophy advocated a long-term buy-and-hold strategy, not a get-rich-quick scheme. Momentum investing—chasing the hottest stocks—should not be confused with growth investing. In fact, Price believed the best time to invest in a company was when it was small, before its shares “gained in stature” or became “glamorized” by Wall Street.

In searching for growth companies, Price plowed what he called “fertile fields” or growing industries. He focused on well-managed businesses whose earnings and dividends were expected to grow faster than inflation and the economy. He saw the real test for a growth company as its ability to sustain its earnings even during economic slow-downs. Such companies, he predicted, would provide long-term growth of capital, preserving the investor's purchasing power against erosion from rising prices. But once a company consistently failed to meet earnings expectations, or was forced into an unfavorable environment such as increased competition, it was time to sell.

To determine if a stock is a good buy, value investors analyze a stock's present value and compare that with the current price. But this practice is not the sole realm of the value investor. It is done by all competent investors, no matter what their style. While value investors want to be rewarded for a bargain (paying 50 cents for \$1 of value and hoping the stock rises to reflect that value), growth investors will bargain for greater long-term reward. Growth investors determine a company's future prospects by projecting its earnings streams and calculating the present value of those earnings streams. They then compare this value with the current price. For example, if I am confident a company can

increase \$1 of value by 12% a year, I may be willing to pay a little more for it, say 75 cents for \$1. Growth investors tend to favor dynamic companies with bright prospects, while value investors often favor mature companies in slower growth industries.

By paying a higher price for a growing company, the growth investor accepts greater volatility. In the long run, however, paying a slightly higher price for a growing company offers the potentially potent combination of above-average returns with less risk than if the stock were bought at “full value”.

In fact, it was Warren Buffet—whom I regard as a growth investor—who said he would rather buy a good business at a fair price than a fair business at a good price. Thomas R. Price never advocated growth at any price, but he favored growth at a reasonable price. Indeed, he refused to “overpay” for growth. It was this philosophy that led him to close the New Horizons Fund twice (currently open).

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113 East Main Street, Suite 310, Rock Hill, SC 29730
800-254-0874 803-324-5044