

The Stuff that Dreams Are Made Of: The Gap Between the Prediction and Performance Of Growth Stocks

Ask the typical investor in stocks what he or she wants and the answer usually comes back “growth”. By this it is usually meant growth in revenues and profits sufficient to propel their stocks ever higher.

What the typical investor usually lacks is a way to value future growth. Without such an ability, investors overpay for the potential for growth only to be rewarded with a stagnant stock if things go well and a falling stock if things do not.

A good case study in growth stock valuation is the performance of technology stocks for the past seven years. Since their peak in 1999 technology stocks as a category underperformed the overall market. In spite of this, technology continues to be one of the highest rated sectors for future performance by investors.

Part of the appeal of growth in general and technology in particular is what can be described as “the gold rush factor”. Because new products do not by definition have a history, their growth and profitability are not correlated to any factors which would constrain a forecast. This makes all estimates of growth equally legitimate at the time. As a product matures and its use is correlated to other factors (interest rates, end user demand, competition, etc.) its growth forecast becomes more tempered by reality.

For this reason technology stocks can sport some of the highest future growth rates in the investment universe. They are also estimates that are more often revised downward rather than upwards with the passage of time.

Part of the downward revision comes from the commoditization of technology. As applications for technology grow, competition forces the price of technology down. At first the increase in unit volume offsets the price declines. At some point the price declines occur faster than unit volume increases. This causes revenues to stall and growth rates to come to earth.

An example of technology’s commoditization is bar codes. Originally the technology to read bar codes was fairly expensive, limiting use to large items like

shipping containers and rail cars. As the price of code readers came down the market expanded to grocery items and other retail merchandise to the point that now they are ubiquitous.

The money made off of bar codes has accrued not so much to the supplier of code readers but to the companies that use them. Bar codes have permitted more precise inventory restocking by Wal-Mart. Chains like Kohl's have been able to have all customers come to a central check-out rather than have a cash register in each department like their department store competition.

This example points up the fact that it is often not the technology that provides the greatest investment opportunity in the end. It is the application of the technology to a business that provides the investment gain. Because Wal-Mart and Kohl's as new entrants patterned their enterprises around technology in a way that their competitors either would not or could not, they gained a competitive advantage in terms of revenues, profits, or both.

The advantage of technology tends to be fleeting. Once adapted by competitors the investment issues shift from technology to strategy and execution. Building on the previous example, Target has used the same technology as Wal-Mart along with a more value-added inventory selection to generate higher rates of growth. Kohl's now faces competition from firms like Sears and JCPenney who have adapted their stores to Kohl's format. Thus technology advantage becomes a requirement once adapted by all. At this stage the price pressure on technology accelerates as its use becomes more defensive and less of an advantage.

Because the value of technology tends to erode as it is adopted, the holy grail of technology investment tends to be the idea of the "proprietary" product or process that has no competition. This is most often seen in the healthcare field. Even here, the amount of capital chasing solutions to problems makes the idea of a drug or medical device having no competition over time an elusive one.

It is perhaps human nature to be fascinated with the new. It is wiser to be intrigued by the application of the same. In the end it is the application and not the technology that provides the investor the greatest chance to profit.

The Economy

Due mainly to downward revisions in the housing industry, economic activity in the last quarter of 2006 was weaker than previously reported. The issue becomes one of whether this weakness will extend into 2007.

At this point it would seem that housing has found a bottom but that the revival of the housing industry will take some time. The basis of the revival is the fact that population growth continues to be in the southern and western parts of the country. The one exception to this trend seems to be Florida. Increases in the cost of property insurance as a result of the number and severity of hurricanes seem to be causing a sharp slowdown in population flows.

For the overall economy the trend seems to be for positive but slower growth compared to last year. Areas of economic vitality include the healthcare industries due to government payments. Also export industries such as capital goods and transportation products should do well. Retailers serving customers of modest means stand a chance of improving their sales upon the completion of the increase in minimum wage, although operating costs will go up as well.

Inflation

Inflation numbers tend to be buffeted by the fluctuation in gasoline prices. Taking food and fuel out of the index reveals an ongoing rate of inflation of about two percent per year.

This rate will get an increase when the new minimum wage increase is signed into law. It will also be affected by rising rental demand from families who no longer qualify for home ownership due to tighter loan standards. Finally a cheaper dollar will make imports more expensive, stoking inflation further in the process.

Interest Rates

Interest rates have been fairly stable in terms of government debt. For debt backed by the mortgages of marginal borrowers the market has been ugly.

In essence, a combination of lax underwriting standards, some fraud in loan applications and higher reset rates on adjustable rate mortgages (ARMs) is causing marginal borrowers to abandon their homes and the loans attached to the same. Due to the fact that the loans were packaged and sold to many entities, the impact of the loan losses appears to be fairly dispersed. The exception is the loan originators, many of whom have filed bankruptcy and closed their doors.

The investment issue is whether this problem will spread to other sectors of the economy. At this point it appears well contained. However, a collapse of a large hedge fund due to the gyrations of interest rates would probably cause a good bit of panic depending on its size. How well grounded the panic would be would depend on the response by government authorities including the Federal Reserve.

The Stock Market

Since the first of the year stocks have been appreciating at a slower rate. One reason for the slowdown is the decline in corporate profit growth. This year is the first year since 2003 that corporate profits are expected to rise less than ten percent.

One interesting phenomenon is the increasing amount of mutual fund money being poured into international stock funds. This is in spite of the fact that over 40 percent of the profits of the Standard & Poor's 500 (an index of US stocks) comes from outside the United States. Couple this with the fact that most international funds have higher fees than their domestic counterparts makes their popularity seem more fad than prudent diversification.

Warren M. Barnett, CFA
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