PAYING UP FOR WHAT?
REVISITING THE GROWTH PREMIUM RATIONALE

If any investment proposition continues to confound us, it's the contorted logic of paying massive premiums for businesses that frankly have yet to prove that they're worth *anything*.

When viewed objectively, the lofty valuations enjoyed by many so-called "growth companies" are rarely deserved, for three related reasons:

1. Those that lack earnings may never generate them;
2. The future earnings growth of those that are profitable is at best highly speculative; and
3. If the earnings growth rate is high, typically it's only because the point of comparison is so low.

Mathematically speaking, a high rate of earnings growth relative to a low baseline isn't necessarily extraordinary. If earnings are increasing at all, large percentage gains relative to a low starting point are in fact almost unavoidable. A company that earned 2 cents per share one year and 3 cents the next has demonstrated 50% earnings growth. In percentage terms it's impressive, but is it material to the enterprise value overall and, more to the point, sustainable? Ultimately, the Law of Large Numbers dictates that such sizable percentage leaps cannot be maintained. Trees don't grow to the sky. If the goal is attractive long-term returns,

**Paying a premium for *predictable* earnings growth can occasionally make sense;
paying up to wager on non-existent, nominal or unsustainable profit growth does not.**

Fundamentally, what should be worth more: A company whose revenue model may never prove effective, or one that has already demonstrated the ability to deliver lower but still-substantive, reliable growth for years?

There's a reason investors concerned with long-term returns focus on management's history rather than its story. Of course, past performance is never a guarantee of future results, even when management has a very long and laudable track record. But absent a past, there's effectively *no* basis for analysis. Investors are extrapolating an ether.

If entirely logical, investors assuming the higher investment risk of such unproven entities would insist on a *lower* price. It's the only means ensured to increase their return. In paying a higher price they're blatantly contradicting the most basic tenet of investing: That the potential return should increase as the risk does.

Banks and other lenders charge less-sound borrowers a higher interest rate precisely because they demand higher compensation for the increased risk they're taking. Providers of equity financing should do the same. And

**The only means by which equity investors can charge more for
"lending equity" is by lowering their purchase price.**

It's undeniable that a few early-stage, money-losing companies eventually deliver spectacular returns. And with each spin, so will some number on a roulette wheel. Both offer lousy odds.

If the average investor fails to appreciate this, it's probably because he's been conditioned to accept that greater reward necessarily entails greater risk. But *anyone* can take more risk in pursuit of bigger gains. The entire point of investment analysis is to achieve higher returns *without* a commensurate increase in risk.

Investors' confusion regarding risk and reward is the foundation upon which the growth premium has been advanced. And it is why commentators have been able to frame growth and value as mutually exclusive, as if value stocks are defined by an absence of earnings growth. Nothing could of course be further from the truth. Among all of the principles Benjamin Graham espoused, the founder of the value investing school emphasized that the most important determinant of a company's value is its future earnings power.

Growth and value are easy to confuse if you define growth generally – but growth isn't a generic quality.

The issue isn't growth vs. value, but rather *reliable* growth vs. *questionable* growth.

When assessing an ongoing enterprise, *all* smart investors look for earnings growth. What separates the value investing disciples from the growth gamblers is the level of certitude the former demand and the price they are willing to pay. In keeping with their fierce aversion to losses, true value investors aren't seeking Growth At a Reasonable Price (aka. "GARP") – they want growth at an *unreasonable* price, because it is within that bargain that their margin of safety resides. As rationalizations go, GARP is a particularly clever piece of sophistry. Only lawyers have stretched the definition of "reasonable" further than fund managers straining to characterize paying through the nose for money-losing, unproven businesses as responsible or even – wait for it – *conservative* investments.

Anyone is of course free to wager that they can ride and exit the price momentum before mathematical reality imposes itself. And some will get lucky. But even if they on occasion succeed, in order to achieve above-market long-term returns they have to do so consistently, because it only takes a handful of losses to destroy one's long-term returns. On what basis are these gamblers assuming they can consistently predict the unpredictable?

The reality should be obvious to investors:

The best way to ensure low returns is to start with high valuations.

For decades investors have been sold on paying sky-high prices for unproven enterprises, but only because they've been successfully conditioned to focus on the magnitude of the potential reward rather than the very low likelihood of their receiving it. If their purchase price were calibrated by the excessive risk they were assuming, they would demand a discount rather than acquiesce to a premium. Unfortunately, most investors are as bad at assessing risk as they are at judging value.

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