CHAPTER 6

My Issue with Growth Investing

THE SAYING I HATE HEARING is that “companies are priced based on future expectations,” or “the market is priced based on future, not trailing earnings.” First off, it’s foolish to think that any of us can predict any future price or outcome. If you don’t believe me, try playing a week of fantasy football. However, this isn’t my gripe with growth investing. I’ve gone through deep thought, critical thinking, and analysis to try and put myself in the shoes of a growth investor. I just can’t justify it, and let me share why.

Growth investors rely on a stock’s price going higher. Many of them forego dividend-paying stocks because they don’t provide the growth these investors want. Fair enough if you think that way. I just can’t agree with the logic. I hear people talk about the Facebook and Google IPOs. They point to the success of Google and claim it proves their argument. But for every single successful IPO, there were countless more which failed spectacularly. How about we examine three similar growth stocks from 15 years ago, and see how their stories ended? There was a list by Fortune

Magazine in September 1999 that listed the fastest growing companies of the time. Stocks #1, #3, and #4 of that list were Siebel Systems ($SEBL), THQ ($THQ), and Network Appliance ($NTAP). We exclude #2 of the list because it was a mortgage company. $SEBL was a hot software company, $THQ was a video game and toy company, and $NTAP had seemingly endless possibilities in the networking business. The hottest trends of that time composed of internet stocks, networking companies, and other technology based stocks. As you can see, these companies represent the hottest trends and greatest growth stories of that time.

What has happened since then? $SEBL peaked to the $90 range, then crashed when the tech bubble popped and was eventually sold to Oracle in 2005 at around $10 a share. $THQ filed for chapter 11 bankruptcy in 2012 and investors never got a return on their investment. $NTAP is still around today at $43 a share, when more than a decade ago it was over $100. An investor who put $10,000 in each company during 2009 would have around $5,000 left of a $30,000 investment. What if you had instead invested in a steady dividend paying company? Assuming an average 3% yield, you would have compounded that yield for 14 years. With just dividends alone, $30,000 would appreciate to $45,377. If you include an 8% average return, the $30,000 would now be worth $129,313.25.

This is a very simplified example, but the chances of these two scenarios are much more likely than finding a growth stock to return you 10,000%. Chances are, once you find out about a hot growth stock the big returns have already been made. As you look through the Fortune list, you'll see many more losers like this than winners. Why is that? Growth companies are all racing to maximize profits, and those stories are the ones that tend to attract over excited

investors. Like the tortoise who beats the hare, the slow growth dividend payers outpace the growth companies time and time again. Short-term thinking and impatience only lead to despair.

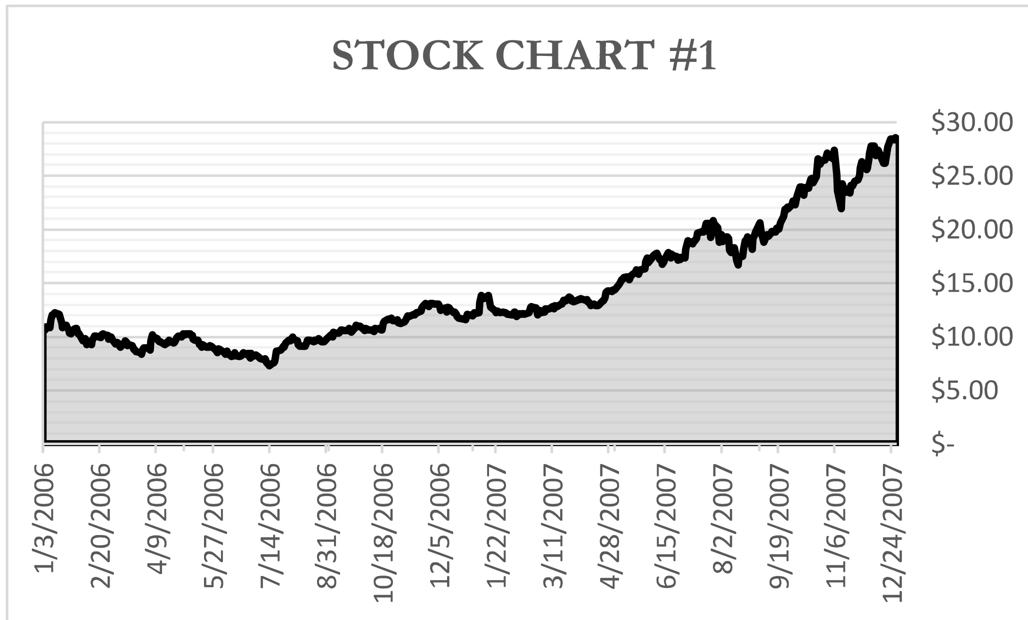
THE SELL AT THE TOP FALLACY

Growth investors don't like dividends. Because of this, they will jump in and out of stocks in order to maximize profit. I hold stocks to keep collecting dividends and so I am almost always holding. I may miss maximized profits in the short term, but I make up for it in the long term. A growth investor that also tries to hold on gets hit much harder than I would. Because of the nature of these stocks, growth stocks rise much higher but also fall much further. Growth stocks are much more volatile than dividend stocks, and this is where the big growth opportunities come from.

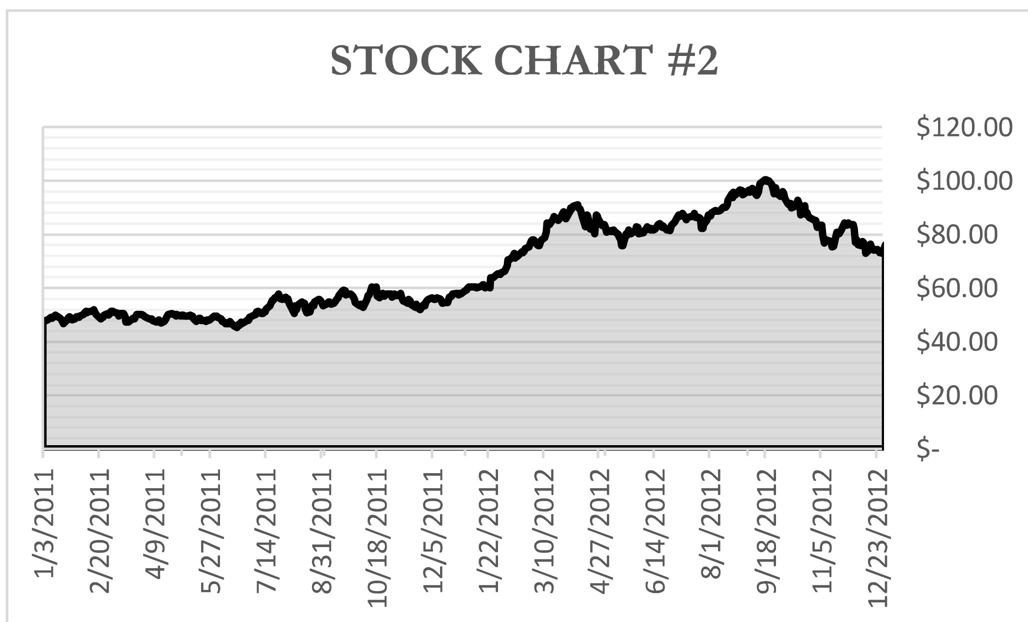
As fast as they rise, they also fall. A growth investor who tries to buy and hold will lose all the profits they just gained when a growth stock loses favor in the market. The investor might even lose part of their capital like we saw with $SEBL and $NTAP. With this explanation, I now present the dilemma. The growth investor knows he can't buy and hold for the reasons explained above. So the growth investor must know exactly when to buy at the top and sell at the bottom. He must be able to time the market, which is so much easier said than done. A common fallacy that investors have is the idea that they will be able to sell at the top. When you look at a past stock chart, it's easy to see where the peak was with hindsight. But actually doing it in the present is much, much harder. In fact, it's damn near impossible. Do you think you're able to guess the top? Take a look at these charts and decide in your head if you would sell or not. Don't

scroll down and cheat. Try to think in your head and see if you were right.

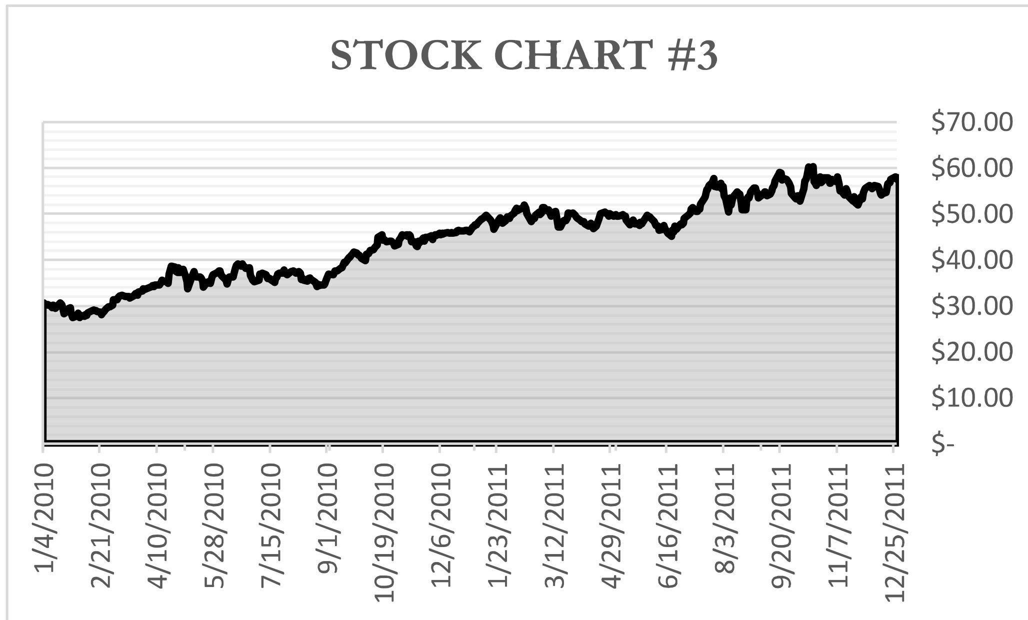
1. Take this chart. Would you sell here?



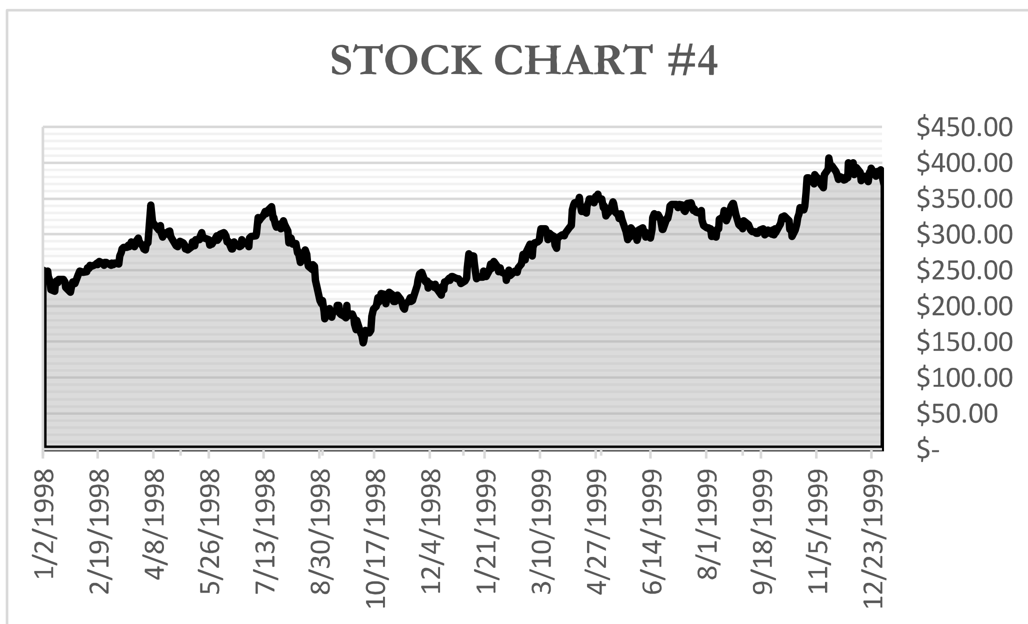
2. What about this one? Sell here?



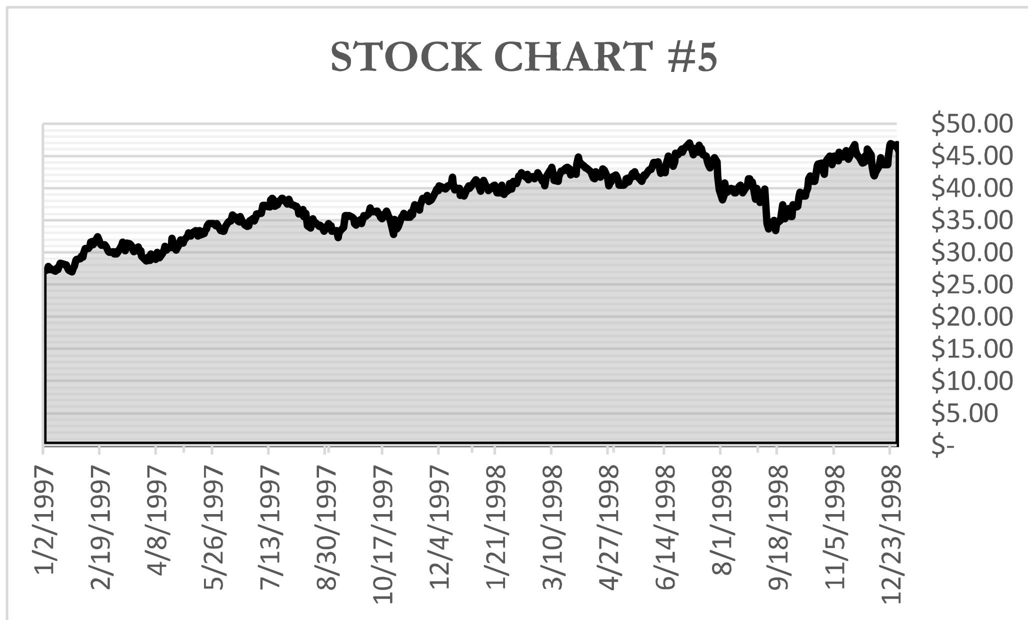
3. This chart seems to have the consistent left bottom corner to right top corner linear shape that investors love to see. So do we sell here?



4. What about this one? After a sharp decrease in share price the stock appears to have rebounded and picked up some momentum.



5. Do you sell here?



Record your answers for #1 – #5. Are you at 100%? Close to it? Confident enough to invest your hard-earned money with? All five of the charts look very optimistic. Each of them would have to credit their success to great market stories and company profits. There would undoubtably be many bullish analysts for each of these stocks. So you're a growth investor and you've made a good pick. Do you hold on for more profits or sell to lock them in now?

GROWTH INVESTING: CHART RESULTS

If you sold in chart #1, you'd miss out on the rise to $700. That stock was Apple ($AAPL). If you held in chart #2, you'd see drops from the $600 range to the $400 range. That stock was Apple ($AAPL) again. Chart #3 was also Apple. So you'd have to have held on until $700 and then sell exactly at that moment. The next chart was Citigroup ($C). It peaked at around $500 during the tech boom and then crashed down

to the $40 range. So, a sell at chart #4 might've been good. But you would've been kicking yourself the whole way up. Finally, chart #5 was Procter and Gamble ($PG). Selling there would torture you, as the stock has since doubled and been increasing its dividends the whole way through. I hope you can see my point here. It's near impossible to predict when to buy and sell any security. The best you can hope to do is buy a company at a reasonable valuation and collect dividends the whole way through. A well thought out value investing strategy will do just that. By ensuring that stocks are bought at low prices and with a sufficient margin of safety, the portfolio holder increases his resilience against short-term market movements and despair.

GET CASHFLOW LIKE MONOPOLY

Instead, smart investors play the stock market like they play monopoly. In a game of monopoly, if you have St. James Place, Tennessee Avenue, and New York Avenue, you aren't selling these properties. Even if the guy next to you wants to give you $2,000 for St. James Place– which you bought for $180– you wouldn't sell it. Why? Because you have three houses on St. James Place and are getting paid income each time someone lands on the property. You don't care that someone will give you $2,000 for it, because you know that in the long run you'll make far more.

The stock market is no different. You should be buying stocks for the income you receive, and forget about the changes in price. The St. James Places of the world are out there, and they're called dividend-paying stocks. If a stock goes up much higher than I paid for it, that's great but I'm not selling. I invest for the income stream, dividends, because it pays off in the long run. This helps me stay relaxed during a stock market crash as well. The price may

have fallen below what I paid for it temporarily, but I'm fine with it as long as my income stream keeps coming in. You may argue, "Dividend stocks don't gain like fast growth stocks do, just look at Google." You're right, but what are the chances of finding stocks just like Google? For every Google you show me, I can show you 10 high growth stocks that crashed and burned. A lottery ticket will give you 100,000% return on investment, more than the returns I expect to get in my lifetime. But what are the odds of that happening?

Contrast that with the odds of my dividends getting paid. I don't see dividends going away anytime soon, and that's a good sign. Don't let yesterday's lessons pass you by. Learn from them, remember them, and profit from them.