

## January 14, 2007 Review

### Summary

The delusional behavior that is Wall Street today was evidenced by the trade in the two largest chip companies Friday. AMD, the number two company warned that 4Q results would be **substantially** lower than expected because of lower margins resulting from a price war with Intel. As would be expected, AMD was hammered for ten percent plus. As one arguably would not expect, INTC opened lower and then rallied to **green** after a few hours **with the Street interpreting a price war crushing margins as a reason to load up the wagon**. So, as the OPM (other people's money) crowd on the Street continues to blissfully damn the torpedoes and "invest" Main Street's money full speed ahead, we share the following breaking heretofore unforeseeable news:

**It will get cold in January, so apparently energy stocks won't go to zero after all.**

It would be difficult to make up things so silly, but I guess truth truly can be stranger than fiction.

On a more positive note, if you are not aware of Canadian energy trusts, it might be worth something for you to get up to speed on. There are a number of factors negatively influencing their price currently that in my opinion will resolve to the upside for long term investors.

### Credit

### Commercial Real Estate

### Commodities

- Jan 12 The big story today was the grains, though. What a day, with corn going lock limit up and soybeans not far behind. Today was the release of the big crop progress report, and it was bullish across the board, except for maybe cotton, which rallied anyway. **Seems that there simply aren't enough corn and soybeans to go around, and fear is that the situation will get worse.** Outstanding Investments <http://www.agorafinancial.com>
- Jan 12 (reuters) Citigroup said it expects the coal market to normalize between the bullish extremes of 2005 and the "bearish misery" of 2006 as U.S. power generation rises by 1.5 percent this year. In the longer term, the industry could also benefit from technologies such as Integrated Gasification Combined Cycle (IGCC) with carbon capture and Coal-to-Liquids (CTL), the brokerage said in its research note. (Reporting by Tenzin Pema in Bangalore) <http://q1.schwab.com/content/rb/2007/01/12/1304064.html>
- Jan. 11 (Bloomberg) -- OPEC's president, describing crude oil's plunge to \$53 a barrel as "unacceptable," urged members to comply with pledged production cuts. **OPEC's President Urges Group to Comply With Oil Cuts** [http://www.bloomberg.com/apps/news?pid=20601087&sid=a9BwsJaG1u\\_8&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=a9BwsJaG1u_8&refer=home)

## Currency

- Jan. 11 (Bloomberg) -- The Bank of England unexpectedly raised its benchmark interest rate by a quarter-point, the third increase since August, saying inflation may accelerate and spur demands for higher wages. The nine-member Monetary Policy Committee lifted the repurchase rate to a five-year high of 5.25 percent today, surprising all of the 52 economists in a Bloomberg survey. Risks of faster inflation "now appear more to the upside," the bank said in a statement. The pound rose and bonds fell. "It's a result of the bank being very worried about the January wage round," Roger Bootle, an economic adviser to Deloitte & Touche LLP who formerly advised the Treasury on interest rates, said in an interview. "Another rise is in the cards, and there may be more after that." Inflation accelerated to 2.7 percent in November, the fastest in at least a decade. Policy makers including Governor Mervyn King have said they're concerned that rising prices will lead to higher wages. The last two rate increases have yet to cool the property market, where prices rose 10 percent last year. Bank of England Unexpectedly Raises Interest Rates  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=ahT92GKv7yTA&refer=home>
- Jan. 11 (Bloomberg) -- European Central Bank President Jean-Claude Trichet said interest rates in the 13-nation euro region are still "low" after six increases since the start of December 2005, indicating a further move in coming months. "Acting in a firm and timely manner to ensure price stability in the medium term is warranted," Trichet today at a press conference in Frankfurt. "Very close monitoring" of the inflation outlook is "of the essence," said Trichet after ECB policy makers left the key rate unchanged at 3.5 percent. Trichet Says Rates 'Low,' Urges 'Close Monitoring' of Risks  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=axB2TQpruZAc&refer=home>

## Diversification

## Derivatives

## Housing

- [the following are excerpts from the monthly subscription only economics report send to home builders and thus is prone to be overly optimistic – I am a paying member of the homebuilders association so I can get these reports and feel, for my \$1500 annual fee, I can “share excerpts”. All of the following is directly from the report ] While the housing market has experienced an impressive “correction” process since late 2005, following the unsustainable housing boom, strong “headwinds” still must be overcome before solid underlying demand fundamentals can raise housing production back to trend. These headwinds relate primarily to historically low levels of housing affordability, an ongoing retreat by investors/speculators, and historically high levels of current and potential inventory in single family and condo markets. **But unsold inventories are quite high, prices are falling in some areas, and sellers (particularly home builders) are offering a broad range of nonprice sales incentives.** Under such “buyers’ market” conditions, many prospective purchasers are remaining on the sidelines as they await even better terms down the line. And many sales contracts that were signed earlier are being cancelled

as the prospects for future price appreciation are marked down. Pegging the trough of net home sales is quite difficult any time of year because of deficiencies in available data, and the task is particularly tough during the winter months when seasonal adjustment problems are multiplied. Indeed, weather conditions were unusually bad in October and unusually good in both November and December, providing some grounds for discounting reported improvements in seasonally adjusted home sales in November **Although measures of housing affordability improved to some degree in the latter months of 2006, a lot still needs to be done to bolster sales for owner occupancy (purchases by investors/speculators are bound to continue downward for some time).** However, mortgage rates are not likely to move down this year and mortgage lending standards are bound to tighten in the wake of the financing excesses during the boom (particularly in the subprime and adjustable rate mortgage markets). It's true that employment will be growing and that gains in household income will be providing some boost to affordability, **but further cuts in house prices along with aggressive use of nonprice sales incentives most likely will be needed to get home sales on a meaningful upswing this year.** On the inventory front, it must be recognized that the **current overhang is heavier than it looks and that the true overhang may actually rise further. Homes left with builders when sales contracts are cancelled are not in the government's estimates of the new home inventory, and an abnormally large portion of previously owned homes for sale are standing vacant —a legacy of the investor/speculator buying binge that compounds the seriousness of the current inventory situation. And then there's that "phantom supply," made up of an unknown number of homes that will be put back on the market by investors/speculators that grow weary of carrying them in down markets.** In this regard, it's certainly worth noting that the single family rental vacancy rate is hanging around a record level. **Seider's Report an internal home builders' economist**  
<http://www.nahb.org/generic.aspx?genericContentID=69476>

- Jan 8 With spring right around the corner, many housing industry experts are hoping the real estate market will see some noticeable improvements. However, there is one snag that can potentially keep prices down — the large number of vacant homes for sale and rent. **In the third quarter of 2006, there were 5.7 million vacant housing units, accounting for a record 4.6 percent of all U.S. homes, according to the U.S. Census Bureau. The average in the 1990s was about 3.5 percent. To get this ratio back to normal, 1.3 million vacant homes would need to be occupied.** Lots of empty homes push home prices downward, says analyst Ivy Zelman of Credit Suisse. Owners of unrented, unsold homes must pay for insurance, lawn service, taxes and, often, a mortgage. Seeing those costs pile up can motivate an owner to sell or rent at much lower prices. When a house sells at a lower price, other would-be buyers expect lower prices as well. *Source: The Wall Street Journal, Justin Lahart (01/08/07)*  
<http://www.realtor.org/RMODaily.nsf/pages/News2007010801?OpenDocument>

## Housing Finance

- Jan 12 Federal Reserve Gov. Susan Bies told a meeting of bankers Thursday that their **loose underwriting standards were at least partially responsible for the increased numbers of late payments and foreclosures.** And, she warned them that **they needed to**

**tighten their risk management practices or risk facing losses, particularly on nontraditional loans.** Bies told members of the National Credit Union Administration: "Many industry observers believe the poor performance of more recently originated subprime loans is due primarily to looser underwriting standards, including limited or no verification of borrower income and high loan-to-value transactions." **She warned lenders that they could expect an increase in large losses if they continued to make shaky loans, particularly since a less buoyant housing market raises the chance that more marginal borrowers will get in trouble.**

<http://www.realtor.org/RMODaily.nsf/pages/News2007011202?OpenDocument>

- Former Jackson County Executive Katheryn Shields and her husband knowingly signed fraudulent paperwork related to the proposed sale of their home, according to a federal mortgage fraud indictment returned Thursday. Shields, 60, and her husband, Philip Cardarella, 59, were indicted with nine others in an alleged scheme to drastically inflate the sales price of their home in the Loose Park area of Kansas City last fall. Under the elaborate plan, the home, which had been on the market for 18 months, would appear to sell for \$1.2 million to buyers who never intended to pay the mortgage, even though Shields and Cardarella had cut the price to \$699,950, authorities said. **Ex-county executive indicted for fraud**  
[http://www.kansascity.com/mld/kansascity/news/breaking\\_news/16387313.htm?template=contentModules/printstory.jsp](http://www.kansascity.com/mld/kansascity/news/breaking_news/16387313.htm?template=contentModules/printstory.jsp)
- [This illustrates what can happen in markets priced to perfection. It also shows what leverage can do to equity] Jan. 12 (Bloomberg) -- Mortgage Lenders Network USA Inc., a provider of home loans to people with poor credit, said **"human error"** caused it to lend \$600 million at below-market rates, fueling losses that led to the closure of its biggest unit. The mistake cost Middletown, Connecticut-based MLN about \$20 million at a time **when a slowdown in the mortgage market was eroding the value of another \$2 billion in loans the company planned to sell**, Chief Executive Officer Mitch Heffernan said in an interview yesterday. Creditors demanded \$40 million in additional collateral, half of MLN's capital. **"The economics of the market went upside-down,"** Heffernan, 49, said. "We could continue to go down the path of funding loans at a loss or we could exit the market completely." The company furloughed about 900 of its 1,800 employees for two weeks and is in negotiations with "a number" of Wall Street firms that might buy the unit or a stake to allow operations to resume, he said. **MLN is one of at least five "sub-prime" lenders to shutter operations because of a slowing housing market and rising delinquencies.** Securities firms and investors that buy such mortgages to package them into bonds have reduced the premium they're willing to pay and in some cases are offering less than even the face-value of the loans. In October, MLN cut back on lending to first-time homebuyers and to borrowers with low credit scores, Heffernan said. To fill the void, it offered new "A++" mortgages for borrowers with better credit who still couldn't qualify for the least-risky "prime" market. The company's error caused the loans to be priced so low they could only be sold at a loss, Heffernan said. Applications for about \$200 million arrived in the first two weeks. MLN employees failed to set a limit on the number of discounts customers could be given, Heffernan said. **"It turned out to be a human error," he said. "Not one person in particular and it wasn't intentional."** MLN told its employees **to stop selling the A++ loans** while agreeing to consider

applications already received as long as closings took place within 30 days, Heffernan said. **Instead, an additional \$400 million of the loans were accepted.** We had a senior officer of the company who was in charge of the sales staff who basically waved on more production while we were actually trying to stop the pipeline," Heffernan said. Closely held MLN **was the 15th-biggest U.S. sub-prime lender in the third quarter of last year, with \$3.3 billion of loans, according to the industry publication National Mortgage News.** "We're working like hell to make sure we still have an ongoing concern," Heffernan said. The company is trying to complete the negotiations with potential buyers by next week, when furloughed workers were told to expect a decision, he said. **Pricing Error on Mortgages Led to Lender's Collapse**

<http://www.bloomberg.com/apps/news?pid=20601109&sid=a7zn9LSjFDMI&refer=home>

- 45% of recent first time home buyers put nothing down according to the most recent survey of the National Association of Realtors. "we do know that borrowers in 2007 will find lending standards significantly tightened, rather than eased as they were in 2006. With the Subprime tap shutting off, many" potential first time buyers will be unable to afford homes. As the pool of first time buyers decreases, existing homeowners looking to sell and trade up will be less likely to do that. The net effect being decreased demand. [As reported in Jan 4 edition of The High Tech Strategist, annual subscription \\$140 \(send name, address and check to The High Tech Strategist, PO Box 3133, Nashua NH 03061-3133\)](#)
- *January 11, 2007* -- J.P. Morgan Securities is shopping Ameriquest, one of the largest sub-prime mortgage lenders in the U.S., to bond hedge funds, sources said. Times have been tough - very tough - for lenders like Ameriquest. A bitter competition for higher-quality borrowers started in 2004 and forced the company and its competitors to cut mortgage fees and rates. Starting last year, concern over consumer default rates started to mount and then the yield curve turned against the company.

[http://www.nypost.com/php/pfriendly/print.php?url=http://www.nypost.com/seven/01112007/business/hedge\\_funds\\_in\\_bidding\\_for\\_ameriquest\\_business\\_rodny\\_boyd.htm](http://www.nypost.com/php/pfriendly/print.php?url=http://www.nypost.com/seven/01112007/business/hedge_funds_in_bidding_for_ameriquest_business_rodny_boyd.htm)

## Macro Economic

- Business inventories in November 2006 were \$1,368.2 billion, up 0.4% from October and up 6.9% from November 2005. **[the YOY number is interesting and could indicate either optimism that there will be a large increase in demand or an existing lack of demand that will lead to softness. You already know what I think]**  
<http://www.economicindicators.gov>.
- Jan. 12 (Bloomberg) -- Global bond fund managers are boycotting Thailand's debt because of government curbs on foreign investors, raising borrowing costs in Southeast Asia's second-biggest economy. ING Investment Management, part of the largest Dutch financial services company, won't buy Thai bonds after the central bank said Dec. 18 it will fine investors who sell assets within a year of purchase. Aberdeen Asset Management in Bangkok, part of the Scottish fund group focused on Asia, sold half its Thai bonds due in 10 years or more, said Pongtharin Sapayanon, who helps oversee \$1.6 billion. "We won't be investing," said Joel Kim, a Hong Kong-based fund manager who helps oversee \$10 billion at ING. "There's going to be very little foreign involvement."

Fund managers are wary because the government has revised investment rules six times since September, when the military seized power in a bloodless coup. Standard & Poor's this week said it will lower the outlook on \$44.1 billion of local debt should an exodus of investors slow economic growth. **ING, Aberdeen Stop Buying Thai Debt, Lifting**

**Yields**

<http://www.bloomberg.com/apps/news?pid=20601109&sid=a41Er4FAFX4Q&refer=home>

- Jan. 11 (Bloomberg) -- China's stock market topped \$1 trillion for the first time and the yuan rose past the Hong Kong dollar, reflecting an economy that's grown 10-fold since Deng Xiaoping opened the Communist nation to international investment in 1978. The value of shares on the Shanghai and Shenzhen stock exchanges more than tripled in the past year and reached \$1.01 trillion as of yesterday's close, according to data compiled by Bloomberg. The yuan climbed to more than 1 per Hong Kong dollar today for the first time in 13 years. The gains reflect economic growth averaging 9.6 percent in the past five years, driven by record trade surpluses that pushed China's foreign-exchange reserves to \$1 trillion. That's prompted U.S. and European pressure for a more flexible yuan and made China's stocks the most expensive relative to earnings in Asia. The Shanghai and Shenzhen 300 Index is trading at 34 times earnings, compared with 16 times for Australia's S&P/ASX 200 Index and 14 times for Hong Kong's Hang Seng Index. The 300 Index fell 1.1 percent today, paring its 12-month gain to 129 percent. **“Excessive liquidity has pushed the market to a level that's unsustainable in terms of fundamentals,”** said Chen Shide, who manages the equivalent of \$212 million at GF Fund Management Co. in Guangzhou, southern China. **“You'd better stay away and sit tight for the moment as most stocks are expensive.”** **China's Stock, Currency Gains Reflect Economy's Rise [I could have put this in the diversification section as well. It is likely that the next down turn will hit across the board and so called diversification will not save those long equities of any stripe.]**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=axUFUy2UNHBw&refer=home>
- **Should you chose to read the following, keep in mind retail investors are notorious for chasing returns in things where the large upside has already been made. Note that the article does not really argue that valuations are where investing in US stocks is attractive, merely that because retail investors have missed the four year run they should be expected to mindlessly get in now.** Jan. 9 (Bloomberg) -- U.S. investors last year put the least money into domestic stock funds in a rising market since 1989, according to industry statistics. Jeff Schappe of BB&T Asset Management Inc. says that's an encouraging sign. Investors' reticence to dive into equities implies there's plenty of cash available to fuel gains, he said. **“The typical retail investor has largely sat out this bull market,”** said Schappe, who helps oversee \$16 billion as BB&T's chief investment officer in Raleigh, North Carolina. **“I would get nervous if everyone was already in.”** Instead, investors piled into international funds as Morgan Stanley Capital International's EAFE Index beat the S&P 500 in dollar terms for a fifth straight year. The EAFE index, which tracks markets in Europe and Asia, climbed 23 percent in 2006, while the S&P 500 advanced 14 percent. Net annual flows to international funds reached \$135 billion as of the end of November, the highest since at least 1984, according to ICI.

In 2000, yearly flows into domestic-stock funds reached a record of \$259.6 billion. [yes, that would be the year the NASAD hit 5,000 plus only to drop well below 2,000 in the next couple of years]. The S&P 500 rose to an all-time high in March of that year, fueled by advances in technology shares. The index then tumbled 49 percent from its peak through Oct. 9, 2002, as the Internet bubble burst, the U.S. economy fell into recession and the Sept. 11 attacks battered financial markets. Domestic-stock funds suffered a net outflow of \$24.7 billion in 2002, the first year since 1988 in which investors on balance withdrew assets from U.S. stocks. **Aversion to U.S. Stocks Among Mutual-Fund Investors Seen Ending**

<http://www.bloomberg.com/apps/news?pid=20601109&sid=a2CDwAWTF32w&refer=home>

January 10, 2007 Assets in world financial markets amounted to \$140 trillion in 2005 -- an increase of \$7 trillion from 2004 -- and more than triple the size of the global gross domestic product, according to a report released by New York-based McKinsey & Co. today. The study, which tracks the flows of the world's financial assets as they move from one region to another, predicted that global assets are expected to grow 53% to \$214 trillion at the end of 2010. Cross-border capital flows also set a new record, topping \$6 trillion in 2005 -- that's more than double their level in 2002 and above the level reached when the stock market was flying high in the 1990s. The U.S. stands at the middle of it all, taking in about 85% of the flows from countries that are net exporters. In market-size ranking, the U.S. leads the world with \$50 trillion, followed by \$30 trillion in the European countries and \$19.5 trillion in Japan. **Global market assets reach \$140 trillion** <http://www.investmentnews.com/news.cms?newsId=3465>

## Retail

## Retirement

## Risk

## Savings Rate

## Tech

- **SUNNYVALE, Calif. -- January 11, 2007** --AMD (NYSE:AMD) today announced revenue, excluding ATI-related segments, for the fourth quarter ended December 31, 2006 is expected to increase approximately three percent from the \$1.33 billion reported in the third quarter of 2006. Fourth quarter operating income, excluding ATI-related segments and acquisition-related charges, is expected to be positive **but substantially lower than in the third quarter**. The fourth quarter **gross margin and operating income were impacted by significantly lower microprocessor average selling prices**, which largely offset a significant increase in unit sales. [http://www.amd.com/us-en/Corporate/VirtualPressRoom/0,,51\\_104\\_543~115302,00.html](http://www.amd.com/us-en/Corporate/VirtualPressRoom/0,,51_104_543~115302,00.html)
- According to a December Russell Investment group survey, technology is the “most favored market among money managers” for 2007, “with more than 2/3<sup>rd</sup> bullish on the sector”. They were “even more wildly bullish in February 2000.” [As reported in Jan 4 edition of The High Tech Strategist, annual subscription \\$140 \(send name, address and check to The High Tech Strategist, PO Box 3133, Nashua NH 03061-3133\)](#)

## Wall Street

- Patrick Harrington, who was a BLX executive vice president and head of the company's Detroit office, was indicted in federal court in Michigan on charges of defrauding the Small Business Administration to the tune of \$77 million. Allied is a business development company that lends money to businesses. Washington-based Allied said that if the allegations against Harrington are true, BLX will have suffered losses. Allied noted that BLX is just one of 140 investments. What it didn't say: As of Sept. 30, it was also Allied's largest investment. **Allied responds to stories on indictment**  
<http://www.marketwatch.com/news/story/story.aspx?guid=18182922630A4933B82ACE4E43CDA995&siteid=mktw&dist=nbc&print=true&dist=printTop>
- “The relentless rally that started last summer is thinning the bear ranks to near zero,” observes Jay Shartsis, a seasoned options pro at R.F. Lafferty in New York. “The Russell Investment Group survey of 87 money managers found 80% bullish. Elsewhere, *USA Today* opened the New Year trumpeting, “10 Reasons Why the S&P 500 Could Hit a Record High in 2007.” The following day’s headlines proclaimed: ‘Up,Up,Up’ and ‘10 out of 10 market gurus interviewed by *USA Today* say stocks will post gains.’...“There wasn’t a single bear!” Shartsis exclaimed. “Not one person calling for a loss!” **“Perhaps the most astounding observation of all comes from the *Elliot Wave Financial Forecast*,” Shartsis continued. “They produced a chart showing the 60-day moving average of bears, as reported by the *Daily Sentiment Index Survey*. Current reading: 12% bears! For perspective, the readings for this gauge, going back to 1987, before the crash, show nothing like the present 12% reading. Figures near 20% bears were the most extreme ever recorded.** So a contrarian interpretation of this survey would point to serious market trouble dead ahead.” DR Jan 12

## Article of the week:

### The truth about growth and value stocks

Investors and fund managers build entire portfolios around the premise that growth stocks grow faster than value stocks. The problem is that they don't.

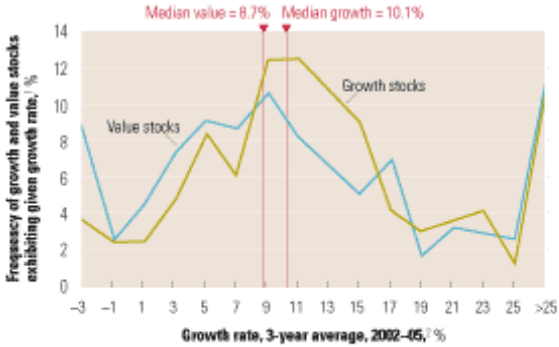
Bin Jiang and Timothy Koller

*Web exclusive, January 2007*

What's in a name? In the vernacular of equity markets, the words “growth” and “value” convey the specific characteristics of stock categories that are deeply embedded in the investment strategies of investors and fund managers. Leading US market indexes, such as the S&P 500, the Russell 1000, and the the Dow Jones Wilshire 2500, all divide themselves into growth- and value-style indexes. Academics also use these categories as shorthand, arguing at length over which investment approach creates more value—a value strategy or a growth strategy. These names explicitly convey the expectation that growth stocks will have higher revenue growth prospects than value stocks.<sup>1</sup> And investors, even large institutional ones, often make investment decisions based largely on those expectations.<sup>2</sup>

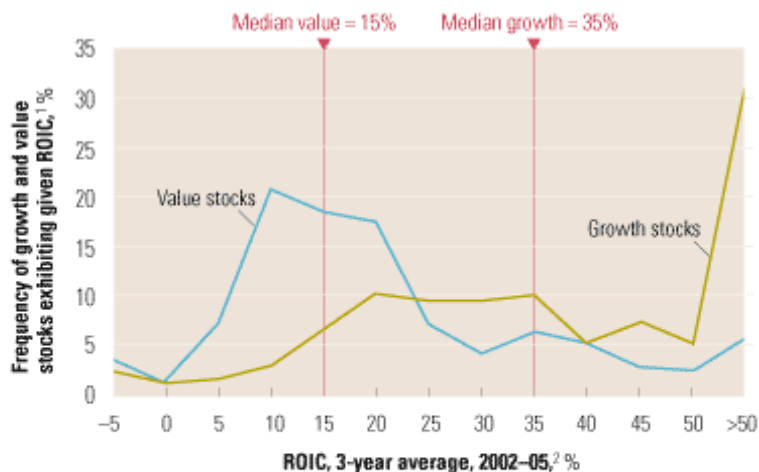
It's not illogical that executives would often draw from this reality an assumption that having the label growth or value attached to a company's shares can actually drive prices up or push them lower. In our experience, many executives have expended considerable effort plotting to attract more growth investors, believing that an influx of growth investors leads to higher valuations of a stock. Some executives even turn this assumption into a rationale for using a high share price to defend risky acquisition programs—for example, in deference to presumed shareholder expectations of growth.

The trouble is that such thinking is wrong in both cases. Evidence comes from a recent McKinsey analysis of the S&P/Barra indexes of S&P 500 companies.<sup>3</sup> Although growth stocks are indeed valued at a higher level than value stocks on average, as measured by market-to-book ratios (M/Bs),<sup>4</sup> their revenue growth rates are virtually indistinguishable from those of value stocks (Exhibit 1). The growth index's 10.1 percent median compounded revenue growth rate for 2002 to 2005 is not statistically different from the 8.7 percent median of the value index. Thus, the probability that a company designated as a growth stock will deliver a given growth rate is virtually indistinguishable from the probability that a value company will do so.



<sup>3</sup> S&P 500/Barra Growth Index and S&P 500/Barra Value Index as of Dec 2005.  
<sup>4</sup> Excluding goodwill, does not include financial-sector stocks; 3-year average adjusts for annual volatility.

What *does* distinguish companies on growth indexes from those on value indexes is return on invested capital. For the value index, the median ROIC, averaged over three years, and excluding goodwill, is only 15 percent, compared with 35 percent for the growth index (Exhibit 2). In other words, the average growth stock is likely to deliver twice the average value stock's book return on capital. In fact, the correlation of M/Bs with ROIC in 2005 was 20 percent, versus 1 percent for growth rates.




<sup>1</sup> S&P 500/Barra Growth Index and S&P 500/Barra Value Index as of Dec 2005; ROIC = return on invested capital.  
<sup>2</sup> Excluding goodwill; does not include financial-sector stocks; 3-year average adjusts for annual volatility.

The point is not that ROIC is a better filter for separating growth stocks from value stocks; it is that the concepts of growth versus value are just not meaningful. Companies can have high price-to-earnings ratios (P/E)s and M/Bs because they have high growth and moderate ROICs, low growth and high ROICs, or high growth and high ROICs. Branded consumer products companies, for example, have high ROICs but modest growth, while hot retail companies have high growth and modest ROICs. This point may seem counterintuitive, but it is actually consistent with the conceptual drivers of value. Both a company's ability to grow and its ability to earn returns greater than its cost of capital generate higher cash flows—and hence higher valuations.<sup>5</sup> Therefore, a high M/B or P/E for a company that is not growing fast is hardly surprising. At such companies, higher returns simply make up for slower growth.

Consider two otherwise similar companies, one with a higher ROIC. For these companies to generate the same growth in future cash flows, the higher-ROIC company needs to invest less capital back into its business than the lower-ROIC company. The excess cash at the higher-ROIC company can then be plowed into higher-return projects or given back to shareholders.<sup>6</sup> Naturally, a company with a higher ROIC is valued at a higher level. In fact, any growth index includes many familiar names that enjoy high ROICs but actually have delivered limited growth relative to their industries from 2002 to 2005. Examples include Boeing (0.5 percent), Heinz (1.6 percent), Anheuser-Busch (3.5 percent), Altria (3.5 percent), DuPont (4.5 percent), Kimberly-Clark (5.4 percent), Hershey (5.5 percent), Coca-Cola (5.7 percent)—compared with a median growth rate of 9.6 percent for S&P 500 companies.<sup>7</sup> Furthermore, executives who believe that attracting more growth investors will improve the value of businesses are bound to be disappointed. Our analysis of companies whose stocks have been newly designated as growth stocks clearly shows that growth investors don't precipitate a change in valuation levels. Rather, they respond to it, moving into a stock only after the share price has already moved to a higher M/B or P/E. And while the number of growth investors does sometimes increase up to three months before a sustained increase in the M/B, it often takes them as long as 12 months *after* an increase in valuation.

Stocks downgraded from growth to value show a more striking pattern: when these stocks changed to value status, their M/Bs peaked and then headed into a sustained decline. Here again, growth investors hold onto a stock until they regard its revaluation as a trend. Sometimes they reach that conclusion fairly quickly, divesting within the first quarter after the stock's revaluation. Often they take much longer—as long as two and a half years.

Simple attempts to discriminate between companies by a dimension or two will always fail to capture the variety of their characteristics, particularly in cyclical industries, where a company's ROIC may change radically from year to year. Even worse, simple classification attempts may mislead investors. Many so-called value companies are distressed and in need of a turnaround. Companies and investors would be

better off focusing on a company's fundamental performance and valuation rather than making arbitrary style comparisons. That's what the best investors do. 

## About the Authors

**Bin Jiang** is a consultant in McKinsey's New York office, where **Tim Koller** is a partner.

## Notes

<sup>1</sup> Although there is no universal definition of growth and value stocks, most investors agree on the broad characteristics of companies in each category: growth stocks tend to have higher price-to-earnings ratios or market-to-book ratios, while value stocks have low P/Es and M/Bs and may have high dividend yields.

<sup>2</sup> Sophisticated investors do sometimes defy the growth and value stereotypes. Legg Mason Value Trust, one of the most successful mutual funds over the past 20 years and widely considered to rank among the leading value investors, includes in its top ten investments some companies that would definitely be classed as growth companies. As of October 2006, Legg Mason Value Trust holds more than 9 percent of its total assets (worth \$1.9 billion) in Amazon.com and Google, both clearly growth rather than value companies.

<sup>3</sup> Barra (which in 2004 merged with Morgan Stanley Capital International to form MSCI Barra) offers financial models and analytics intended to provide insight into the risks behind investment decisions. S&P and Barra collaborated from 1992 to 2005 to produce the official S&P 500/Barra Value and the S&P 500/Barra Growth indexes. Constituents for the S&P 500/Barra Value and Growth indexes studied in this article are as of the end of 2005.

<sup>4</sup> The median M/B for growth stocks was 4.8 at the end of 2005, while the median M/B for value stocks was 2.2. The medians are the same with or without financial-sector stocks.

<sup>5</sup> See Bing Cao, Bin Jiang, and Timothy Koller, "Balancing ROIC and growth to build value," *McKinsey on Finance*, Number 19, Spring 2006, pp. 12–6.

<sup>6</sup> This comparison can be reduced to a simple formula: growth = ROIC × reinvestment rate.

<sup>7</sup> We compared the companies in the S&P 500/Barra Growth and Value indexes at the end of 1995 with the companies in those indexes at the end of 2005. The comparison yielded a list of 84 companies that have switched at least once from one classification to another during that ten-year period. Of these, we identified companies that made a clear one-way switch from value to growth or growth to value and then examined the change in their investor base in relation to the market valuation changes.