By Geoff Gannon

Someone sent Geoff this email (to ask your own question: just send me an email) :

Hey Geoff,

The last 10 years saw the dominance of 'growth' (as quantitatively defined) over 'value'.

If you were a value (however it is defined) investor, you probably underperformed the relevant indices.

(1) Is there a lesson to be learned here? When I see stocks trading at really high multiples, my immediate instinct is to ignore them – either too hard to value or too expensive.

But by automatically ignoring such stocks, a potential stock picker immediately omitted a lot of profitable stock ideas.

(2) Do you see these high-multiple stocks' multiples ever regressing to median multiples, potentially hurting future returns? I think arguing that stocks like Google, Visa or Amazon should have median (historical) multiples is a bit misleading since most of these are natural monopolies. On the other hand, it's not clear to me what the fair value should be.

Answer: High P/E Stocks of Great, Wide Moat Businesses Don't Worry Me Right Now – It's the Super Speculative Growth Stocks with No Real Earnings That You Need to Watch Out For

So, first of all, types of stocks that have outperformed for a decade or so are not necessarily going to be great performers in the future even if they continue to be great performers as businesses. In the past, some excellent businesses have underperformed as stocks even while the underlying businesses continued to perform well. The "Nifty Fifty" stocks of the late 1960s and early 1970s underperformed for the next 10 years or so. In fact, as a group, they did not outperform over even a 25-30 years holding period. While some of the reason for that is stocks that looked like great businesses but eventually lost their competitive position – a lot aren't. They just were expensive. A study of the Nifty Fifty stocks – it used two different lists – looked at performance from 1972 to 2001. It found that there was a strong negative correlation between the 1972 P/E ratio of the stocks on that list and their returns over the next close to 30 years. That's an important warning. Differences in P/E ratios – even among very good businesses – can still cause differences in the returns you get over holding periods as long as 30 years.

Does this mean growth stocks will underperform value stocks in the 2020s?

It depends on what you mean by growth? If you mean Visa and Amazon and Google – I'm not so sure. They are financially sound companies. They have strong market positions. And Google is not even expensive versus the S&P 500 generally. Google's EV/EBITDA, EV/Free Cash Flow, P/E, etc. are mostly a bit elevated at most compared to the index. It's not a very expensive stock. Visa is even more elevated. Of those stocks – the one to be worried about is probably Visa. The stock trades at a very, very high EV/Sales ratio. It's a special company that can trade at such a high EV/Sales ratio – and Visa might be that company. But, really only a business model EXACTLY as good as what Visa has now could justify that kind of EV/Sales ratio. So, you have to be careful. A deterioration in the competitive position of Visa would be devastating for the stock. I'm not saying it's overvalued. But, you have to be careful.

A lot of the reason for Visa's high valuation is that it has very high returns on capital and is believed to have a long runway for future growth. Just having the high returns on capital but no growth wouldn't be enough. So, being a monopoly isn't enough to justify that price. In fact, even being a monopoly with very high returns on capital isn't enough. The only justification for trading at like 30 times free cash flow is that you're expected to grow that free cash flow over time.

If Visa grows free cash flow per share by 5-7% a year for a very, very long time – the stock's not overpriced. So, maybe that is what the market is pricing in. Maybe it is expecting growth of 5-7% a year forever. That's certainly possible. They've achieved it in the past. The payments industry is just not something I can predict though. I imagine that most forms of payment that people would prefer to use in the future would simply be piggybacking on what Visa has in place already. So, the fact that many people won't actually carry a Visa card doesn't mean Visa wouldn't make just as much money. It's a very good business. I could imagine it staying a very good business for a very long time. But, it's not an industry where I feel comfortable predicting the future.

Google – like you said – is similar. It has a strong position in search and video (YouTube). Like Visa, it would seem to have a position that is just strengthened over time by networks effects and stuff like that (in video). I assume the actual Google search engine will become less dominant over time just as people use other forms of search. But, it's easy to justify Google's price.

We're not really seeing pricing in wide moat stocks like Google, Amazon, and Visa that would concern me. I don't own the stocks. And that's because I'd have to predict a lot of future growth at those companies – which I find harder than with some companies. For example, I own OTCMarkets (OTCM) just because I'm more comfortable with the price and hitting the growth needed to justify that price than I would be with stocks like Google, Amazon, and Visa. Those 3 companies are in great positions. But, the industries they are in are potentially a bit more competitive. Even having a small share of those big industries makes you a lot of money. So, people will always be trying to come up with some idea to take share from them. Will it be successful? Probably not. But, those industries are areas of interest for a lot of companies.

The companies that are more problematic from a "growth" stock perspective are things like Tesla (TSLA), Uber (UBER), etc. These companies lost – or are still losing – money for a very long time. They grew up in an era where it was very easy to get funding without having to self-finance growth. These are the kind of growth stocks that are potentially really risky. They grow a lot, but they don't establish themselves as leaders in a business that proves profitable. A lot of this comes down to business model. An advertiser supported media company like

Google is a well established business model that has been extremely profitable in print, radio, TV, desktop computer, and mobile phone. It doesn't matter. The economics have proven to be pretty similar in all those forms. It's a very profitable business for the leader in whatever form of media is important at the time. Google is successful at it. But, so is Facebook.

I don't see a lot of absurdly high prices right now on bigger, well-established companies that are seasoned. Companies that have shown profits for years just aren't that expensive right now. Are some companies that are public but not showing gains, that are private and would like to one day go public, etc. valued way too high? Yes. And some of those will end with losses of 90%+ for investors. I really don't see the risks being in stocks like Visa, Amazon, and Google.

So, should you invest in other companies you can find that look like those despite having high P/E ratios?

Maybe. Phil Fisher would say yes.

You have to take the approach that can work for you. Are you comfortable betting on a company having to grow 10%+ a year for a while to get you a market beating return? Or: are you comfortable betting on a company in an industry with tough challenges being able to eke out consistent profits but no growth?

You can make money either way. You just need to be right about the bets you make. It will depend on your personality, your skills, etc. to tell you which way to go. There's nothing wrong with buying stocks at the P/Es that Google and Visa once traded at. They just have to be the right stocks.

The big caveat though is to avoid buying into the same stocks others are just because others are. You can buy Visa. But, you have to establish – using math – a rational argument for the purchase that makes sense to you. Like, I said that if the company grew free cash flow by 5-7% a year indefinitely, you could match the market in Visa. So, let's say you want to buy Visa instead of the market. Then, all you need to prove is that growth in FCF will exceed 7% a year. If you believe margins will expand, then you don't even need sales growth that high. So, you can start figuring out how confident you are in hitting various levels of growth. Like, if you need just 4% annual growth (because of margin expansion) – then how sure are you Visa will always grow at least 4% a year. Are you more confident Visa will grow 4% a year than that a cheaper company just won't shrink?

You need to ask questions like that. And then, using basic arithmetic, reach a conclusion you can be confident in.

Keep two rules in mind. These are kind of the big two rules of stock picking.

Other things equal, it's always better to buy the better business.

And…

Other things equal, it's always better to buy the cheaper stock.

You're doing fine as long as you never forget either of those rules. So, if someone tells you what a great business Visa is and that they bought the stock and that person never mentions the price – that's not investing. Visa is a bargain at some price and overvalued at another price. No matter how good a business you think it is – the market cap probably shouldn't be

$3 trillion. So, there is some price at which even the best business in the world would make a bad stock.

The same thing is true for a value stock. You can find stocks at discounts to book value right now. You can buy Dave & Buster's at a P/E of 3-4. You can buy Carnival at a P/E of 2. But, will those stocks be in business in a year, or two, or three? If not – then, even the lowest price isn't good enough.

So, a super cheap price alone can't make up for zero business quality. And even infinitely great business quality can't compensate for a price that's ridiculous.

That means "value" stocks can be good investments. And it means "growth" stocks can be good investments. But, you should never buy something just because it's a tremendous value or just because it has a tremendous business.

Right now, I don't see people doing a lot of that. There are some weird speculative stocks people are buying for dubious reasons. But, they aren't great businesses – they're just pure moonshots. So, the speculation I see now is not in the kind of wide-moat businesses you were talking about.

My only warning is that in stocks like Visa – you're going to do worse as a long-term shareholder than the business does. As the company's growth slows, its price multiple will contract. So, if you buy it at 15 times sales – you have to expect it'll eventually trade at 10 times sales. It may take a very long time to get there. But, once growth has declined to nearly nothing, it'll just be a good no growth business. If that time is very, very far in the future then a decline in the P/S ratio from 15 to 10 won't hurt you much. For example, a contraction in the P/S multiple from 15 to 10 over a 20-year holding period only trims 2% a year off the stock's return. So, as long as you are feeling sure that Visa can grow earnings more than 2% a year better than the market for at least 20 years – you're fine. Don't worry about it. However, if that contraction happened over 10 years, it'd be a 4% drag on your return in the stock. That means you'd need Visa to grow more than 4% a year faster than the market generally for more than 10 years. How confident are you of that? If you're confident – you can buy the stock.

Obviously, if you can only see 5 years of almost certain, high growth left at Visa – you can't touch the stock. You need to have visibility going out more like 10-20 years here to make investing in the stock a sure bet. But, if you have that kind of confidence – I see nothing wrong with paying today's high price for the stock. Yes, the P/E is high. But, it's rare to find a stock you're sure will grow quite a bit faster than the market for another 10-20 years. So, if you think you've found it – go ahead and pay a P/E close to 30. There's no doubt that some stocks that have a P/E of 30 right now will turn out to be better investments than some stocks that have a P/E of 3.

It's harder to say that a basket of stocks with a P/E of 30 are better than a basket of stocks with a P/E of 3.

So, yes, some growth stocks will outperform.

But, that doesn't mean value stocks as a group will underperform. Both of this things can be true at the same time.