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Article Background

This essay was originally published in the November, 1999 newsletter.

Stock Bubble Still Floats

In the last newsletter, I wrote about a stock bubble. The subject centered on Yahoo!, an Internet company whose stock price bears no resemblance to its actual value.

At the time, the stock was trading at $207 (adjusted for splits). The week of May 10th as I write this, the stock dropped $27 to $147, so although it's down 25%, it hasn't burst completely (yet). Also that same week, Barron's, a U.S. financial newspaper, estimated the value of Yahoo! at about $8-$12 per share. That's a long way from $147. Stay tuned.

Value Investing

Investment managers have their own personal style of investing, much as we all have our own personal style in the things we do. A manager's style will have an important effect on what the portfolio looks like. For example, some managers like high growth companies, some like companies that represent good value. As an investment advisor, it is important for me to ensure the manager's style is appropriate for the client.

One of the oldest debates is about the "growth" style versus the "value" style. I will borrow from an article in the Wall Street Journal last year to illustrate how growth differs from value.

One of the best known growth companies is Coca-Cola. It's a great company, no question. But does the stock represent good value?

The market value of the company (the value of all the stock) is about $170 billion (all figures US$). Now, imagine that you have $170 billion to invest. Would you buy Coke stock or something else?

Rather than buy Coca-Cola for $170B, a value manager might buy all of Chrysler for $24B (Mercedes recently did), plus all of Aetna Insurance for $16B, Compaq Computer for $35B, Merrill Lynch for $22B, Chase Manhattan Bank for $44B, Federal Home Mortgage for $22B, and Barnes and Noble for only $1B. After buying all these companies entirely, you'd still have $6B for spare change.

Okay, Coke could easily be worth more than all those companies combined, if it earned more profits. Coke's expected earnings are about $4 billion. But the seven companies in the value portfolio are expected to earn about $12 billion, plus the interest on the spare change.

But, says the growth manager, Coke could still be worth more than all the other companies above, if its earnings were growing much faster. Unfortunately, Coke would have to continue growing its earnings at 18% per year for the next seven years just to catch up to the value portfolio today. This assumes that value portfolio wouldn't have any earnings growth at all over seven years, which is hard to imagine.

What's happening is that investors are flocking to Coke, bidding the stock price higher and higher, until it is difficult for the company to meet investors' expectations.

The point is that while Coke may be a great company, its price does not represent good value. The stock price is susceptible to a bad jolt if there's negative news.

On the other hand, the value stocks are not popular, but they too are great companies. Their stock prices are open to positive surprises, one of which can be simply no bad news.

I prefer value.

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