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Invest in statistics, not stories

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Everyone knows a growth story, like that of Mark Zuckerberg's Facebook.

A growth stock is always accompanied by a seductive storyline. Today, social-networking stocks exude the allure that they are poised to capitalize on a revolution in shared digital communication. Internet World Stats estimates that there are now over two billion Internet users globally, up 480% over the past decade. With this fertile, expanding market, spectacular growth seems assured.

There is, however, a fly in the ointment. These stocks are already priced at nosebleed levels. A recent article in Barron's found that the eight leading social-networking stocks are 20% to 100% overvalued even if they emulate the fantastic success of Google. The problem with a growth story is that everyone knows it. Overly enthusiastic investors quickly bid up such stocks to exorbitant valuations.

Throughout history, investors have appeared to prefer stories to statistics. Leading finance professors Eugene Fama and Kenneth French have tracked the returns of growth and value stocks in the United States since

1927. The growth stocks of large and small companies have delivered annual returns of 9.5% and 9.1%, respectively — respectable, but hardly dazzling.

In contrast to growth stocks, value stocks typically have modest revenue growth. Their storylines aren't seductive, they are soporific. These stocks rarely make the headlines unless there's bad news. Not surprisingly, these unexciting stocks are low priced relative to their earnings, dividends or book value. Yet, the returns from value stocks have trumped growth stocks by a wide margin. Since 1927, value stocks of large and small companies have generated double-digit returns of 11.3% and 14.2%, respectively.

The long-run outperformance of value stocks isn't restricted to the United States. In Canada since 1975, the MSCI value index has earned 12.3% annually, far outpacing the 8.7% return of growth stocks. In every region of the world, including emerging markets, value stocks — over the long run — have outperformed their growth counterparts.

Many behavioural finance experts claim that cognitive biases explain this outperformance. David Dreman, a leading apostle of this view, believes that investors routinely overreact to news about a stock. If the news is positive, they project a continuance of this favourable trend and bid up the stock's price. When the news is bad, an opposite reaction is triggered. Believing a negative trend to be firmly in place, investors either hold or sell and the stock price subsequently languishes. Inevitably, some negative event occurs to cause the higher-priced growth stock to tumble, while, conversely, eventually some positive surprise arises to send the price of the value stock spiralling upward.

Another behavioural view holds that investors often confuse the characteristics of a good company (e.g., a powerful brand and superior growth) with the elements of a good stock (i.e., a price that is low in relation to future cash flows). One study found that the stocks of companies considered "excellent" according to the standards outlined in the bestseller In Search of Excellence materially underperformed the stocks of companies deemed "unexcellent."

Some financial experts offer a completely different view. To them, value stocks represent riskier investments. Value stocks not only have slower revenue growth, they tend to have higher debt levels and poorer operating margins than growth stocks. Hence, investors demand a higher return for investing in value stocks.

If earning superior long-run returns is as simple as investing in value stocks, why don't most investors embrace this approach? Because the reality is that there can be many years, such as during the tech boom, when value stocks lag. During these periods, many investors simply become too impatient and sell off their value stocks to chase the growth story of the day. Fortunately, their short-sighted behaviour opens the door of opportunity to patient investors who prefer statistics to stories.

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