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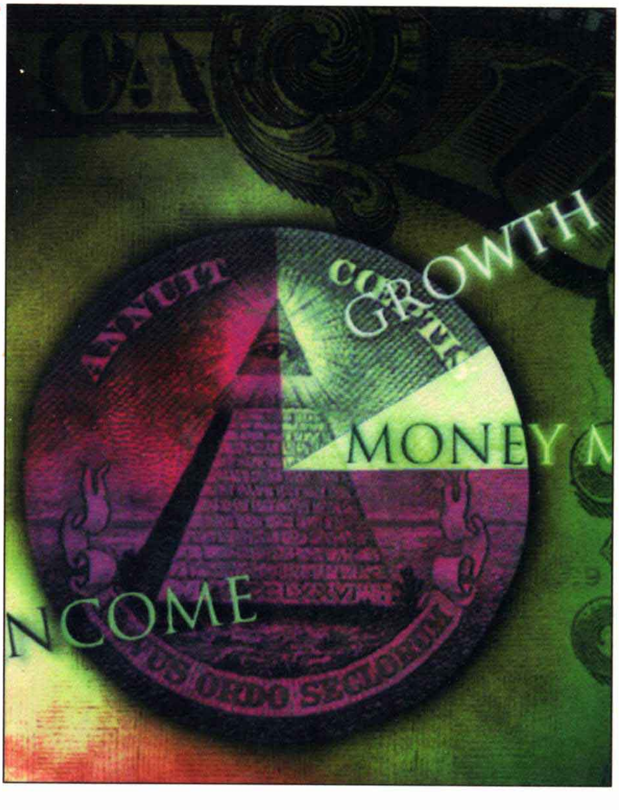
How to Be a GROWTH INVESTOR

ESSENTIAL GUIDES TO TODAY'S MOST POPULAR INVESTMENT STRATEGIES

BY VALERIE F. MALTER and STUART P. KAYE

- *Features over a quarter century of research on the performance of growth stocks*
- *Highlights the critical investment variables of growth investing*
- *Shows any investor how to build a winning growth portfolio*
- *Comparisons to other types of stocks*
- *Historical performance records*



Essential Guides to Today's Most Popular Investment Strategies

How to Be a GROWTH INVESTOR

Valerie F. Malter and Stuart P. Kaye

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To

MATTHEW ROBERT KAYE

and

ARIN SUZANNE KAYE

INTRODUCTION

This book is written for intelligent investors, investors who want to make their own choices about what stocks to buy and sell, who like to learn about companies, who want to achieve their goals without taking on too much risk, and who have a long-term investment horizon. If you feel that you are not this type of investor, then you should not buy this book. If you believe, as we do, that it is possible to build good portfolios on your own, and if you believe that it can be profitable to hold onto those portfolios for long periods of time without making substantial changes, then you should read this book. Owning a good portfolio of growth stocks is analogous to owning a forest of trees. To be able to create a beautiful forest that will last a long time, it is best to start with good, healthy trees and plant them in fertile soil. While some will grow to be big and strong, others will be crowded out by the stronger trees and will need to be removed. Creating a large cap growth stock portfolio requires a similar process. You first find industries that provide healthy growth for companies that are in them. You then choose the stocks to buy and "plant" them in your portfolio. As the years pass, some stocks will continue to deliver strong earnings growth and will become large holdings in your portfolio, while other stocks will not perform well and should probably be sold. In this investment book, we will walk you through the process you will need to create your own beautiful forest.

Over the years, investment books have fallen into two categories:

1. Stock selection books (how to pick the best stocks, just focusing on the trees).
2. Asset allocation books (when and how much to invest in stocks, bonds, or cash).

This book falls into the category of stock selection books, but it is much more. Most of the stock selection books we know about have focused solely on how to find good stocks. They are often so focused on the individual trees that they do not see the forest. Our book adds two forestlike elements:

1. How to build a diversified portfolio (an entire forest). Being able to build a diversified portfolio is critical, because it will allow you to lower your overall risk while maintaining a high level of expected return.
2. Where to own different types of investments. In general, you should own a balanced portfolio of growth stocks, value stocks, small cap stocks, government bonds, and corporate bonds. From a tax standpoint, it would make more sense to own the value stocks and corporate bonds in your income tax-free individual retirement account (IRA) or 401k account because these investments generate a high level of taxable income. And it makes more sense to own government bonds, growth stocks, and small cap stocks in your taxable account because government bonds are state tax-free and growth stocks and small stocks generate low amounts of taxable income.

If, after you finish reading this book, you want to further explore the subject of investments and building stock portfolios, you should read *Investments* by William F. Sharpe. *Investments* is written at an academic level and is very good in its discussion of the valuation of common stocks, portfolio analysis, and risk and return.

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PART ONE $$$

Getting Started

CHAPTER

1

The Riches of Growth

Why Investing in Stocks That Deliver High Earnings Growth Can Help Create Wealth

Roses are growth. Dandelions are value. A diamond ring with a gold band is growth. A silver bracelet is value. Shopping at Saks Fifth Avenue is growth. Shopping at Sears is value. These are a few ways to think of the differences between "growth" and "value" investing. Growth investors buy stocks that are beautiful and everyone knows that they are beautiful. Value investors buy stocks that they do not have to pay very much for relative to their current value, acknowledging that these stocks are not beautiful today. However, the value investor hopes that some day some other investor will think the stock is beautiful and be willing to pay a high price for it.

Growth investors will tell you that growth stocks outperform over time because their underlying earnings grow at rates faster than the market as a whole. Value investors will tell you that value stocks outperform over time because they buy cheap stocks that will be revalued upward. What should an investor believe and do?

Our goal is to help you answer this question. We will do this by increasing your knowledge about investing in growth stocks and providing you with a disciplined approach to investing in growth stocks. By the time you finish reading this book, you will be able to build your own portfolio of growth stocks to help increase your personal wealth.

Why Investing in Stocks That Deliver High Earnings Growth Can Help Create Wealth

For an investor whose income and capital gains are taxable, growth stocks should be the preferred investment vehicle for building wealth. This statement does not necessarily apply to nontaxable investments like individual retirement accounts (IRAs) or 401Ks. To understand the logic behind this strategy, we can start by analyzing the components of total return for an investment in a stock.

Total return[1] is a function of dividend yield and earnings growth.

FORMULA

Dividend yield + earnings growth + valuation change = total return

The definitions of these components of total return are listed below:

Dividend yield is the current indicated annual per share dividend of a stock divided by the stock's current price.

Earnings growth is the earnings per share growth that is delivered by a stock over the investor's investment horizon.

Valuation change is the change in the price to earnings (P/E) ratio of a stock over the investor's investment horizon, where the P/E ratio is calculated by dividing today's price by the trailing 12 months' earnings per share of the stock.

FORMULA

P/E ratio = price per share / earnings per share

A few examples of how the total return formula works will make everything come alive. We have three friends—Mary, Nikki, and Odette—who like to invest. Imagine that each can choose only one of three stocks:

1. RJR Nabisco, which has a 7% dividend yield and a P/E ratio of 10.
2. AT&T, which has a 2% dividend yield and a P/E ratio of 20.
3. American Airlines (AMR), which has no dividend yield and a P/E ratio of 15.

Let's assume that all three of these stocks are priced to provide the same total return of 10% and that their P/E ratios will remain unchanged over the next year. Their expected earnings per share growth rates and total returns would be as follows:

Company	Dividend Yield	Earnings Growth	Valuation Change	Total Return
RJR Nabisco	7%	3%	0%	10%
AT&T	2%	8%	0%	10%
AMR	0%	10%	0%	10%

If our investor friends did not have to pay taxes, they would be indifferent about choosing between AT&T, AMR, or RJR Nabisco because all three of the stocks will provide the same pretax return of 10%. However, for investors who have to pay taxes, AMR would be the best stock to own in this example. Assuming that an investor has to pay tax on 40% of her income, RJR Nabisco would produce an after-tax return of 7.2% (10% – (40% of the 7% dividend yield)); AT&T would produce an after-tax return of 9.2% (10% – (40% of the 2% dividend yield)); and AMR would produce an after-tax return of 10%. Taxes reduce the income that is received from a stock. This is why the earnings per share growth that a company delivers is critical to the performance of the stock of that company.

Now what happens to three different investors who are required to pay taxes? Assume that Mary buys RJR Nabisco, Nikki buys AT&T, and Odette buys AMR. Mary and Nikki will have to pay income taxes on their dividends every year, whereas Odette will not. For an individual investor

A Word to the Wise

The important concept to understand is that individual investors who do not need to live off of the income they are getting from their stocks are much better off, on an after-tax basis, buying low-dividend-yielding growth stocks than buying high-dividend-yielding value stocks. (This assumes that the investor has no reason to believe that there will be pretax performance differences between growth and value stocks over time. This assumption will be addressed in Chapter 2.)

TABLE 1-1 Hypothetical Pretax and Post-Tax Results of Mary, Nikki, and Odette's $10,000 Investments

	Pretax Cumulative Wealth			Post-tax Cumulative Wealth		
End of Year	Mary	Nikki	Odette	Mary	Nikki	Odette
1	$11,000	$11,000	$11,000	$10,720	$10,920	$11,000
2	$12,100	$12,100	$12,100	$11,492	$11,925	$12,100
3	$13,310	$13,310	$13,310	$12,319	$13,022	$13,310
4	$14,641	$14,641	$14,641	$13,206	$14,220	$14,641
5	$16,105	$16,105	$16,105	$14,157	$15,528	$16,105
6	$17,716	$17,716	$17,716	$15,176	$16,956	$17,716
7	$19,487	$19,487	$19,487	$16,269	$18,516	$19,487
8	$21,436	$21,436	$21,436	$17,440	$20,220	$21,436
9	$23,579	$23,579	$23,579	$18,696	$22,080	$23,579
10	$25,937	$25,937	$25,937	$20,042	$24,112	$25,937

to build wealth, she wants to avoid paying taxes if at all possible. Let's assume that Mary, Nikki, and Odette invest $10,000 each in their stocks, pay taxes on dividends at the rate of 40%, and then reinvest the after-tax dividends back into their chosen stock each year. Table 1-1 shows the after-tax results that Mary, Nikki, and Odette would achieve over the next 10 years.

As you can see, Odette ends up with the most after-tax wealth because her investment in AMR provided all of its returns to her through the capital appreciation of the stock, which was due entirely to the delivered earnings per share growth.

Be a Long-Term Investor, Not a Short-Term Speculator

At this point it is necessary to distinguish between investing and speculating. *Investing* is when an investor purchases an asset without borrowing money to do so, to provide returns through income and capital appreciation over the long term. *Speculating* is when an investor purchases assets, possibly with the use of borrowed funds, for the short term. When you hear someone talk about buying Netscape because he thinks it will go up 10% over the next two weeks, that is speculating. If, on the other hand, someone buys Hewlett-Packard (HP) because he thinks that the stock will have good earnings per share growth over the next five to ten years, and that HP is reasonably priced given those earnings per share growth expectations, that is investing. We will focus on investing because investing keeps down transaction costs and taxes, which can erode the returns of individual investors over time. In addition, investing requires fewer day-to-day decisions than speculating and therefore is more achievable for most people. Because of these benefits, we feel that the odds of building wealth are on the side of the investor and not on the side of the speculator.

Many individuals think of investing in the stock market as being similar to gambling. When they think of the stock market this way, they miss one big point: A gambler has a negative expected return, while an investor has a positive expected return. Over time, the more money that an individual gambles at a casino, the more money she will lose. In gambling the odds are on the side of the house, not on the side of the gambler. In investing, the more money that an individual commits to long-term investing, the more money that individual will make because the odds are on the side of the investor. Historically, stocks have returned about 10% per year before taxes.

People who view the stock market like a casino tend to act like speculators, trading in and out of stocks every few months, or in extreme cases, every few days. These speculators are stacking the odds against themselves because every time they trade they have to pay transactions costs. They may very well be turning a positive expected return into a negative expected return. Transaction costs for the individual investor include brokerage commissions and the bid-ask spread for the stock that the investor or speculator wants to buy and sell. A *brokerage commission* is the fee that the broker charges. The *bid price* is the price at which an individual investor can sell a stock. The *ask price* is the price at which an individual investor can buy a stock. Here's an example of how to calculate the potential transaction costs for a stock. Assume that Aunt Annie goes to Alligator Broker to buy 200 shares of Nike's stock at $50 per share because Aunt Annie thinks that Nike will provide investors with some well-heeled gains over the next few years. Nike is currently trading with a bid of $49½ and