An Aggressive Growth Approach to Investing in Expanding Businesses

By Maria Crawford Scott

Investment approaches are often divided into two primary camps: value investing and growth investing. Many strategies, though, straddle the two extremes—value investing among small growth companies, for instance, or buying growth companies at a reasonable price.

One well-known investment adviser who is in the pure growth camp of investing is David Alger, president of Fred Alger Management and lead portfolio manager of the Alger group of stock funds. The funds, which range from small-cap stocks to large-cap stocks, reflect his investment style—they tend to have very high price-earnings ratios, and they are volatile, with sometimes stellar returns (78.6% for the Alger Capital Appreciation Fund in 1995) mixed with years of significant underperformance. Morningstar performance ratings for these funds range from two stars to four stars out of a possible five. The funds are not covered by AAII's "Individual Investor's Guide to Low-Load Mutual Funds" because of their 5% front-end load; the funds also sport exceptionally high expense ratios.

While the funds are expensive for investors to buy into, the investment approach can be used to purchase individual stocks, and Mr. Alger described how to use this approach in a book published five years ago entitled, "Raging Bull: How to Invest in the Growth Stocks of the '90s" (published by Richard D. Irwin, 1992). This book was used as the basis for this article.

The Philosophy

Mr. Alger is a strong proponent of investing in growth stocks—the stocks of companies that are expanding their businesses and that plan to continue to do so for at least the next five years.

Mr. Alger favors growth stocks because investors can make money from them in two ways:

- The stock price will rise as the company's earnings and revenues increase, a result of the underlying business fundamentals.
- The stock price will rise due to higher valuations that investors are willing to pay for them—in other words, as their future growth prospects become more obvious, investors will be willing to pay more for $1 of earnings, resulting in a higher price-earnings ratio. Mr. Alger views this as the "fashion" element or emotional component of investing, where investor perceptions influence prices.

Of course, the largest increases in share price come when both valuations and earnings increase at the same time—a dual boost to share price. (On the risk side, however, valuations can plummet when earnings come in lower than expected—a double-whammy on the downside.)

Mr. Alger also believes that certain economic environments favor growth stocks over value stocks; and, when he wrote the book in the early 1990s, he felt that these characteristics would predominate during the decade of the 1990s. These characteristics include: relative peace and American self-confidence; a stable economic environment characterized by a high employment level; modest inflation; positive real interest rates; expanding exports; reduced federal deficits; and rapid technological change. This kind of environment should lead investors to increase the valuations they are willing to pay for stocks in general, and it is conducive to companies increasing their revenues, providing the compound boost to share prices that Mr. Alger says favors growth stocks.

What Is a Growth Stock?

Mr. Alger defines a growth company as one that is growing significantly faster than the economy as a whole. "Growth" is indicated when a number of financial indicators, including earnings per share, are showing increases.

However, earnings or revenue growth on their own don't necessarily flag a growth stock. For one, historical growth does not necessarily indicate that growth will continue in the future. In addition, revenues and earnings can be increased simply by

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raising prices. In a competitive economy, it is not easy to keep increasing prices year after year, so if a business wants to keep growing, it must do so by increasing the amount of the product it is selling.

For that reason, the key indicator Mr. Alger suggests looking for is some measure (depending on the type of company) of unit volume growth, which measures the amount of goods or services a company is selling. Comparing unit volume growth among similar companies will give you an idea of which one is best at increasing the amount of products it sells each year.

Identifying the kind of growth company is also useful, because it forces you to think about the nature of the company, the industry, and the prospects for growth. Mr. Alger categorizes growth companies into four primary groups:

1) Superior companies that are gaining market share in an industry that is itself rapidly growing.
2) Companies that are only maintaining their market share in a growing industry; they do not have an edge over their competitors and may face competitive problems once the industry's growth wears off.
3) Superior companies that are gaining market share in an industry that is growing slowly.
4) Companies that are actually losing market share in an industry that is growing rapidly. These companies may still show growth because of the rapid industry growth, but it is not likely to last.

Market perceptions play an important role in categorizing growth companies, and the list above is in order of their market appeal. Thus, superior companies in growing industries will receive the highest market valuations because their growth potential is viewed as virtually unlimited. Similarly, a company that is losing market share in a growing industry will have a much lower valuation, since it will be viewed as having very little growth potential.

Perceptions, however, are not always accurate, and some companies may in fact be more competitive than "the market" perceives. Diminished perceptions may lead to lower valuations and sagging share prices even though revenue growth is undiminished. Mr. Alger points to Nike in 1985 as a good example. Although revenues had grown steadily, its net income was down from the prior year. The company was facing stiff competition and saw a drop in market share—a "Category 4" growth company, whose shares were selling for just under $7 a share. Nonetheless, the company was the first in the industry to perceive a major shift in the market for athletic shoes—a physical fitness craze among higher-income groups that demanded higher-quality shoes. The company used its technical skills to build a better shoe, and its marketing savvy to push sales, substantially boosting unit volume growth, and eventually re-establishing the company as a Category 1 growth company. By 1989, shares sold for $34.

It is equally important, Mr. Alger states, to weed out growth stock "impostors"—stocks that may appear to be growth stocks because of recent earnings and revenue increases, but in which earnings growth is unlikely to be sustained. Mr. Alger identifies four types:

- *Non-growth stocks:* Companies that should have growth stock characteristics but don't—their revenues are rising, they appear to have good products and they are in a growing industry, but these positive attributes have not translated into earnings growth due to unusual factors. Mr. Alger used the semiconductor industry in the early 1990s as a good example, where intense global competition has prevented sustained growth.
- *Growth due to life-cycle changes:* Companies that have seen recent growth due to a change in the fortunes of the industry or the company. A change in management, for example, may substantially improve a company's earnings by trimming costs, but this will not result in sustained long-term growth.
- *Growth due to a cyclical upswing:* Companies that are benefiting from the current stage of the business cycle, but that will contract at a different stage of the business cycle—cyclicals.
- *Wannabe growth stocks:* Companies that offer products typically found in a growth industry, but that haven't been able to find a market for the product, and there is no unit volume growth. These companies can sell at high multiples, because of the "promise." Examples include certain biotechnology firms.

Where to Look

Where do you find growth stocks? Mr. Alger says they tend to cluster in particular industries, and therefore it is easier to start a search for growth at the industry level. Indeed, much of the book is devoted to descriptions of the industries that Mr. Alger viewed at the time of writing as potential growth industries in the 1990s, including investment tips for analyzing each group. Those groups include:

- Healthcare, including biotechnology companies; conventional drug companies; new medical technology companies; and companies specializing in medical cost containment (such as HMOs);
- Data processing, including hardware and software manufacturers;
- Communications technology, including cellular communications; and
- Specialized growth areas such as environmental cleanup firms.

One drawback to these areas, Mr. Alger notes, is that they tend to require specialized knowledge about the particular industry. But not all growth companies are in these "hot" and rapidly growing markets. Others may derive growth from providing a simple yet superior product as a result of cultural shifts, or from finding a different way to do things. Nike was one example of a company taking advantage of a new "craze." Another example given by Mr. Alger was Food Lion in the 1980s, which operated small-scale grocery stores in areas too small to support a full-sized supermarket.

Many of these kinds of growth companies use what Mr. Alger terms the "cookie cutter" concept—a new format for selling a product that proves highly successful and is then replicated

Table 1.
David Alger's Approach to Valuing a Growth Stock

	Current	Year 1	Year 2	Year 3
S&P 500 EPS	43.50	46.11	48.88	51.81
S&P 500 P/E	21.0	19.8	18.7	17.6
Stock's EPS	1.00	1.25	1.56	1.95
Price to Equal S&P Multiple		24.75	29.20	34.32
Price-Earnings Ratio		24.7	29.2	34.3

Assuming the S&P 500 is at 913.50, with a price-earnings ratio of 21.0, with current earnings per share of $43.50 growing at an estimated long-term rate of 6%.

Also assume a stock currently has earnings per share of $1.00, but earnings are growing at the rate of 25% annually. In three years, earnings are projected to be $1.95 per share.

At a price of $34.32, the stock's price-earnings ratio based on Year 3 earnings would be equal to the S&P 500's Year 3 price-earnings ratio ($34.32/$1.95 = 17.60). The highest price-earnings ratio an investor would pay would therefore be 34.3 ($34.32 divided by today's earnings of $1).

across the country. McDonald's; Blockbuster Video and Toys R Us were all examples at one point in time of successful growth companies that used this approach.

One advantage with these kinds of companies is that they do not require a high level of specialized knowledge to analyze the business prospects. Instead, Mr. Alger says investors should rely on their common sense and pay particular attention to the company's ability to deliver a superior product, their site selection, and their financial management skills, since the concept is based on relatively small margins and demands high levels of cost control.

What about market capitalization? Mr. Alger's mutual funds tend to hold the stocks of smaller firms in terms of market capitalization (share price times number of shares outstanding), and he is therefore sometimes associated with "small-stock" investing. Interestingly, Mr. Alger says he actually prefers large, fast-growing companies because they are less vulnerable to external forces over which the company has little control. On the other hand, there are many more fast-growing small companies than there are large ones. For that reason, he suggests medium caps, those in the $500 million to $2 billion range—they are small enough to have room for long-term growth, yet they are large enough to be able to withstand outside pressures that could bring down a smaller firm.

Valuing a Growth Stock

Mr. Alger's approach to valuing a stock focuses on estimating future growth. In analyzing growth, the three questions to focus on are how fast will the company grow, how long will the growth last, and how certain is the company's future? Companies that have greater and longer growth prospects have higher valuations (reflected by higher price-earnings ratios), as do companies that are viewed by the market as having more certain futures.

According to Mr. Alger, most mistakes are not made by paying too high a price for a stock, but rather by misjudging the firm's growth prospects. Although it sounds like a small distinction, Mr. Alger is arguing against the strategy of focusing on stocks with low price-earnings ratios—stocks that are "cheap." A higher-growth stock, he notes, will always have a higher return than a lower-growth stock even if it sells at higher valuations as long as it remains at higher valuations; and it will still have a higher return if its valuation level drops to the same valuation as the low-growth stock if earnings growth continues simply because its earnings are growing faster. The "trick" is to determine how much more an investor should pay for that growth.

Mr. Alger suggests one approach to valuing a growth stock is to determine how high a price-earnings ratio can be such that its price-earnings ratio based on projected earnings three years in the future and the market's projected price-earnings ratio three years in the future (based on Year 3 earnings) are the same. The price-earnings ratios of growth stocks rarely drop below the market's average for very long, according to Mr. Alger, and at that level, the growth stock should still provide a greater rate of return over the years due to higher earnings growth. That assumes, of course, that growth rates for both the market and the stock remain unchanged over that time and only the valuations change.

For the approach, he first makes an estimate of earnings for the "market" as a whole for the next three years, but using a very long-term earnings growth rate for the market and analyst estimates for earnings per share for the current year. He then determines price-earnings ratios for each of those years, based on today's price.

Similarly, he projects earnings for the next three years for the prospective stock, based on estimated earnings per share for the current year and the firm's long-term earnings growth rate. He then determines what price the stock would have to be in order for its price-earnings ratio based on year three's earnings to be equal to the market price-earnings ratio based on year three's earnings. This is accomplished by multiplying the projected earnings per share in three years by the expected market price-earnings ratio for that year; the resulting price, divided by current earnings per share, indicates the price-earnings ratio that could be paid today that would equal a market price-earnings ratio based on projected earnings in three years. An example is shown in Table 1, using a long-term earnings growth rate for the S&P 500 of 6%, and a 25% earnings growth rate for the prospective stock.

Mr. Alger warns that the growth approach is volatile; earnings reports must be carefully monitored. He also states that the approach doesn't work in every market; in fact, the book discusses the period of the 1980s, when the growth approach did not fare as well as the value approach. And he notes that he is focusing on relative performance, and if the whole market drops, growth stocks will sink as well. Nonetheless, he feels that over long time periods, growth "will always win out."

Stock Monitoring and When to Sell

Mr. Alger recommends against timing the market, and attempting to switch to lower price-earnings ratio stocks when the "time" is right, because it is simply too hard to predict the proper times. In addition, bull markets last longer and are more frequent than bear markets, and so the percentages favor a longer-term buy-and-hold approach.

He is also a strong advocate of diversification to protect against misjudgments and fundamental events that could adversely affect a single firm. As a range, he suggests 10 to 20 stocks for portfolios of up to $1 million, and 20 or more for those over $1 million, although he notes that a portfolio of over 20 can get cumbersome for individuals doing their own trading. On the other hand, he does not discuss diversifying among industries, and his mutual funds do tend to be concentrated in a few groups.

Mr. Alger says investors should monitor their portfolios continuously, evaluating stocks they own relative to similar stocks with similar growth. He provides a number of rules regarding when to sell shares. They include:

1) Sell immediately if your expectations turn out to be incorrect—for instance, earnings do not increase when you expected a 25% increase, or if a product you expected to do well is doing poorly.
2) Sell if the stock does worse than similar stocks or the market fairly consistently over time. This should be a warning, he says, that there may be problems that you don't know about. The decision is tricky, however, because some stocks lag or lead others.

The David Alger Approach in Brief

Philosophy and style

Investment in the stocks of companies that are expanding their businesses faster than the overall economy. These stocks are favored because investors can gain from price rises due to underlying earnings growth as well as higher valuations (price-earnings multiples) by investors.
Growth stocks are particularly favored during times of stable economic environments and rapid technological change.

Universe of stocks

A preference for large-capitalization growth companies because they tend to be more financially self-supporting. However, there are many more growth companies to be found among smaller firms; mid caps are a good compromise.

Criteria for consideration

• Expected growth rates significantly greater than the market average for a number of financial indicators, including earnings and revenues per share.
• Unit volume growth greater than similar companies.
• To better understand the firm's growth prospects, try to identify the sources of future growth: Is the company gaining market share in a fast-growing industry; is it only maintaining market share in a fast-growing industry; is it gaining market share in a slow-growing industry; is it losing market share but in an industry that is rapidly growing?
• Weed out growth company 'impostors'—companies that have growth stock characteristics but no real growth; companies that have seen recent growth due to one-time events or that are on a cyclical upswing; and companies that are selling the promise of growth but that do not yet have a market for the product.
• Growth stocks tend to cluster in certain industries; it is easier to first find the growth industry and then look for promising stocks. In some growth industries such as healthcare and technology, specialized knowledge is necessary.
• Also look for growth companies among firms that are exploiting new ways of delivering superior products, particularly those that use the "cookie cutter" concept—a successful way of selling that can be replicated across the country.

Valuing a stock

Determine how high the price-earnings ratio can be such that the price-earnings ratio of the stock and the market based on estimated earnings three years from now are the same:

1) Project earnings for the next three years for the "market" based on current earnings per share and the long-term earnings growth rate; then determine price-earnings ratios for those years based on future earnings per share and the current market price.
2) Project earnings per share for the next three years for the stock based on current earnings per share and its estimated earnings growth rate.
3) Multiply projected earnings per share for the stock by the market price-earnings ratio for that year to determine what price the stock would have to be in order for its price-earnings ratio to be equal to the market price-earnings ratio.
4) The resulting price, divided by current earnings per share, indicates the price-earnings ratio that could be paid today that would equal the market's price-earnings ratio. According to Mr. Alger, price-earnings ratios for growth stocks rarely drop below the market's price-earnings ratio for very long.

Stock monitoring and when to sell

Diversify among at least 10 to 20 stocks.
Monitor stocks continuously, especially for changing earnings expectations. Compare holdings to similar stocks with similar growth, and sell if:
• Your expectations turn out to be incorrect—for instance, earnings are down when you expected them to be up.
• The stock does worse than similar stocks or the market fairly consistently over time. Be careful, however, of stocks that tend to lag or lead others.
• The stock reaches your expectations, but keep your expectations up-to-date. Do not sell if the fundamentals are strong and the stock is doing well, since growth stocks can stay strong for many years.

3) Sell if the stock reaches your expectations, but keep your expectations up-to-date. He warns against hasty selling if the fundamentals of a growth stock are strong and the stock is doing well. Good growth stocks, he says, can stay strong for many years.

Alger in Summary

The debate between value and growth investing concerns not only returns, but also risks. Mr. Alger acknowledges the criticism that growth stock investing can be volatile, but argues that the glass is half-full rather than half-empty—volatility on the upside, doing better than the market, is the whole point. And volatility on the downside can present buying opportunities.

Mr. Alger presents his case for investing in growth stocks not only as a general investment approach but particularly in the economic environment of the 1990s, a "decade characterized by investment and a feeling of peace and prosperity." While the decade is in its second half, many of the conditions that he views as positive for growth investing still exist.

Mr. Alger wrote his book in 1992, just after the Dow topped 3000, and he predicted that the Dow would top 6000 by the late 1990s—a bit short of today's 7000, but not too wide of the mark. Of course, the decade isn't over yet. . .