The Tortoise and the Hare, Revisited

The year is 1950. With the Great Depression becoming a faint memory, your grandfather decides to invest $1,000 in the stock market. He hopes to invest this money for the very long term so he can leave it to his grandchildren. Since he is not a sophisticated investor, he plans on buying stock in a company and not touch it until 2012. Furthermore, he will choose to reinvest all dividends back into new shares of the company.

Your grandfather narrows his choices down to two companies. Company A operates in a young and exciting industry, and promises to grow by leaps and bounds throughout the foreseeable future. Company B, on the other hand, is an old stalwart in an industry that is vital to the economy. Any growth it will achieve will probably be similar to the overall economy.

While your grandfather is struggling to make a decision, a genie appears. “What is your wish?” asks the genie. “Which of these two stocks will make me the most money?”, your grandfather says. The genie is not in a very accommodating mood that day and says, “I will not tell you which one to buy, but I will tell you exactly how much each company will be able to grow its revenues, earnings, and dividends for the next 62 years. That should tell you all you need to know about making your decision.”

The table below summarizes the genie’s predictions:

	Company A	Company B
Revenue per share	10.0%	8.3%
Dividends per share	10.7%	6.3%
Earnings per share	11.1%	7.9%

With this vital and certain look into the future, your grandfather makes the decision: Company A it is. It's a no-brainer that this will be the best investment; after all, for 62 years Company A will grow revenues, dividends, and earnings per share at a significantly faster rate than B.

Breaking News: Tortoise Beats Hare

Fast forward to 2012. Your grandfather, now a rich old man, tells you the incredible story of the genie that appeared to him all those years ago. He says, “And I want to give you as a gift that investment that I have locked away for all these years.” He gives you the shares he bought in International Business Machines (IBM) more than 60 years ago and you’re delighted to learn that his $1,000 initial investment is now worth over $771,000.

Even though you’re excited about this newfound windfall, your curiosity gets the better of you and you can't help yourself from asking, “Hey, grandpa, what was that other company that you were thinking about buying?” He replies, “Oh, it was some slower growth company called Standard Oil of New Jersey. I think it is called ExxonMobil today.”

Curiosity being what it is, you decide to do a little research. You fire up your spreadsheet and calculate how much money you would have inherited if your grandfather had invested in Standard Oil of NJ instead of IBM back in 1950. This is what you find:

	IBM	Standard Oil of NJ
Price appreciation	8.95%	7.58%
Dividend return	2.17%	4.72%
Total return	11.32%	12.66%
$1k invested in 1950	$771,860	$1,620,781

If your grandfather had invested $1,000 in 1950 in Standard Oil of NJ, he would have earned over 1 percent per year more than he did with IBM: 12.66% versus 11.32%. While that might not seem like much, after 62 years the compounding effect is remarkable. An investment in Standard Oil would have yielded over $1,620,000 in 2012, or more than twice what you got from IBM.

So, how is it possible for Standard Oil to be the better investment if it grew less than IBM for all those years?

The Growth Trap

The genie, when looking into the future, should have had the foresight to read the book *Stocks for the Long Run,* by Wharton professor Jeremy Siegel. While this book provides all the growth rates that the genie provided to your grandfather on that fateful day, it also shows the all-important factor that the genie missed in helping your grandfather make a decision: how the valuation differed between the two companies.

According to research done by Dr. Siegel, here are the average price/earnings (P/E) ratios and dividend yields for IBM and Standard Oil of NJ from 1950-2012:

	IBM	Standard Oil of NJ
Average P/E ratio	25	14
Average dividend yield	2.2%	4.2%

While IBM grew faster in all major categories during those 62 years, the price paid was just too high. The chart above shows that during that timeframe, investors buying IBM's stock paid on average 25 dollars for every dollar of profits versus just 14 times for Standard Oil of NJ.

Additionally, Standard Oil’s average dividend yield was almost twice that of IBM. And dividends matter. That 2 percent difference in dividend yield meant that Standard Oil’s shareholders got to re-invest more money back into the company’s shares, and that made all the difference in causing the oil company to be the winner for investors.

Your Homework Assignment

When looking at a potential investment, it is absolutely important to understand the growth characteristics of the business. But even more important than that is to pay attention to its valuation: the price you pay in relation to the earnings and dividends you receive. Warren Buffett said it well in his 1992 Letter to Shareholders:

> *"Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive."*
>
> *"… business growth, per se, tells us little about value. It's true that growth often has a positive impact on value, sometimes one of spectacular proportions. But such an effect is far from certain.*
>
> *Growth benefits investors only when the business in point can invest at incremental returns that are enticing - in other words, only when each dollar used to finance the growth creates over a dollar of long-term market value. In the case of a low-return business requiring incremental funds, growth hurts the investor."*

So here is your homework assignment: think of some stocks you know today and try to figure out whether they will turn out to be more like Company A or Company B over the next few decades.

In our opinion, while IBM may have been a Company A type of enterprise back in 1950, in 2015 it is much more like Company B. Its growth prospects now are much less than they were a few decades ago, and its dividend yield of 3.5% is currently one of the highest of stocks in the Dow Jones Industrial Average. The ExxonMobil of 2015, too, still seems like a Company B to us, especially given its dividend yield of over 4% as of this writing. IBM and XOM also sport reasonable P/E ratios of just 9 and 15, respectively.

But what about a young and exciting company with a more promising future, like Tesla? Or Amazon? Or Netflix? These are certainly all fine companies with long runways of growth ahead of them. We have nothing against them and enjoy many of the products they offer. But with current P/E ratios of 95, 98, and 347, it will be awfully difficult for an investor at today's prices to earn a satisfactory return in these stocks over time.

So seek out growth in your investments, if you must. But just make sure that you pay a reasonable price for it, or your portfolio may pay a price for your lack of prudence.

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