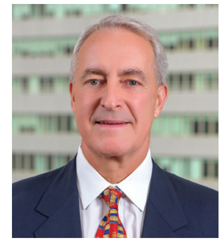
THE BORIS KAPLAN PUTRICH GROUP

ALEX. BROWN
A DIVISION OF RAYMOND JAMES

Thoughts for Investors



Albert C. Boris, III
Managing Director, Investments
215.854.1527 or 800.443.7500
New York/Philadelphia/Naples
al.boris@alexbrown.com
alexbrown.com/boriskaplanputrich

Growth Investing vs. Value Investing. Which is Better for These Times?

Fall Client Letter 2022

"Don't play what's there. Play what's not there."

– **Miles Davis**

We hear a lot of discussion about what type of investing is better, and perhaps "less risky," for these turbulent and inflationary times: "growth" or "value." To us, they are not mutually exclusive. *Growth and value are like the eaves on the roof of a house, if you don't have both you're going to get wet.* Growth is a precursor to value. Without growth first, there would be no value. When is the value of an apple greatest, when it is tiny, green and still on the tree or large, red and in your hand? We believe the best investment – for any times – is growth + value.

"Extinction is the rule. Survival is the exception."

– **Carl Sagan, astronomer**

Value doesn't last forever. Sam Walton opened his first store in 1962 and a St. Louis newspaper headline at the time questioned whether Walmart could survive against K-Mart, an established and profitable company. In 2022, there are three K-Mart stores left, whereas there are 10,500 Walmart/Sam's Clubs in 24 countries. "Growth" has made Walmart more "valuable."

If a company's value declines over time, it is usually for lack of innovation and its derivatives, including competition, changing consumer attitudes and macroeconomic changes such as regulatory and inflation. Even management hubris can lead to value decline. Eastman Kodak invented the digital camera but didn't want to give up highly profitable film sales. Now both Kodak and film cameras are essentially gone.

"The Stone Age didn't end because they ran out of stones."

– **Unknown**

The Stone Age ended because of innovation, though success is never guaranteed and innovation is often considered "folly" by those with a vested interest in the status quo. An example of innovation and the intertwining of growth + value is the story of Microsoft. Thanks to the success of Microsoft Windows operating system for personal computers and its Office productivity tools, from its IPO price in 1986 to its Financial Crisis low price in 2009, Microsoft investors who owned the stock the entire time received a 25.6% annualized return.[1] But the Microsoft story wasn't over.

"Growth stocks are worth buying when their prices are reasonable."

– **Benjamin Graham, famed value investor**

When Microsoft's stock price declined dramatically during the Financial Crisis of 2008-2009, the debate became whether it was a "value stock" or a "washed-up growth stock." It turned out to be another opportunity. From its Financial Crisis stock price low in 2009 to this writing (8.19.22), investors in Microsoft who *owned the stock the entire time* received a 27.2% annualized return. Being able to buy Microsoft stock at a "reasonable" or "value" price certainly helped the return. More important to creating this subsequent appreciation were management changes including Satya Nadella elevated to CEO and innovative new products capitalizing on the explosive "growth" opportunity of the new industry called "cloud services." Had further innovation and change not happened at Microsoft, the stock could have ended up like K-Mart, a “value trap,” so named when a stock is cheap but has issues including little growth potential. By the way, from its IPO price in 1986 to this writing, *buy-and-hold* Microsoft investors who *owned the stock the entire time,* through the Crash of ’87, Tech Bubble Burst of 2002, Financial Crisis of 2008-2009, COVID Crash of 2020, the 2022 “bear market,” and a few presidents, congresses, wars, regulatory and management changes received a 26.2% annualized return. Impressive. Now imagine the taxes and lost opportunity if you sold at every crisis.

“The bamboo that bends is stronger than the oak that resists.”

– **Japanese proverb**

In inflationary or recessionary times, one of the first survival techniques for any company is to cut costs. Turning “fixed” costs into “variable” costs allows companies to save money by adjusting their purchases with a rise or fall in demand. That is precisely the promise of “cloud services” with its flexible subscription/consumption-based sales model. Pay for what you use. Even labor can become a variable cost through “freelancing.” Microsoft established its “Freelance Services Program” in 2017. “Cloud services” has been so successful that Gartner Research estimates public “cloud services” spending will collectively rise to around One-half trillion dollars next year.[2] Inflation may further accelerate its use. Microsoft achieved $58 billion in total revenue in fiscal year 2009. Today, Microsoft’s “cloud services” sales alone will soon surpass $100 billion per year, putting it #2 behind Amazon Web Services in “cloud services.” It appears Microsoft has been a “growth + value” stock.

“It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change.”

– **Charles Darwin**

“Pricing power” is the ability of producers to raise prices to consumers. It’s another business survival technique. Some producers raise prices to continue funding research & development, the result being sustainable competitive advantages such as superior products, “first mover” advantage, or intellectual property. Others raise prices because they need more capital for new factories. Pricing power is the “icing on the cake” for any company. But pricing power is fleeting. Investors should be wary of companies who don’t innovate and change and instead raise prices to maintain profitability eroded by inflation/recession. Who enjoys paying a higher price for the same product at a smaller size? It’s no longer a half-gallon of ice cream! Without innovation, consumers revolt and eventually change, substitute and/or do without. Internet “search” capabilities have led to the “democratization of information.” This has shifted more control to “consumers” from “producers,” reducing the power to easily raise prices. For us, real growth is “unit volume growth,” i.e., “selling more stuff.” Campbell’s, General Mills and Unilever recently announced an increase in quarterly revenue due to price increases but at the same time a decrease in unit volumes. The rebellion by consumers seems underway. Are these companies, traditionally viewed as “value” and “less risky,” good investments for the future?

Any company, growth or value, which has lots of debt and/or needs more capital to compete can, no doubt, be adversely affected by higher borrowing costs. Switching factories (or workers) from making internal combustion engine cars to making electric cars requires more capital. Recently Ford’s CEO even stated how it sells cars, the dealer network, will also need to change. If consumer demand slows, changes or evaporates, “fixed” costs such as manufacturing plants, distribution facilities and labor contracts will adversely affect profitability. In an effort to lower “fixed” costs, Peleton announced it will stop producing its own products, lay off workers and sell a just completed $400 million factory.

“It’s better to look ahead and prepare than to look back and regret.”

– **Jackie Joyner-Kersee, US Olympic Gold Medalist**

Maintaining and increasing your purchasing power is raison d’etre for investing. If you run out of money, it doesn’t matter how you define your investments. With inflation in excess of 8%, there may be comfort investing in a "less risky" ten-year US Treasury bond. But with a 2.9% yield, that's a recipe for eventually running out of money. Even commodities are not an inflation hedge if less are used during a recession, substitutes are found, or the dollar is strong (many commodities are priced in dollars). Investing in "value" stocks with traditionally incremental advances aimed at protecting the status quo may also seem comforting and less "risky" today. Yet these stocks can become "value traps" if they have minimal to negative volume growth and depend on fleeting pricing power. On the other hand, innovative "growing" companies can use these times to gain a toehold through exponential advances in their goods and services and production and distribution systems. By the way, isn't that how the economy and society advance? For example, how different, and better, the world and economy are because of the "telephone." It worked fine even as a single-function device tethered to a wire. Its incremental advance occurred when handsets became available in colors other than black! Yet much more functionality, and value, has been created by the exponential advance of "digital wireless communications" and the "smartphone," which even replaced the camera. It was generally not existing companies which created that "value."

"If I had asked the public what they wanted, they would have said a faster horse."

– **Henry Ford**

In summary, turbulent times, what we call "punctuated equilibrium" and explained here, are often the breeding ground for exponential advances by innovative companies. These upend the incremental advances of non-innovative companies. I daresay consumers might be willing to pay more if they get more. It is not only the size or perceived "value" of a company that should matter to investors. K-Mart's mistakes made room for Walmart. Even Walmart's once exponential advances and "growth," in time, became incremental and made room for Amazon's exponential advances and the "growth" of e-commerce. Now Walmart is the one playing "catch-up." To believe investors should shun "growth" in favor of "value" may seem appealing right now, but in the long run that's a sure way to get wet. The lesson is that *growth + value, along with patience, is often the best investment value.*

AUDI PARTEM ALTERAM

“HEAR THE OTHER SIDE”

The Boris Kaplan Putrich Group // 1735 Market Street, Suite 1400 // Philadelphia, PA 19103 // T 215.563.2300
320 Park Ave., 14th Floor // New York, NY 10022 // T 212.430.2385
www.alexbrown.com/boriskaplanputrich

1. *https://www.pcmag.com/news/the-rise-of-dos-how-microsoft-got-the-ibm-pc-os-contract*
2. *https://www.saasbrief.com/edition/weekly-payfac-payment-features-2022-05-28?open-article-id=21656013&article-title=gartner--public-cloud-spending-to-rise-20--next-year-to--500-billion--saas-to--200-billion&blog-domain=saastr.com&blog-title=saastr*

To subscribe, unsubscribe or to request back issues mentioned in this client letter, simply send an email to al.boris@alexbrown.com.

The Boris Kaplan Putrich Group manages over $1 billion in assets on behalf of private families, foundations and institutions. We create custom strategies consisting of 35 positions. We are long only, all cap, opportunistic investors. If you would like to discuss the topic of this client letter, or our team’s approach to investing, please contact us.

Thoughts for Investors is a quarterly client letter written for clients since 1997 by this author. The purpose is two-fold. First, it is meant to help explain the investment philosophy that guides the author’s approach to portfolio management. Second, it is meant to remind readers of important behavioral skills that the author believes are necessary to help them become successful investors. The author welcomes comments and criticisms, especially if they can be shared for the betterment of all investors. Quotation is permitted with full attribution.