



# Joined at the hip

In general, it can be said that the natural sciences describe how the universe works, while the social sciences boil down to the study of human behaviour.

In the world of natural science it is possible to irrefutably prove any number of principles and define axiomatic truths (an apple will fall down to the ground if you drop it thanks to the wonders of gravity, for example, and  $2+2$  will always equal 4).

Unfortunately, no such mathematical certainty exists in the world of social science: human behaviour will always evolve, and people will continue to adapt to changing circumstances. Worse still is the fact that this process of adaptation will often not be optimal or even rational, as we all happen to be emotional beings driven by traits such as greed, fear and regret (to mention but a few).

This core difference between natural science and social science has also given rise to the concept of “physics envy”, which can be defined as the envy of scholars in other disciplines for the mathematical precision of fundamental concepts obtained by physicists.

Economics and finance do of course form part of the social sciences, and it can therefore be said that these fields contain few if any absolute truths. Accordingly, one should be very sceptical if you come across anyone who tries to sell you an investment product which simply “cannot fail” (especially if the stated upside is purported to be particularly attractive).

Having said all of this, **it is also true in the world of investing that you can skew the probabilities in your favour by learning from the past whilst introducing disciplines designed to try and minimise the impact of irrational human behaviour.**

One such example relates to the difference between a variety of investment philosophies, notably those of value and growth investing. Value investors generally buy stocks at lower than average valuation ratios (e.g. price to earnings, price to book, et cetera), whilst growth investors are typically

prepared to pay a premium for a stock, based on their expectation of superior growth in future earnings.

Various studies over time have come to a very similar conclusion, namely that value tends to beat growth over the longer term. This is also the core reason behind Credo’s stated value-based investment philosophy (as clients will be well aware).

One of the “problems” with value investing (or any other investment philosophy, for that matter), is that it can go through extended periods of under-performance relative to either the market in general, or alternative approaches in particular. In fact, it is probably fair to say that if value did not perform relatively badly at times, it wouldn’t really work at all: it is the very pain of under-performance which “shakes out” some of the weaker holders of securities near a market or sector bottom, leading to a self-fulfilling cycle of even lower prices that do not only test the resolve of remaining investors, but also provide them with the opportunity to build their holdings at an increasingly better average cost price... enhancing future returns when eventually the cycle reverses.



## ...the difference between value and growth investing is often misunderstood...

From a totally different perspective, it is also important to bear in mind that the difference between value and growth investing is often misunderstood. Warren Buffett probably summed it up best in the 1992 edition of the Berkshire Hathaway shareholders letter, where he said:

*"Most analysts feel they must choose between two approaches customarily thought to be in opposition: "value" and "growth." Indeed, many investment professionals see any mixing of the two terms as a form of intellectual cross-dressing. We view that as fuzzy thinking (in which, it must be confessed, I myself engaged some years ago). In our opinion, **the two approaches are joined at the hip:***

*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."*

Some eight years later, Buffett elaborated as follows:

*"Common yardsticks such as dividend yield, the ratio of price*

*to earnings or to book value, and even growth rates have nothing to do with valuation, except to the extent they provide clues to the amount and timing of cash flows into and from the business. Indeed, growth can destroy value if it requires cash inputs in the early years of a project or enterprise that exceed the discounted value of the cash that those assets will generate in later years.*

*Market commentators and investment managers who glibly refer to "growth" and "value" styles as contrasting approaches to investment are displaying their ignorance, not their sophistication.*

*Growth is simply a component - usually a plus, sometimes a minus - in the value equation."*

Based on this, it would be fair to say that a one-dimensional classification of someone like Warren Buffett as a value investor (which is how most commentators refer to him) is probably an over-simplification.

Whilst we subscribe to a value-based investment philosophy at Credo, we are also mindful of the fact that a sub-section of clients exhibit a preference for more of a growth-based approach. In response to this, we have recently launched the **Credo Growth Fund**, which, as its very name suggests, follows more of a growth philosophy rather than a value one (even though the latter will continue to be the bedrock of our main product suite).

The manager of the Credo Growth Fund has been investing successfully in this manner on behalf of himself and a number of his clients for more than 20 years; these same clients were also the first subscribers to the fund when it launched. As far as prospective new subscribers are concerned, it would be important that they understand the core differences between the Credo Growth Fund and the rest of our equity products which are all managed in accordance with a value-based philosophy. ■

*For those who have any questions, we would suggest that they have a discussion with their Relationship Manager.*