Why Can't You Outperform With Growth Stocks All the Time?

Description

Growth stocks such as **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI) and **Alimentation Couche-Tard Inc.** (TSX:ATD.B) outperform the market in the long term.

Over a 10-year period, Canadian National delivered annualized returns of 12.6% and Couche-Tard delivered returns of 23.7% per year. They greatly outperformed the S&P 500, which delivered annualized returns of 6.6% in the same period.

If these growth stocks tend to deliver higher returns with above-average growth, then why don't investors fill their portfolios with only growth stocks?

Can underperform in the short term

In the past 52 weeks, Canadian National's shares are up 3.5%. Adding its roughly 2% yield, that's an annualized return of 5.5%.

Now, any stock can underperform in the short term. However, if you hold a high-yield company that pays a safe dividend, its returns will be more predictable and consistent because a bigger part of its returns will come from the dividend component instead of the price-appreciation component.

Small dividend and risk of multiple contractions

High-growth stocks tend to pay little to no dividend. Canadian National's yield is just under 2% and Couche-Tard's is 0.5%. Their shareholders are essentially accepting a lower yield for the potential of higher growth.

What happens if the company's growth slows?

Canadian National's earnings per share increased by 18% last year, but it's expected to have 0% growth this year and roughly 8% per year growth in the medium term. For a company as strong as Canadian National, its share price has essentially traded sideways for the year.

However, looking a bit further out, it actually contracted from a multiple of roughly 22.3 times in February 2015 to a multiple of about 17.2 times today, translating to roughly an 11% share-price decline.

In other words, when growth slows, companies trade at a lower multiple and their share prices dip.

Conclusion

High-growth stocks are great for investors who don’t need to cash out anytime soon. However, for investors who need to sell shares throughout the year to help pay the bills, it wouldn’t be a prettypicture if share prices fell because of slower growth.

These investors may be better off looking for quality companies with higher yields to pay the bills.

Growth companies can’t maintain a high growth rate forever. At some point, growth is bound to slow.

In the case of Canadian National, its growth rate depends on the health of the economy. So, shareholders should expect sluggish growth periods occasionally.

Because of growth stocks’ expensive multiples and potentially slower earnings growth, most investors don’t hold a growth-stock-only portfolio.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

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2. TSX:CNR (Canadian National Railway Company)

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