



## Growth vs. Dividend Stocks: How to Choose Using This 1 Metric

### Description

Determining *the correct* investment strategy that accurately corresponds to an investor's risk profile can be quite difficult. Investors often choose between growth (think **Amazon.com, Inc.** ([NASDAQ:AMZN](#))) or dividend income (think **Telus Corporation** ([TSX:T](#))([NYSE:TU](#))) and the safety of value stocks or the massive upside potential of speculative-grade penny stocks.

I will dive into one fundamental metric that I believe trumps all other metrics as a measure of value (and McKinsey & Company Inc. agrees; in fact, two consultants from McKinsey wrote a book covering this topic in more detail: see *Valuation: Measuring and Managing the Value of Companies*.)

This metric will help investors discern across completely different stocks to provide a more balanced overall perspective on the performance of companies, whether the stock issues a dividend or not.

### Return on invested capital

ROIC, or return on invested capital, is the measure of a company's efficiency of using capital or investment. In other words, this measure is a look into the underlying company's operations, allowing investors to "peek" into how well the company uses its invested capital relative to other firms and the underlying firm's cost of capital.

The formula for ROIC is very simple:

$$[\text{net income} - \text{dividends}] / \text{Invested Capital}$$

What this formula does is essentially take the performance of the firm, net of dividends (net income – dividends) and compares it with the total capital invested in the firm. The fact that dividends are subtracted from net income allows for an accurate assessment of the relative performance of all firms whether a given firm decides to issue a dividend or not.

The simplicity of this fundamental measure cannot be understated. That said, using this ratio can be quite difficult, as it requires the calculation of two other measures to provide context as to the performance of a given firm to its cost of borrowing, and other firms in its industry.

First, to calculate if a company is creating or destroying value (a pretty darn important goal), investors should ensure that the ROIC of the target firm is higher than its cost of capital. In other words, as long as the company's invested capital is generating a return higher than the cost of the investment, we can say that the company is creating value.

To determine if the ROIC is sufficiently high, investors will need to calculate the firm's WACC (weighted average cost of capital) and compare the two values. This can be a very difficult calculation, requiring many assumptions, and different analysts will often come up with different WACC values. As a rule of thumb, using the average of a few analyst estimates for WACC can be viewed as a pretty close approximation of the company's WACC.

Comparing the two values will provide insight into how well the company is doing (if the company's WACC is 10%, but the company is earning 20% on every investment dollar, we can say the company should continue to keep borrowing or issuing shares, as its operations are producing a 10% return annually, over and above investment costs).

The second key comparison that should be done is to determine how a given firm's ROIC compares to its industry. Picking three to five comparable competitors in the firm's industry and averaging the ROIC and WACC values will allow for comparison across the industry.

Stay Foolish, my friends.

## **CATEGORY**

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1. NASDAQ:AMZN (Amazon.com Inc.)
2. NYSE:TU (TELUS)
3. TSX:T (TELUS)

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## **Date**

2025/08/06

## **Date Created**

2017/01/23

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