Buying Growth Stocks Doesn't Mean You Should Forgo Value

Description

If you're buying stocks with the intention for growth that leads to strong price appreciation, there are different ways to go about it. Some are more aggressive, but they could deliver explosive returns and have big downside risk. This includes stocks such as **Tesla Inc.** (NASDAQ:TSLA).

There are growth investments which may give lower returns but are also safer. For example, **Open Text Corp.** (TSX:OTEX)(NASDAQ:OTEX) trades at a reasonable valuation for its double-digit growth potential. The company has shown it's capable of generating growing earnings and cash flows in the long run.

An aggressive growth stock example

Since Tesla had its initial public offering, the company had lost money in most years. Yet the stock has delivered an annualized rate of return of 45%.

This is the kind of return any investor would jump on. However, shareholders really need to have a strong conviction in the company's future and its role in developing, manufacturing, and optimizing electric vehicles.

Any bad news can send the stock much lower, because it doesn't have consistent earnings and cash flows to support its share price. That said, analysts project that the company could start posting profitability by 2019.

A safer growth stock example

Open Text has had above-average growth. Since fiscal 2003, the stock has delivered an annualized rate of return of 17.4%. And since fiscal 2012, the rate of return has been 21.5%.

In the last five years, Open Text's earnings per share have increased at a compound annual growth rate of 11.9%, and in the last three years, the company increased its dividend per share by +15% per year.

Open Text generates about 84% of recurring revenue, which it plans to increase to more than 90% by 2020. That should improve the stability of the company’s earnings and cash flow.

Although Open Text’s payout ratio seems low at roughly 26%, the company will probably keep it at that level and increase its dividend in line with its earnings growth, because it continues to be a consolidator in the information management space.

The company has been doing an excellent job by finding and integrating acquisitions. This is evident by its consistent return on equity of +11% every year since fiscal 2010. The company also has the opportunity to improve the margins of the acquired businesses.

At under $42 per share, Open Text trades at a multiple of about 15.4, while some analysts think the company will grow its earnings per share by 14-20% per year for the next few years.

Investor takeaway

While most, if not all, stocks will decline in a market-wide correction, aggressive growth stocks, such as Tesla, will probably be attacked the most viciously by the bears at such a time.

Companies such as Open Text, which are growing at an above-average rate, backed by earnings and cash flow growth, and trading at reasonable multiples, can deliver extraordinary returns with lower risk.

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