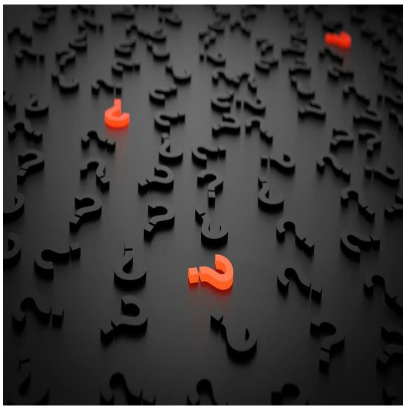

Could Another Growth-to-Value Rotation Happen in 2018?

Description

It's been quite a year for growth stocks, many of which have seen gains that dwarf the U.S. and Canadian indices. With the recent outperformance of high-growth names, it can be tempting to drop everything and simply load up on tech, Bitcoin, or pot stocks, all of which have been the talk of the town in 2017.

While such high flyers may continue to see their momentum continue into the new year, it's important to remember that value and diversification still matter in the grander scheme of things. Earlier in the month, we saw a small rotation from growth stocks into value names.

While it appears that the rotation is in the rear-view mirror, I think it should be treated as a wake-up call for investors who've overexposed their portfolios to overvalued high-growth names, which are starting to become speculative in nature. I believe that the mild rotation experienced at the start of the month is a sign of a much bigger rotation that could present itself as early as next year.

If you're overexposed to high-flying tech stocks, like **Shopify Inc.** (TSX:SHOP)(NYSE:SHOP) or **Nvidia Corporation** (NASDAQ:NVDA), then you could be in for a rude awakening should the growth-to-value rotation be a part of a long-term trend. In investing, diversification is truly the only free lunch, even though it may not seem like an effective strategy when a specific sector enjoys a majority of the gains.

What about for younger investors who should be more aggressive?

I firmly believe that young investors should have a large chunk of their portfolio reserved for growth stocks, but one must always consider the price they're paying for a stock for the value they're getting. It's worth it to pay up for a superior growth profile, but it just doesn't make any sense to be accumulating shares of a severely overvalued growth stock like Shopify with its ~17 price-to-sales multiple.

The problem with overexposure to extremely expensive growth stocks

Red-hot growth stocks are few and far between in Canada, but you've got to realize that the risks are elevated substantially if you overpay for a stock, especially one that's been called out by short sellers. As I've mentioned before, there's expensive, and there's Shopify expensive. Yes, the company is a promising e-commerce player, but if you're paying for many years' worth of earnings, it really doesn't make sense, even for a growth investor.

Shopify has a ~330 forward price-to-earnings multiple, and given the recent churn concerns I've addressed in a piece published before Andrew Left released his short report, investors really need to exercise caution when putting money down on red-hot stocks like these; they could correct violently in the event of an industry-wide pullback, which would come with the growth-to-value rotation — a trend that I think we haven't seen the last of.

In addition, solid earnings beats for red-hot growth names aren't enough to impress investors anymore, as we've seen in the past with many high flyers. There's so much hype and optimism baked in already, so if you're jumping in at current levels, make sure you keep ample cash on the sidelines to average down should a rotation out of growth stocks present itself once again.

Bottom line

Growth stocks are great to have, but some of the hottest names may be too hot to handle at current levels. If you already find that you're overexposed to such stocks, it may be time to take some profits off the table; doing so has never hurt anyone!

I can't emphasize enough the importance of diversification. If your portfolio is properly diversified across various sectors, you're essentially protected should sector-wide rotations occur.

Stay hungry. Stay Foolish.

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joefrenette