2 Important Lessons for Growth Investors

Description

Growth investors have been having a heyday. Over the previous one-year, five-year, and 10-year periods, growth stocks have outperformed value stocks, often by a large margin. It's not surprising that many growth advocates believe value investing to be dead. Just be careful — over a 30-year period, value stocks still reign supreme.

In the end, investing strategies are largely cyclical. Some cycles last only a few weeks. Others persist for decades. The number one lesson is to remain aware of your downside. What can go wrong in your portfolio? Which stocks are priced for perfection? Which stocks will crumble during the next recession?

I'm not arguing against growth investing. In fact, growth investors were better prepared to take advantage of the many lucrative opportunities in technology. Few self-identified value investors took a chance on **Facebook**, **Square**, or **Netflix**. But despite the recent success of growth investing, there are still risks to avoid.

If you want to maximize the value of your growth portfolio, carefully consider the time-tested lessons below.

Don't fear the multiple

Shopify (TSX:SHOP)(NYSE:SHOP) is ridiculously expensive. Or maybe not. In September of 2017, shares traded at a mind-boggling 18.5 times sales. It's rare that such a high valuation is achieved. Short-sellers like Citron Research soon argued that Shopify stock had nowhere to go but down. The opposite happened — shares *tripled*.

Here's the lesson: crazy valuations can quickly be justified in exponential sectors like tech. Over the past three years, Shopify has averaged 70% annual sales growth. Many bulls believe double-digit sales growth can be maintained for *decades* to come. That could make the current price a steal. Sure, shares trade at a lofty 24 times sales, but within 12 months, they'll trade at 18 times sales. Rinse and repeat for a few years, and the multiple normalizes fairly quickly.

If you're a staunch growth investors, don't be scared off by nose-bleed multiples if the company is scaling exponentially.

But valuation matters

Just because some wild valuations are worth it doesn't mean a growth stock can't be overvalued. As we mentioned, sales in the tech sector can often move exponentially for decades. That can make over-priced multiples look cheap after just a few years. In slower-growing sectors like retail, exponential sales growth is significantly more rare. That should make you think twice before paying a steep premium.

Consider **Canada Goose Holdings** (TSX:GOOS)(NYSE:GOOS). The stock quadrupled in value from 2017 to 2018, with shares typically trading between 50 and 100 times earnings. That's a 250-500% premium versus the **S&P/TSX Composite Index**. Given the rapidly rising share price, growth investors were lulled into a complacent belief that this premium was always worth the cost. In May, they were proven wrong.

After revising its multi-year sales growth forecast from around 30% per year to "at least" 20% per year, the stock lost one-third of its value overnight. That wiped out more than a year's worth of gains. Suddenly, the market had no idea how to price the stock. Shares traded as low as 30 times forward earnings. I argued that this valuation was a steal. Shares are up nearly 20% since.

Here's the lesson: unless you're investing in exponential sectors like tech, sky-high valuations are tough to justify. Only a handful of non-tech industries like cannabis will experience exponential growth.

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