Why Value Stocks Outperform Hot Stocks

Description

Many new investors are drawn to the idea of buying “hot stocks” — that is to say, high-growth companies in innovative new industries. Common thinking is that these stocks have the potential for outsized returns. Indeed, some of them do. But most of the time, value stocks (stocks that are cheap compared to their cash flows and assets) outperform growth stocks.

Several academic studies have shown that value stocks deliver better returns than growth stocks. Stocks with low price-to-book ratios (stock price divided by assets minus liabilities) tend to do particularly well. There are many reasons why this could be the case. First, unprofitable growth stocks are at an elevated risk of bankruptcy, because they don’t have any cash left after paying expenses. Second, value stocks are, by definition, cheap, so they stand to gain from being valued more like the rest of the rest of the market. Third, value stocks are out of favour, so not that many people are looking at them. This means that today’s buyers are getting in early.

“Hot” is a red flag

One problem with “hot stocks” is that their very “hotness” creates risk. If a stock is hot, that means a lot of people are buying it. Once a stock begins trending on social media or getting tons of press, countless amounts of money has already been spent on it. It doesn’t take much for an obsessive buying frenzy to reverse. For one thing, the people buying up the stock might run out of money or hear about a different “hot” stock and decide to sell so they can buy it. Second, crowd psychology tends to influence the buying and selling of hot stocks; if you’re buying because of mass excitement, you’re more likely to sell when the mood surrounding a given stock turns depressive.

Value stocks are often very profitable

One of the big reasons value stocks are often good buys is because they tend to be quite profitable. It’s true, by definition, that value stocks are cheap, but numerical cheapness in itself doesn’t mean anything. If you buy a stock for just five times earnings and it goes bankrupt and gets delisted the next year, you paid too much. Fortunately, value stocks aren’t all bankruptcies waiting to happen, some are actually very profitable.

Take **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) for example. It's a classic value stock trading at just 10.5 times earnings. It's not the fastest-growing company in the world, but it's no slouch either: its revenue has grown at 5.5% per year over the last five years, and its earnings at 8.3%. So, its earnings growth is beating the inflation rate.

It doesn't take much to see that TD Bank is very profitable. In its most recent quarter, TD did $3.8 billion in earnings on $11.6 billion in revenue. That gives us a profit margin of 32%. A profit margin is a common measure that tells us how big a company's profit is as a percentage of sales. When a company has a high profit margin, it can take a substantial hit to revenue and remain profitable. Given its 38% net margin, TD Bank is profitable enough to ensure investors a reasonable degree of safety.

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