"Are *quality* stocks a justified purchase at <u>any</u> price?"

Have you heard the new movement towards buying "quality stocks" at any price? Business magazines tout it, brokerage houses prepare it and a pundit has even decreed that "*you will never lose money in a sector leader*" (Unitech anyone?). Quality stocks are currently bought with the same fervour as were its older siblings – "The-big-Indian-middle-class" in mid-90s, the technology boom around early 2000s and infrastructure in the mid-late 2000s.

No accepted definition of "Quality" exists but a general reading implies a stock that has stability of earnings and growth. Besides, a quality stock is theorized to have other sought after features like a strong competitive position, durable margins, long 'runway' etc. Finally and quite subtly, such stock should be expensive to buy to make the quality cut! Practically however if a stock is seen to be growing and is expensive all other quality criteria are *made* to fall in place!

A quality stock investment may be a sound thesis but as soon as it gets vindicated by a rise in price, investors rush to buy at any price fuelling a further rise that serves as a stronger validation of the thesis. The outcome is a seemingly unstoppable upward spiral of prices.

Is it worth paying a premium for quality (aka expensive growth stock)?

The task before us is to examine if it is worth buying a quality stock at *any* price. We undertake a rudimentary exercise into the past to find out if paying a premium for quality was adequately rewarded. We created 3 growth stock portfolios using purely quantitative standards, in April 2001 (Growth Stocks 2001), April 2005 (Growth Stocks 2005) and April 2010 (Growth Stocks 2010). Their price performance by way of returns and underlying economic performance 4-5 years hence were compared with the market (Nifty).

Table 1 shows outcome of this handiwork.

<u>Table 1</u>

	Returns* %age	Trailing PE multiple Starting	Ending	EPS growth %age
	April 2001 - March 2005			
Growth Stocks (2001)	89.7	33.8	26.9	101.9
Nifty	81.1	17	11.6	98.9
	April 2005 - March 2010			
Growth Stocks (2005)	166.2	26.3	23.6	187.6
Nifty	169.7	11.6	17	77.6
	April 2010 - March 2015**			
Growth Stocks (2010)	89.9	37	40	71.1
Nifty	68.8	17.1	20.6	27.4

* Returns includes dividends

** Returns for this period till May 2015

<u>Notes:</u>

1. Growth Stocks selection criteria is outlined below

Selection parameters	Growth Stocks (2001)	Growth Stock (2005)	Growth Stock (2010)
M Cap	> ₹ 50 crore	> ₹ 100 crore	> ₹ 100 crore
Past 2 year EPS growth	> 25% median EPS growth	> ~ 50% annually	> 50% Nifty EPS growth
Premium over Nifty	1.5 times Nifty PE ratio		

2. EPS adjusted for non-economic changes in share count like splits and bonus

Our observations

We notice that Growth Stocks (2001) provided marginally better returns and Growth Stocks (2005) marginally worse relative to simply investing in Nifty. However in 2010 the Growth Stock (2010) portfolio gave a 20% higher return than did Nifty over the ensuing 5 years. Possibly the tremendous earnings growth (187.6% over 77.6% for Nifty) of these stocks during 2005 – 2010 built the faith, even as absolute growth faltered. In fact the PE multiple for the 2010 portfolio is now at 40, in other words, even more expensive than in 2010!

A mixed bag. So how do we read this?

We have two periods where expensive growth stocks did not significantly outperform the index and one in which it did. This rules out objective conclusions on whether expensive growth stocks payoff. Nevertheless we hazard a subjective assessment weighing the results on balance and adding our own conservative investing attitudes.

Consider that most experts foresee India to grow at a slower pace than it did in the 2005-2010 period. Further global economic growth is also seen to be subdued. It is then sensible to assume that growth stocks as such are unlikely to exhibit the earnings growth seen in 2005-2010. In fact their earnings growth in 2010-2015 is 71% or just 11.3% annually. However their high price levels despite poor showing in earnings needs explanation. One possibility is prevalence of low interest rates globally. Ultimately like Benjamin Graham said optimism and price levels justify each other making it almost impossible not to carry them too far. The price then has to correct.

History has an instructive example

Not too long ago during the tech bubble in March 2000, a much fancied stock was priced at about 205 times its FY 2000 earnings. Over the next 15 years the business discharged the implicit promise in its price. It grew profits 42 times or 28% annually without too much addition to its capital. Its price (excluding dividends) however grew by just 4 times. In other words the growth was fully priced in March 2000.

That stock is Infosys Limited. And ultimately price has to be a consideration irrespective of quality.