STOCK ANALYSIS WORKSHOP

The T. Rowe Price Approach to Investing in Growth Stocks

By Maria Crawford Scott

Being a copycat isn't necessarily bad, at least as far as investing is concerned. Instead of reinventing the wheel—and possibly losing money doing so—individuals who are selecting stocks on their own can follow in the footsteps of a successful investor and use an approach that has been tested in the real world.

How can "successful investors" be identified? It's hard to argue with long-term success, and one of the earliest investors who met with long-term success was T. Rowe Price.

T. Rowe Price, who died in 1983, was the founder of T. Rowe Price Associates, the Baltimore investment advisory firm that manages the T. Rowe Price family of no-load mutual funds. In the process of managing private accounts, Price started several mutual funds using his approach (the family's Growth Stock, New Horizons and New Era funds); he sold the firm when he retired in the early '70s.

Price developed his investment philosophy in the 1930s, when the prevailing approach was to jump in and out of stocks based on the cyclical nature of the stock market. Instead, Price felt that investors should mimic the owners of successful business enterprises, who "do not attempt to sell out and buy back again their ownerships of the businesses through the ups and downs of the business and stock market cycles."

T. Rowe Price's approach focuses on growth stocks. The basics of his strategy, which are outlined in this article, are gleaned from articles he wrote for various financial publications [particularly Barron's, for which he wrote a series of articles in May-June 1939, as well as several at later dates; and Forbes], and pamphlets he wrote for clients and prospective clients describing the investment philosophy of his firm.

When reading about his approach, keep in mind that Price's primary goal was to invest in growth, and that "growth industries" change over time. Growth industries at the time he formulated his philosophy would be considered mature today, and some of Price's secondary rules would need to be adapted to today's—and tomorrow's—circumstances.

Price himself would have been the first to do so. "Change is the investor's only certainty," he stated in 1937, a statement that he repeated over the years, unchanged.

Why Growth Stocks: The Philosophy

T. Rowe Price essentially sought stocks among all stocks listed—he did not restrict his growth stock search among any subset of stocks. Price's growth stock approach was based on the theory that, over time, both dividend payments and market values will increase as earnings grow, which he felt to be particularly attractive as protection against inflation. At the time he developed his approach, many investors preferred high-dividend-yielding stocks for steady returns in the form of dividends. However, Price felt that these stocks showed less promise for gains and dividend increases and, thus, in the long-term, real growth could be threatened by inflation. Interestingly, Price recognized the threat of inflation in the '30s, despite the prior devastating experience faced by investors—the Depression, a time of deflation.

The search for growth stocks was based on Price's "life cycle" theory of corporations, which held that companies go through a cycle of growth, maturity, and decline. The greatest possibility for gain and least risk, he felt, is when the long-term earnings trend in a company is positive. And the best time to invest in a company, he stated, is when it is small, before its shares "gain in stature" and sell at high price-earnings ratios.

During the earlier years, many of the stocks that Price considered to be growth candidates paid at least some dividends, which explains in part Price's mention of dividends in his growth approach. Over the years, however, many growth companies, particularly those with smaller market capitalizations, chose to forego dividends. These firms, of course, were certainly considered within Price's

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approach. In 1960 he extended his growth stock criteria to smaller, emerging growth companies (through the New Horizons Fund). This particular fund picks from a universe of smaller capitalization companies.

Growth Stock Criteria

Price's definition of a growth stock is: "A share in a business enterprise that has demonstrated long-term growth of earnings, reaching a new high level per share at the peak of each succeeding major business cycle, and that gives indications of reaching new high earnings at the peaks of future business cycles."

In addition, he stated that earnings per share should be increasing faster than the rate of inflation to offset any erosion in the purchasing power of the dollar.

Price did not focus on year-to-year earnings growth because of possible distortions in the reported earnings pattern caused by business cycles and developments within the industry or firm. He noted, for instance, that a cyclical decline in earnings due to a general economic slowdown could be misinterpreted as an end of growth for the firm, or similarly a cyclical recovery in earnings could be mistaken for a resumption in earnings growth. Most importantly, a non-growth company enjoying a cyclical recovery in earnings as the overall economy improves could be mistaken for a growth stock. Price spent a considerable amount of time examining a firm's industry and the firm itself to identify the ongoing cycles, so that real changes in earnings could be detected from within those cycles. The real test for Price, therefore, was growth in earnings during successive business peaks.

Buying Growth, But at a Reasonable Price

Price's approach concentrated on growth, but he would not pay any price for growth. In fact, part of his reasoning in selecting growth stocks was to find firms before they became "glamorized," particularly by institutions. Thus, although institutional ownership or scrutiny was never a factor in his selection process, he was clearly concerned about it, and favored stocks that were not in the market's spotlight.

Price used price-earnings multiples in his valuation analysis. He evaluated the price-earnings ratios of firms relative to their historical norms—preferring, for instance, not to buy stocks selling at high levels relative to their historical average. Interestingly, Price became alarmed at the valuation levels of most growth stocks in the early 1970s, and in particular, he disagreed with the managers of the funds he started, which he no longer managed. He didn't convince the managers—but he correctly anticipated one of the worst downturns in 50 years.

Top-Down Factors

Price was a careful observer of overall trends concerning social, political, and economic influences that could affect the market and particular industries, and he invested accordingly—a top-down approach.

His view of trends, however, was broad and very long-term. For instance, in the mid-1960s he predicted that inflation would accelerate, and he therefore developed an investment strategy that concentrated on natural resource companies, the New Era Fund.

However, he also viewed trends in a somewhat shorter-term context, although he was not a market timer, nor a cyclical investor who jumped from sector to sector depending on the economic cycle.

In particular, he felt that it was important to select companies in growing industries. He defined his ideal "growing industry" as one that was growing both in volume and earnings. For example, in one article written in the '30s, he contrasted the railroad industry, which had increasing earnings but was not increasing passenger miles, with the power and light industry, which was expanding its customer base and increasing its earnings at the same time. (Interestingly, he had other reasons—fear of government regulation—that made him cautious of the latter industry).

In Price's view, industries that offered the most "fertile fields" for growth were:

- New industries;
- Divisions of old industries that are experiencing vigorous growth as a result of new products, or new uses for old products, and
- Specialty industries with expanding products and markets.

Management and Other Factors

Of course, in any approach many other factors are important, and Price listed a number of important secondary characteristics he sought. Of these, Price felt that the first—good management—was the most important, since good management can cope with many of the other factors that may be unfavorable and possibly turn those factors around.

To evaluate good management, Price posed these questions:

- Are directors and officers actively on the job?
- Do they have a substantial stock interest in the firm, or is sole compensation from big salaries and pensions?
- Are they planning for the future growth of the company through intelligent research?
- Do they understand social trends and have the good will of their employees?

His other secondary factors include:

- Intelligent research: Companies that are looking to ensure their future growth through efforts to develop new products, new markets for existing products, or both.
- Strong finances that would allow a company to survive short-term downturns in earnings. Two items he examined in this area include increases in capital from retained earnings, as well as the availability of additional financing.

• Relatively high return on invested capital and returns on invested capital that are not declining over the long term. In particular, he felt that companies should be able to lower production costs and develop expanding markets without reducing return on invested capital. [Return on invested capital is earnings before interest, taxes and dividends divided by total capital, which is stockholders' equity plus preferred stock and long-term debt; it provides a measure of management's efficient use of capital.]
• Favorable profit margins relative to the firm's industry, and a favorable trend in profit margins. [Profit margin is net income divided by revenue, and it measures the ability of a firm to generate earnings from revenue. Favorable profit margins relative to the industry provide an indication of the competitive advantage a firm has against its peers. A favorable trend in profit margins provides an indication of the strength of management and its abilities over time.]
• Absence of cut-throat competition in the industry, which would cut down on growth prospects.
• Companies that are not subject to government regulation, since this will tend to restrict earnings.
• Companies with good employee relations, but in which total payroll is not large in relation to gross revenue. This would allow a company to more easily adjust to any fluctuations that may occur in its business.

Monitoring Stocks

Price believed in a long-term buy-and-hold strategy, in which growth stocks would be held until they were no longer growth stocks. That, of course, means monitoring the holdings to determine if the long-term growth in earnings will continue. To do that, he focused on many of the factors used in the original selection process and, in particular, a study of the trends in sales, profit margin, and return on invested capital.

He noted it was important when trying to detect the end of earnings growth to measure both growth in volume of sales and the trend in return on invested capital. High profit margin companies, he said, do not always prove to be better growth stocks; companies with low profit margins are sometimes able to increase sales volume without increasing capital investment. On the other hand, if increasing capital investment does not increase the profits, a decline in the return on invested capital results. This declining trend, he said, is a warning signal.

Price said that the causes of these changes in trend could often be seen before the results could actually be measured, and therefore he scrutinized companies to see if certain changing circumstances could lead to a change in trends. The changing circumstances he kept an eye on included:

Table 1.
The T. Rowe Price Approach in Brief

Philosophy and style
Investment in stocks of companies with long-term earnings growth prospects, under the theory that growth in earnings will ultimately be reflected in growth of market values and dividends; and investment in stocks in the early, growth stages of their life cycle before they become "glamorized."

Universe of stocks
No restrictions, but smaller capitalization stocks viewed as particularly fertile ground.

Criteria for initial consideration
• Earnings per share increasing at the peak of each succeeding major business cycle, as well as increased projected earnings per share at peak of future business cycles. Earnings are examined relative to industry and overall market to find distortions caused by business cycles to determine the real trend in earnings, and to rule out non-growth "cyclicals." To ensure long-term growth of earnings, companies should be in growing industries. Areas of possibility include: new industries, divisions of old industries experiencing vigorous growth as a result of new products or new uses for old products, and specialty industries with expanding products and markets.
• Long-term earnings per share growth greater than inflation.
• Price-earnings ratio not high relative to historical average.

Secondary factors:
• Management, which is key. Look for management with substantial interest in the firm, and that appears to be planning intelligently for the future
• Strong finances: increase in capital from retained earnings; availability of additional financing
• Relatively high return on invested capital
• Favorable profit margins relative to industry; favorable trend in profit margins
• Absence of cut-throat competition in the industry
• Little government interference
• Good labor relations, but total payroll not large relative to gross revenue

Stock monitoring and when to sell:
• Monitor for changes in trends of sales, profit margin and return on invested capital
• Monitor for changes in management, competitive stance, regulatory changes, and changes in industry
• Sell when company no longer fits definition of "growth" company, when the outlook does not continue to be favorable, when there is a break in trend of sales, profit margin, and return on invested capital
• Trim when prices reach excessively high levels, as measured by price-earnings ratios relative to historical levels

- Saturation of markets
- New inventions
- Expiration of patents
- Increased competition
- Adverse legislation
- Unfavorable court decisions
- Sharp rise in cost of materials
- Sharp rise in labor costs
- Increase in taxes

When to Sell

The time to sell, according to Price, was when a company no longer appeared to have favorable future growth prospects. Significant price declines did not trigger any sales, but rather offered an opportunity to add to a holding, assuming the stock still filled the growth criteria.

T. Rowe Price also felt that if prices reached "excessively high levels," investors should sell enough shares to permit the withdrawal of the original capital invested in the stock, plus the amount needed to cover capital gains taxes, and the original capital could then be invested elsewhere.

Summarizing Price

As a final note, Price also discussed the need for diversification in a growth stock portfolio. In fact, he felt that as many as 60 stocks would be necessary, which would allow an investor to participate in a wide range of basic industries and natural resources. He also felt that such a large number would act as a hedge against almost any conceivable crisis that could stem from changes in social, political, and even international developments.

Table 1 provides a brief summary of some of the key points in T. Rowe Price's approach. But not surprisingly, the best summarization of the Price approach is his own:

"In short, invest money in a business that must cope with the minimum of consumer, labor, and government interference, that is managed by men with vision who understand the significance of the social and economic trends, and who are preparing for the future through intelligent research and development."