Why boring is best

By Tom Stevenson, 11 November 2009

The out-performance of Imperial Tobacco underlines the dangers of chasing growth.

It is not often that a share price chart is genuinely shocking but the one I have replicated below really took me aback when I saw it on the front page of my Financial Times today. It shows the spectacular out-performance of Imperial Tobacco over the 14 years that outgoing chief executive Gareth Davis has been at the helm.

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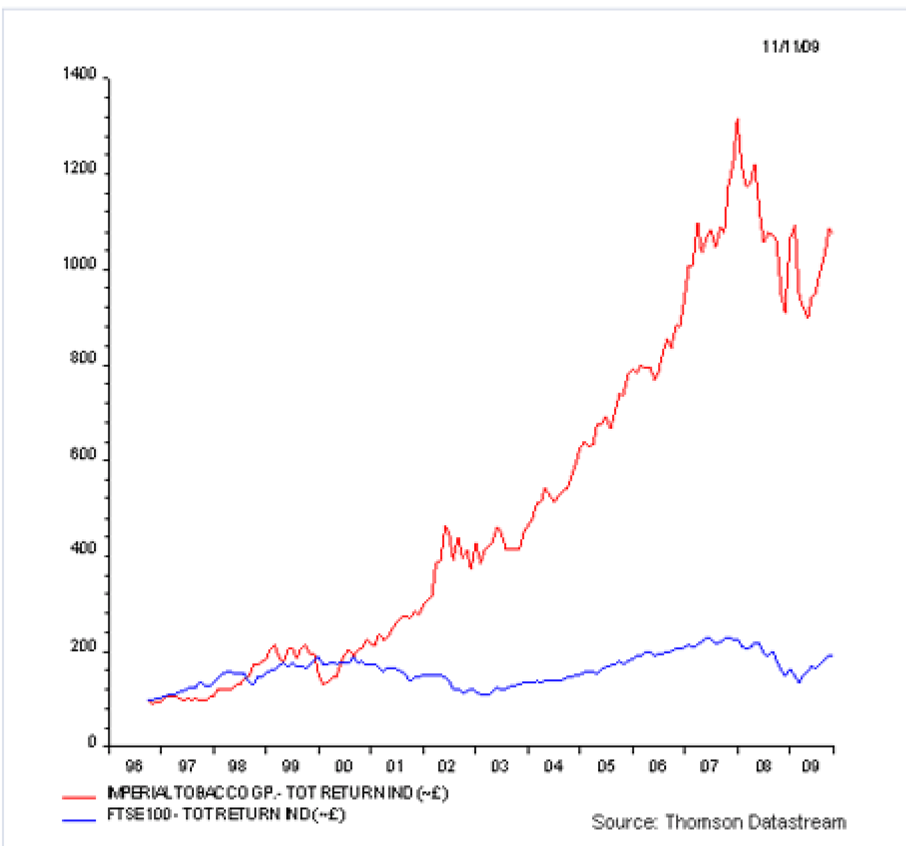

The numbers behind the chart are equally compelling. They show that £100 invested in the cigarette maker in 1996 would now be worth more than £1,000. That compares with just over £200 for the same amount invested in the UK market overall.

Who would have thought that a business supplying a mature market with the threat of class action law suits hanging over it would have left the rest of the market so far behind? Following on from my comments last week about Warren Buffett's purchase of the Burlington Northern Santa Fe railroad, it is another clear example of the fact that, in investment, boring can be best.

It is true that hidden within Imperial Tobacco there is a growth story. Although we started giving up the weed long ago in Britain, in many parts of the world cigarettes, and especially foreign ones, still have a certain cachet. When Mr Davis took over Imperial in 1996, the company was largely a UK operation but its tentacles now reach into 160 countries.

But the Imperial story also has an important lesson for investors about the dangerous allure of chasing growth. We are hardwired to follow compelling stories when we choose investments – which is why the emerging markets are such the flavour of the month these days – but history shows that a better approach can be to back the tried and tested and out of favour.

All too often, chasing growth can lead to investors overpaying for the expectation of higher profits in the future. This is a strategy doomed to failure for two reasons. Firstly because shares which already have good news factored into their price cannot benefit from an upward re-rating, which is one of the major sources of stock market return. Second, because the forecasts on which investors are pinning their hopes are often too optimistic.

By contrast, value investors try to buy shares for which expectations are low. This kind of share has two advantages. Because its shares are cheaply priced they are unlikely to be downgraded by the market and stand a good chance of being upwardly re-rated if things don't turn out to be as bad as the market feared. And because forecasts are invariably wrong, things very often are indeed not as bad as feared.

This is not to say that growth investing is wrong per se, but it is certainly very difficult and best practiced by an investor who also has a good understanding of value. Growth at a reasonable price is as much about the reasonable price as the growth!

James Montier, a behavioural finance expert, wrote at length about the virtues of value investing over growth investing in his excellent book Behavioural Investing. In it, he showed that a simple strategy of buying the most expensive shares (measured by the ratio of share price to earnings per share) led to substantial underperformance of the market while buying the cheapest shares on the same basis has led to substantial outperformance.

His is not a popular approach for two reasons. First, because investors prefer to invest in today's popular story. It makes us feel good to be running with the pack and if we have to pay a higher price for the privilege, well so be it – the extra return we get in years to come will make the price seem reasonable, won't it?

The second reason we favour growth is because we tend to be over-confident about our ability to pick winners. Sadly, there's plenty of empirical evidence that investors are not good at spotting next year's growth.

The final reason why value investing is the safer approach is that dividend income has over time made up a significant proportion of the total return for shares and out of favour shares tend for purely arithmetical reasons to offer investors attractive dividend yields. In the case of Imperial Tobacco, its yield has only been less than 3.5% during a handful of the years since 1996 and at times has yielded as much as 7%.

Investors do not like to adopt a value approach because it can feel like an admission of failure, an acknowledgement that we are not so good at spotting growth and that we have a tendency to follow the crowd and overpay for our investments. But, as the chart of Imperial Tobacco's performance, makes clear, humility can pay rich rewards.

Note the value of an investment and the income from it can go down as well as up, so you may get less than you invested. The ideas and conclusions in this column are the author's own and do not necessarily reflect the views of Fidelity's portfolio managers. They are for general interest only and should not be taken as investment advice or as an invitation to purchase or sell any specific security. Past performance is not a guide to what may happen in the future. Investments in small and emerging markets can be more volatile than more established markets. For funds that invest in overseas markets, changes in currency exchange rates may affect the value of your investment.