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EQUITY ANALYSIS: *Growth Stocks*

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Growth Investing Defined

- ◆ Growth investing is based on the premise that earnings growth drives stock prices and dividend growth.
- ◆ Growth managers screen for companies with high earnings growth rather than low valuations.
- ◆ Other things being equal, growth managers would prefer to buy at a lower price and often trade growth stocks based on relative valuations.
- ◆ Growth investing requires fundamental analysis to determine whether growth rates are sustainable.

Two questions:

1. What do we mean by valuation?
2. What makes stock prices go up?

Valuation—What's a P/E?

- ◆ A stock's valuation is often measured by a price/earnings ratio or P/E.
- ◆ The P/E is defined as the current stock price divided by earnings per share.
- ◆ Investors typically start with Wall Street analysts' consensus estimates of expected earnings for either the current year or the following year to calculate a P/E.
- ◆ Consensus estimates are widely disseminated and a good proxy for market expectations. However, estimates are not always right!

Valuation—What's the **right** P/E?

Deciding the appropriate P/E for a stock is, in the end, a matter of judgment.

Some general guidelines:

- ◆ Price/earnings ratios will be higher,
 - the higher the level of expected earnings growth.
 - the lower the volatility of that growth.
 - the longer growth can be sustained.
 - the more consistent growth has been historically.

What makes stocks go up?

Price appreciation occurs when

- ◆ over time the P/E rolls forward to the following year.
- ◆ the P/E expands.
- ◆ consensus earnings estimates go up.

Stock price appreciation for growth investors

- ◆ Growth investors rely mainly on above-average earnings growth for stock price appreciation.
- ◆ P/E expansion and upward earnings revisions can enhance returns even further.

How stock prices appreciate

Example: P/E rolls forward to the following year.

	Current Year	Next Year
Earnings per Share Estimate	\$1.00	\$1.50
P/E	20	20
Stock Price	\$20	\$30

Price Appreciation: 50%

Assumes P/E remains the same.

Buying growth stocks: Fundamental analysis

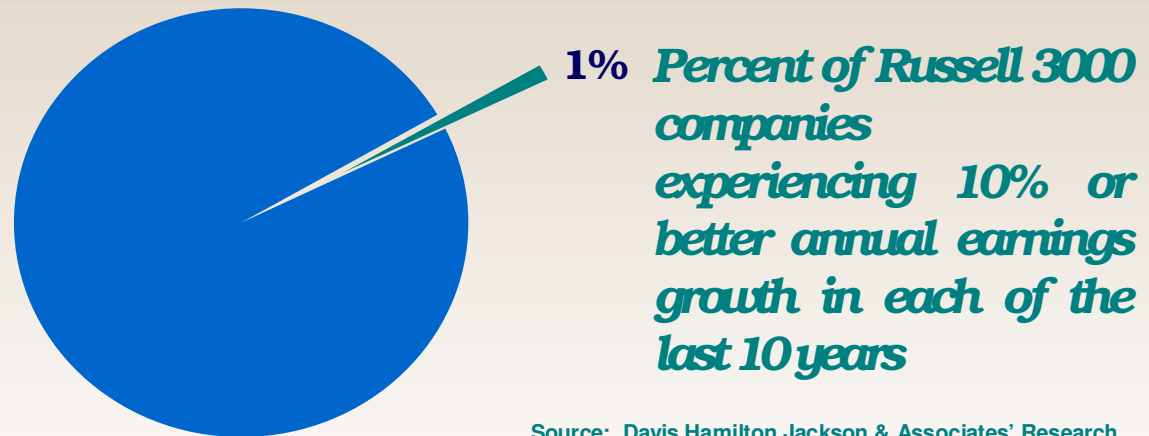
The growth investor evaluates

- ◆ sustainability of growth.
- ◆ the potential for upward earnings revisions.
- ◆ current valuations with respect to history and fundamental outlook.
- ◆ expectations embedded in the stock.

*Very few companies achieve
sustainable long-term
above-average growth.*

The Problem for Growth Stock Investors

In the real world, there are actually very few sustainable above-average growth companies.



Furthermore, any anticipation of slowing growth causes P/E's to compress, offsetting the benefits of earnings growth.

So What's A Growth Stock Investor To Do?

Russell 3000

Companies whose earnings have grown by at least 10% each of the last 10 years

Affiliated Comp Services

Applebee's Int'l

Automatic Data Proc

Autozone

Bed Bath & Beyond

Cardinal Health

Corvel

DeVry

Donaldson

Express Scripts

Fannie Mae

Fifth Third Bancorp

Fiserv

Freddie Mac

Harley-Davidson

Kohl's

MBNA

Medtronic

Patterson Dental

SEI Investments

Sonic

Starbucks

Sungard Data Systems

Synovus Financial

Total System Services

Walgreens

Buying growth stocks: What to look for

Find sustainable above-average long-term growth

- ◆ Companies who constantly reinvent themselves – [Fisher Scientific](#), [Danaher](#)
- ◆ Unique stories – [Whole Foods](#), [Getty Images](#)

Find accelerating growth by looking for change

- ◆ Shift to higher growth trajectory
- ◆ Acceleration above historical trendline
 - Business mix change – [Monsanto](#)
 - New product – [Rockwell](#)
 - Change in industry dynamics – [Burlington Northern](#)
 - Change in management – [C.R. Bard](#)
 - Change through acquisitions – [CVS](#)

Selling growth stocks: When to sell

A growth stock will often look expensive on a P/E basis.

How do you know when to sell?

- ◆ Sustainability of future growth is in question.
- ◆ Potential for further upwards earnings revision is limited.
- ◆ Expectations for the stock or industry become unrealistically high.