Printer Friendly Version

# Growth Stocks vs. Value Stocks

Investors are often confused about the differences between growth stocks and value stocks. The main way in which they differ is not in how they are bought and sold, nor is it how much ownership they represent in a company. Rather, the difference lies mainly in the way in which they are perceived by the market and, ultimately, the investor.

Growth stocks are associated with high-quality, successful companies whose earnings are expected to continue growing at an above-average rate relative to the market. Growth stocks generally have high price-to-earnings (P/E) ratios and high price-to-book ratios. The P/E ratio is the market value per share divided by the current year's earnings per share. For example, if the stock is currently trading at $52 per share and its earnings over the last 12 months have been $2 per share, then its P/E ratio is 26. The price-to-book ratio is the share price divided by the book value per share. The open market often places a high value on growth stocks; therefore, growth stock investors also may see these stocks as having great worth and may be willing to pay more to own shares.

Investors who purchase growth stocks receive returns from future capital appreciation (the difference between the amount paid for a stock and its current value), rather than dividends. Although dividends are sometimes paid to shareholders of growth stocks, it has historically been more common for growth companies to reinvest retained earnings in capital projects. Recently, however, because of tax-law changes lowering the tax rate on corporate dividends (through 2012), even growth companies have been offering dividends.

At times, growth stocks may be seen as expensive and overvalued, which is why some investors may prefer value stocks, which are considered undervalued by the market. Value stocks are those that tend to trade at a lower price relative to their fundamentals (including dividends, earnings, and sales). Value stocks generally have good fundamentals, but they may have fallen out of favor in the market and are considered bargain priced compared with their competitors. They may have prices that are below the stocks' historic levels or may be associated with new companies that aren't recognized by investors. It's possible that these companies have been affected by some problem that raises some concerns about their long-term prospects.

Value stocks generally have low current price-to-earnings ratios and low price-to-book ratios. Investors buy these stocks in the hope that they will increase in value when the broader market recognizes their full potential, which should result in rising share prices. Thus, they hope that if they buy these stocks at bargain prices and they eventually increase in value, they potentially could make more money than if they had invested in higher-priced stocks that increased modestly in value.

Growth and value are styles of investing in stocks. Neither approach is guaranteed to provide appreciation in stock market value; both carry investment risk. The return and principal value of stocks fluctuate with changes in market conditions. Shares, when sold, may be worth more or less than their original cost. Investments seeking to achieve higher rates of return also involve a greater degree of risk.

Growth and value investments tend to run in cycles. Understanding the differences between

them may help you decide which may be appropriate to help you pursue your specific goals. Regardless of which type of investor you are, there may be a place for both growth and value stocks in your portfolio. This strategy may help you manage risk and potentially enhance your returns over time.

The information in this article is not intended to be tax or legal advice, and it may not be relied on for the purpose of avoiding any federal tax penalties. You are encouraged to seek tax or legal advice from an independent professional advisor. The content is derived from sources believed to be accurate. Neither the information presented nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. This material was written and prepared by Emerald. © 2012 Emerald Connect, Inc.