'Growth Traps' Outnumber 'Value Traps': GMO

By Ben Inker *Thu, May 26, 2022*

About 30% of stocks in the MSCI US Value index underperform that index by 9% on average in a typical year, writes our guest columnist. But about 37% of the MSCI US Growth index underperform by an average of 13%.

What do Netflix, Peloton Interactive, Coinbase, and Palantir Technologies have in common? I admit it isn't a particularly challenging question. As anyone who has been following the US stock market in the last 10 months knows all too well, they are all US large cap growth stocks that have lost more than 50% of their value from their 2021 highs, actually well more than 50%.

[Note: This guest column is a condensed version of a longer article, available at the GMO **site**.]

But I'd like to point out that they have something else in common that should be more broadly concerning for investors. They are all growth traps. Growth traps are a subset of the growth universe and get much less attention than their cousins, value traps, despite my attempt to call attention to them in the 2Q 2021 GMO Quarterly Letter, "Dispelling Myths in the Value vs. Growth Debate."

That is a shame, because investors would be well advised to recognize the damage growth traps can do to their portfolios. I'd like to offer a quick refresher on growth traps, why they are so painful, and why I believe they are probably going to continue to snap shut painfully on investors' portfolios for some time yet to come.

My Quarterly Letter last summer defined a trap as a company in either the value or growth universe that both disappointed on revenues in the last 12 months and saw its future revenue forecast decline as well. When it occurs to a stock in the value universe, it is a value trap.

Investors seem to believe value traps teem in the portfolios of value managers and that those value traps cause massive damage to those portfolios when they appear. While I would love to tell you that the investors are dead wrong on those presumptions, sadly, they are pretty close to spot on. In a typical year, about 30% of stocks in the MSCI US Value index turn out to be value traps, and they underperform that index by 9% on average.

But what seems to be somewhat less well known is that growth traps are both more common and more painful than their value brethren, with a prevalence of about 37% of the MSCI US Growth index and an underperformance of 13% on average.

The fact that growth traps are more painful than value traps is, in one sense, not really a surprise. Value stocks are already companies that investors don't have particularly high hopes for. They trade at lower-than-average multiples by definition. The fact that a company trades at lower-than-average multiples certainly doesn't mean it can't fall when its fundamentals disappoint, but it does generally mean that the pain isn't compounded too severely by falling valuations as well.

For a growth stock, however, a disappointment in the performance of the company is extremely likely to result in a falling valuation multiple. After all, these are exactly the companies that the market has awarded higher-than-average multiples because of outsized expectations of their growth prospects. When those prospects deteriorate, valuations almost invariably fall significantly, often precipitously.

Some of the pain was inflicted by a generic de-rating that hit the growth universe this year pretty indiscriminately. But a lot of it was driven by growth stocks that fundamentally underperformed investor expectations—growth traps. These growth traps actually had their worst showing on record relative to the growth universe. This fact should be of interest to market historians and, I will admit, it is also a source of some satisfaction for those investors who positioned their portfolios to be short growth stocks a year ago.

But what should be of note to all investors whatever their positioning is that conditions today suggest that it is likely there will be more growth traps in the next year than there were in the last one and there is good reason to believe their underperformance will remain worse than usual until a full unwinding of the growth bubble occurs.

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