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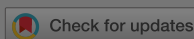
Equity Investments

Fundamentals of Value versus Growth Investing and an Explanation for the Value Trap

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Notes

¹ This article draws on Penman and Reggiani (2013); Penman, Reggiani, Richardson, and Tuna (forthcoming); and Penman and Zhang (2018) – papers that connect earnings growth to the market value of firms. For more on the link between earnings growth and firm value, see also the special issue of *Journal of Applied Corporate Finance*, Volume 29, Number 4.

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³ Earnings are calculated as the sum of earnings before taxes and the provision of taxes, divided by the effective tax rate. We use the effective tax rate calculated in the prior year to calculate earnings for the current year. We use the effective tax rate calculated in the current year to calculate earnings for the prior year. Earnings are calculated for companies with stock prices greater than \$1.00. For companies that are



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¹⁶ Because added investment from retention in the first year ahead adds to earnings growth two years ahead, we also calculated the residual earnings growth rate two years ahead to subtract for the added investment. Residual earnings were calculated as earnings with a charge against beginning-of-period book value at the prevailing yield on the 10-year US government note. Results were similar. Portfolios were formed on the basis of [redacted] and E/P in

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¹⁸ For the weighted average, we used the following weights: 10% for the first group, 20% for the second group, 30% for the third group, and 40% for the fourth group.

portfolio relative to price. The market earnings are total earnings for all companies relative to price.

¹⁹ The earnings betas here are consistent with the findings of Cohen et al. (2009) and Campbell et al. (2010), who attributed the higher returns of value stocks to higher “cash flow betas”—that is, the sensitivity to news about future cash flows.

²⁰ A similar table (with decile portfolios) can be found in Penman et al. (forthcoming).

²¹ In Table 2, B/P is positively correlated with subsequent earnings growth conditional on E/P. However, Penman et al. (forthcoming) reported that B/P is unconditionally positively correlated with subsequent earnings growth. Chen (2017) reported that low-B/P stocks do not have significantly higher dividend growth than high-B/P stocks.

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