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Value versus growth investing: Why do different investors have different styles?[☆]

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ABSTRACT

We find that several factors explain an individual investor's style, i.e., the value versus growth orientation of the investor's stock portfolio. First, we find that an investor's style has a biological basis and is partially ingrained in an investor from birth. Second, we show that an investor's hedging demands as well as behavioral biases explain investment style. Finally, an investor's style is explained by life course theory in that experiences, both earlier and later in life, are related to investment style. Investors with adverse macroeconomic experiences (e.g., growing up during the Great Depression or entering the labor market during an economic recession) or who grow up in a lower socioeconomic status rearing environment have a stronger value orientation several decades later. Our research contributes a new perspective to the long-standing value and growth debate in finance.
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1. Introduction

The concepts of value and growth investing have a long history in financial economics. Today, some 2,050 value funds and 3,200 growth funds cater to investors with preferences for these investment styles.[1] For more than two decades, Morningstar has provided a Value-Growth Score to help investors choose a fund with their preferred style. Fidelity, the world's largest provider of employer-sponsored retirement plans such as 401(k) plans, prominently features a

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description of value and growth funds on their Learning Center website.[2] There are best-selling books about both value and growth strategies, and countless business magazine articles boast recommendations about the "best value funds" or the "best growth funds." Wall Street professionals are educated about value and growth investing already in business school, with many Master of Business Administration (MBA) programs today offering, e.g., value investing courses. Most important, from the perspective of academic research, one of the most debated issues in the past several decades is the differential returns of investments in value versus growth stock portfolios, that is, the value premium debate (e.g., De Bondt and Thaler, 1985; Fama and French, 1992, 1993, 1996; Lakonishok, Shleifer, and Vishny, 1994; Daniel and Titman, 1997).[3]

Despite all this attention to value and growth investing, little research has attempted to explain the determinants of an individual's investment style (e.g., Kumar, 2009a). That is, why are some investors relatively more value oriented, while others are more growth oriented? In this paper, we argue that differences in investment styles across individuals, in principle, stem from two non-mutually exclusive sources: a biological predisposition that translates into a preference for value or growth stocks and environmental factors that determine an individual's portfolio tilt with respect to value and growth.

In recent years, individual characteristics of importance for portfolio choice, e.g., having a propensity to take financial risk or exhibiting investment biases, have been shown to be partly explained by an individual's genetic composition (e.g., Cesarini, Dawes, Johannesson, Lichtenstein, and Wallace, 2009; Barnea, Cronqvist, and Siegel, 2010; Cesarini, Johannesson, Magnusson, and Wallace, 2012; Cronqvist and Siegel, 2014). As a result, we hypothesize that an individual's investment style has a biological basis, i.e., a preference for value versus growth stocks could partially be ingrained in an investor from birth. We begin our empirical analysis by assessing whether and to what extent variation in investment style across individual investors correspond to genetic variation across these investors.

We then examine which individual characteristics explain investment style and relate the evidence to portfolio choice and asset pricing models that account for the value premium (e.g., Fama, 1996; Larsen and Munk, 2012; Gârleanu, Kogan, Panageas, 2012), as in the empirical investigation of household portfolio choices in Betermier, Calvet, and Sodini (2014). In rational models, differences in portfolio holdings are generally determined by investors' hedging demands. Behavioral models of the value premium, meanwhile, suggest that the value premium arises due to overreaction or excessive extrapolation of past performance or due to non-standard preferences.

Finally, based on life course theory, an approach to research in social psychology and neuroscience,[4] which has recently made its way into finance research (e.g., Kaustia and Knüpfer, 2008; Malmendier and Nagel, 2011, 2013; Schoar and Zuo, 2013), we hypothesize that an individual's specific life experiences affect behavior, including the individual's investment style, later in life. We consider several potentially relevant, and plausibly exogenous, life experiences of individuals. We analyze whether experiencing an adverse and significant macroeconomic event, e.g., growing up during the Great Depression, affects an individual's value versus growth orientation. We also analyze the impressionable years during an individual's life course, e.g., the economic conditions when an individual entered the labor market for the first time. Finally, we also examine the socioeconomic status (SES) of the rearing environment in which the individual grew up.

The experience of Benjamin Graham and T. Rowe Price, Jr., constitute a colorful illustration of some of our hypotheses. Graham is commonly dubbed the "father of value investing" because he preferred stocks with comparatively low valuation ratios and other characteristics that subsequently came to define value investing. Price, the founder of the large money management company with his name, is often referred to as the "father of growth investing" because of his preference for companies characterized by strong earnings growth, research and development (R&D) intensity, and innovative technology. Their different investment styles could very well have a biological basis, but this is not possible to investigate without data on their genetic differences. Graham grew up very poor, with his father passing away unexpectedly when he was young and his mother losing the family's savings in the stock market crash known as the Panic of 1907. Among his brothers, Graham was often tasked with bargain hunting at different grocery stores (e.g., Carlen, 2012). In comparison, Price had a privileged upbringing, his father being an medical doctor who served as a surgeon his entire professional career for a rapidly expanding railroad company, a growth company at that time. We hypothesize that such differences in life experiences can contribute to differences in investment styles later in life.

Our research contributes a new perspective to the long-standing value versus growth debate in finance. First, an investor's style has a biological basis. A preference for value versus growth stocks is partially ingrained in an investor already from birth. We estimate that genetic differences across individuals explain about 26% of the variation in value versus growth orientation, if using price-to-earnings (P/E) ratios as an investment style measure, and about 27% if using Morningstar's Value-Growth Score. Second, we examine which individual characteristics explain investment style. Concurring with prior household finance evidence supporting risk-based theories of the value premium (e.g., Betermier, Calvet, Sodini, 2014), we find that investors' hedging demands related to human capital and displacement risk as well as behavioral biases in form of a preference for speculative assets contribute to investment style. Finally, an investor's style is explained by life course theory in that experiences, both earlier and later in life, are related to investment style. In particular, investors

[2] See https://www.fidelity.com/learning-center/mutual-funds/growth-vs-value-investing.

[3] The value premium debate has not been limited to only the US stock market. It extends to several international stock markets (e.g., Chan, Hamao, and Lakonishok, 1991; Fama and French, 1998; Daniel, Titman, and Wei, 2001) and also to other asset classes (e.g., Asness, Moskowitz, and Pedersen, 2013). We refer to Fama and French (2012) for recent empirical evidence on the prevalence of a value premium in international stock markets.

[4] For further details and references related to life course theory, see, e.g., Giele and Elder (1998) and Elder, Johnson, and Crosnoe (2003).

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