Why High Growth Stocks Like Netflix (NFLX) are Risky

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"High risk investments have higher rewards."

You've heard this your whole life, but what if I told you it's completely wrong.

One area that I feel has improved greatly over the past few years is the way I think about and manage risk.

Ben Graham has always been a big influence, as well as Walter Schloss, Seth Klarman but most of all Howard Marks in the area of risk.

In his latest memo where he revisits the topic of risk, there's an interesting graph that sums up why we've been wrong in thinking that higher risk equals higher return.

Here's a graph of the traditional thinking.

> *The line slopes upward to the right, meaning the two are "positively correlated": as risk increases, return increases.*
>
> *In both the old memo and the book, I went to great lengths to clarify what this is often – but erroneously – taken to mean. We hear it all the time: "Riskier investments produce higher returns" and "if you want to make more money, take more risk."*
>
> **Both of these formulations are terrible. In brief, if riskier investments**

Risk Equals Reward | Source: Oaktree

> *could be counted on to produce higher returns, they wouldn't be riskier.*

And here's the actual graph that portrays a better view of reality when it comes to defining risk with reward.

> *Investments that seem riskier have to **appear** likely to deliver higher returns, or else people won't make them.*

The word "appear" is important because the last vertical line shows you that the higher the risk, the larger the range of return possibilities.

Recall the phrase Charlie Munger parrots all the time:

The True Definition of Risk and Reward | Source: Oaktree

> *Invert, always invert.*

Instead of "higher risk leads to higher returns", the inverse is that higher risk can also lead to higher losses as the graph above shows.

Howard Marks goes on to say:

> - *the expected return increases (as with the traditional graphic)*
>
> - *the range of possible outcomes becomes wider, and*
>
> - *the less-good outcomes become worse.*
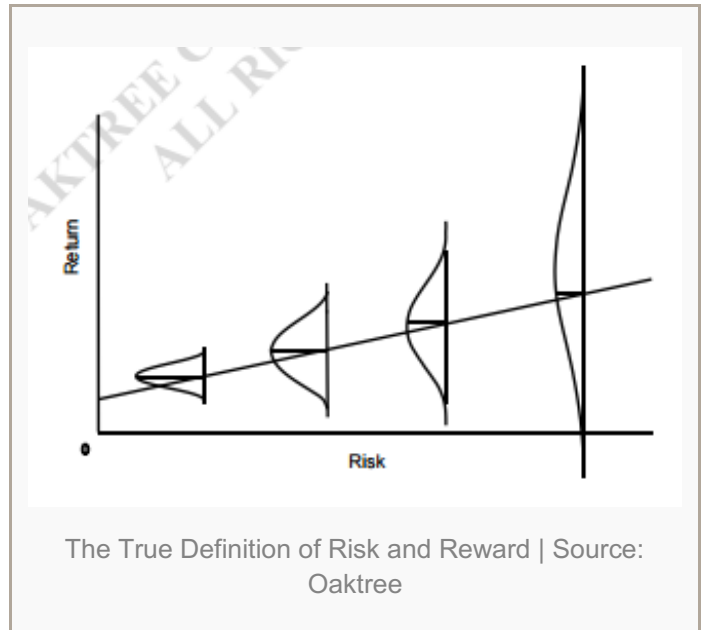
Why Netflix is a Risky Stock

One area of risk comes from paying for too much growth.

In a 2013 letter to investors, Seth Klarman's wrote about the speculative valuation of Tesla (TSLA) and Netflix (NFLX).

And if you haven't looked at NFLX, it's piercing the clouds and at all time highs.

In terms of the business, Netflix is fantastic.

Their demand has surged, they are finding ways to grow further, and penetration into new markets are a huge success. In Australia, the demand has been so strong that ISP's are hurting badly from the heavy usage.

But expected earnings growth of 142% from analysts?

The industry long term growth is currently at 8.2% and while that number includes all sorts of companies bundled together, a growth rate of 142% is extreme and puts NFLX on the last bar of the graph.

So far the returns have been phenomenal.

Up 93% YTD.

I'd be lying if I said I don't want that type of gain.

But right now, is that risk worth it?

Where on the return scale will you be at current prices? Towards the middle of the band? At the top? Below the line?


NFLX Risk vs Return

One way to get a clear picture is to do a simple valuation and refer to a sensitivity matrix.

It's a simple matrix version of Howard Marks graph.

How To Tell The Risk Level of a Company With Numbers

Since there is no mathematical formula for risk, I use a simple method of checking how much the valuation number changes if I change growth or the discount rate by 1-2%.

If the valuation of a stock doesn't change much, that company is mostly likely undervalued
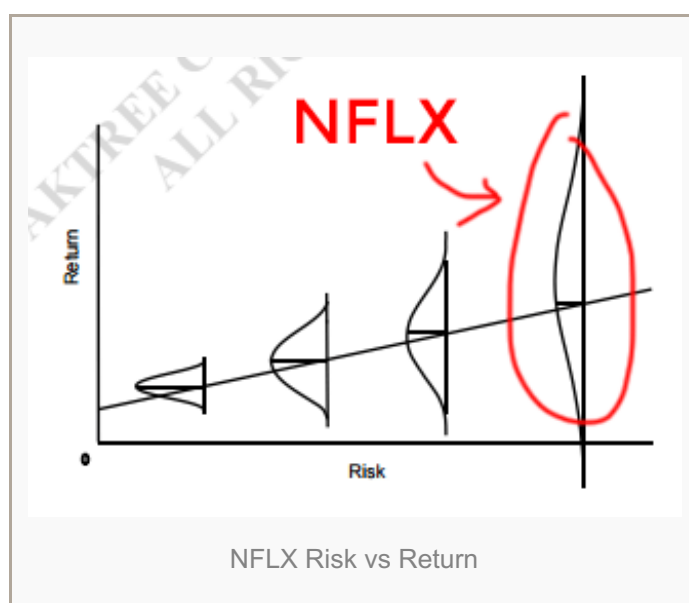
from a numbers standpoint.

When there are big differences just by changing the growth rate just a couple of percentages, that shows the risk and the range of possibilities are higher.

The first thing to do is to do a perform a **reverse Discounted Cash Flow** with the current earnings or net income to show what the market is currently expecting from the stock.

For Netflix, the reverse DCF shows the expected growth rate is 45%.

Netflix Reverse DCF Numbers

45% is not as bad as 142% that analysts are expecting, but is 45% a "safe" growth rate?

Here's the sensitivity matrix I'm talking about that gives a numbers representation of how safe the valuation is.

Sensitivity Matrix: Growth vs Discount Rate

The number in the middle is the fair value using the reverse engineered 45% growth rate.

When the growth rate decreases 2% to 43%, the intrinsic value decreases $71 to $588.

When the growth rate increases 2% to 47%, the intrinsic value increases by $78 to $737.

Same thing applies if the discount rate is changed with the growth rate fixed at 45%.

A 10% discount rate decreases the value to $592 and an 8% discount rate increases the value to $734.

The thing to note are the big jumps here.

Sensitivity Matrix: Margin of Safety %						
			Discount Rates			
		7%	8%	9%	10%	11%
	41%	-0.9%	-12.6%	-25.2%	-38.8%	-53.4%
	43%	10.1%	-0.4%	-11.8%	-24.2%	-37.4%
Growth Rates	45%	19.9%	10.4%	0.1%	-11.1%	-23.1%
	47%	28.5%	20.0%	10.7%	0.6%	-10.3%
	49%	36.2%	28.5%	20.1%	11.0%	1.1%

Sensitivity Matrix: Percentage Form

In percentage form, everything are in 10% increments.

That means if you are wrong by just a small margin, your expected value is wrong by 10% at a minimum.

That's where focusing on the downside plays such a big role.

Growth and Value Investing

Growth is a vital part of investing. I just prefer to pay as little as possible for growth.

In fact here's what Buffett wrote in his 1992 letter that sums up this article.

> *most analysts feel they must choose between two approaches customarily thought to be in opposition: "value" and "growth." Indeed, many investment professionals see any mixing of the two terms as a form of intellectual cross-dressing.*
>
> *We view that as fuzzy thinking (in which, it must be confessed, I myself engaged some years ago).*
>
> *In our opinion, **the two approaches are joined at the hip: Growth is always a component in the calculation of value**, constituting a variable whose **importance can range from negligible to enormous and whose impact can be negative as well as positive**.*

That's exactly what Howard Marks is talking about.

If you were playing a game where the odds of winning are 1000:1 but you could win $1m,

would you take it?

Or would you prefer to play a game where the odds of winning are 50:1 with the prize being $1,000?

Sure.

It's an oversimplified example.

But the question is whether you'd go for the stock with limited upside, that also protects your downside, or the high upside, high downside stock?

Me?

I've chased plenty of the stocks on the far right end and felt the merciless punishment as the stock reversed and went the wrong direction for a mile, then another mile.

I prefer to to look for stocks in the 2nd or 3rd bell curve where the upside is lower, but the downside is much lower as well.

My Preferred Investment Area