



Growth investing beyond P/E ratio - What you should really look at

For decades, growth investing has rested on a seductive but flawed shortcut: if a stock is expensive, it must be growing. This logic, embedded in mainstream indices from Russell to MSCI to S&P, sorts the equity universe into two bins - value for the cheap, growth for the expensive - leaving little room for companies that are both fast-growing and reasonably priced, or conversely, slow-growing yet still highly valued. The costs of this binary classification are not merely theoretical.

Arnott et al. (2026) document that the correlation between a stock's valuation multiple and its actual fundamental growth rate is strikingly low. Among the top 1,000 US companies by market capitalisation at end-2024, a large proportion of those labelled growth by conventional indices are growing slowly, while many genuinely fast-growing companies carry moderate valuations. The implication is uncomfortable: billions of dollars allocated to growth mandates may be systematically buying the wrong stocks. This concern is not new. Lakonishok, Shleifer, and Vishny (1994) were among the first to show that markets systematically mislabel fundamentally weak but expensive stocks as growth companies, conflating genuine business expansion with what they termed glamour stocks - a distinction that has only grown more consequential as passive index flows have scaled.

A more disciplined framework begins with a simple question: is this business actually growing? Growth, properly understood, shows up in financial statements before it shows up in prices. The authors identify three fundamental measures that are fully independent of price: growth in sales per share, capturing market expansion; growth in research and development (R&D) expenditure, capturing innovation investment; and growth in gross profitability, capturing operational efficiency improvement. The choice of gross profitability follows the logic of Novy-Marx (2013), who demonstrated that top-of-income-

Vuong Vu Nguyet Minh
Junior Quant Analyst
Quantphemes

Ho Law
PhD
Quantitative Researcher
Quantphemes
mark.law@quantphemes.com

Andrew Mack
PhD
Director of Research
CASH Algo Finance Group
andrew.mack@cshalgo.com

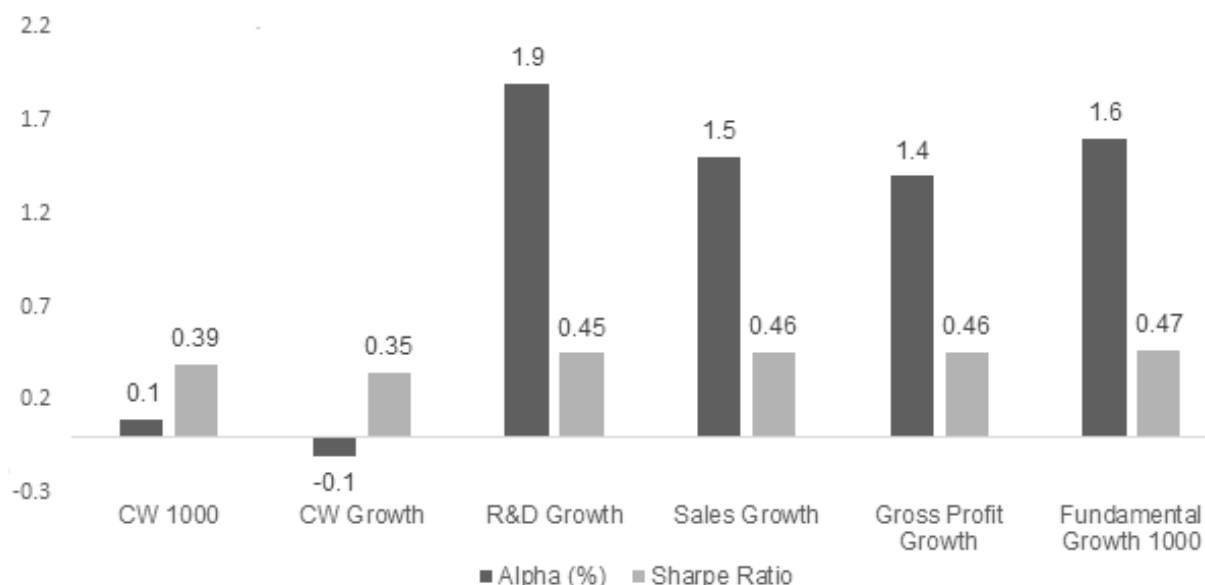
Prof Alfred Ma
PhD, CFA
Director
CASH Algo Finance Group
alfred.ma@cshalgo.com

statement measures are cleaner signals of business quality precisely because they are less distorted by the accounting choices that affect net income and cash flow figures lower down.

The construction methodology follows naturally from this philosophy. Stocks are selected based on the rate at which these fundamentals are improving - the five-year percentage change in each measure, normalised by initial sales per share - and weighted in the portfolio according to the absolute magnitude of that improvement, not according to market capitalisation. A company with a high P/E ratio does not automatically qualify; a company with modest valuation multiples but exceptional revenue growth is fully eligible. The three signals are then blended into a composite growth score, which Arnott et al. (2026) show to be more robust than any individual measure in isolation.

Arnott et al. (2026) construct and test this approach, which they call the Fundamental Growth 1000 (FG 1000) portfolio, over the full period from March 1969 to December 2024, a span of 55 years. Figure 1 below compares the CAPM alpha and Sharpe ratio of each portfolio type across the sample. Among the individual signals, R&D growth posts the highest raw CAPM alpha at 1.9%, while Sales Growth and Gross Profit Growth each deliver Sharpe ratios of 0.46. However, the composite FG 1000 achieves the highest Sharpe ratio of all at 0.47, alongside a CAPM alpha of 1.6% (t-statistic = 3.5). This is the central argument for combining signals: no single fundamental measure dominates on a risk-adjusted basis across all market conditions, and the composite - by diversifying across innovation, revenue growth, and profitability, delivers more consistent outperformance than any individual signal in isolation. The conventional cap-weighted growth index, by contrast, returned 10.7% annually with essentially zero CAPM alpha and a Sharpe ratio of just 0.35.

Figure 1: CAPM Alpha and Sharpe Ratio by Portfolio, Mar 1969 to Dec 2024



Source: Research Affiliates; data from CRSP/Compustat.

A key strength of the Arnott et al. (2026) framework is its transparency about the source of returns. Following the return decomposition methodology of Brightman, Clements, and Kalesnik (2017), which breaks portfolio log returns into three components - income return, earnings per share (EPS) growth, and valuation change - the outperformance of the fundamental growth portfolio is driven overwhelmingly by superior EPS growth, with negligible or slightly negative contributions from valuation expansion. The fundamental growth portfolio does not benefit from rising price-to-earnings multiples; the excess return reflects genuine business value creation, making it far more likely to persist than returns driven by sentiment-driven re-rating.

The historical episode of the dot-com bubble illustrates this distinction vividly. During the technology mania of the late 1990s, the conventional cap-weighted growth index surged as investors paid ever-higher multiples for companies with limited revenues and no profits. The Arnott et al. (2026) fundamental growth portfolio participated in some of that rise, but more modestly, because its inclusion of technology companies was constrained by the requirement to demonstrate actual growth in observable fundamentals. When the bubble burst between 2000 and 2003, the conventional growth index gave back enormous gains, while the fundamental growth portfolio continued to build on its prior position. Over the full 55-year span, an investor in FG 1000 ends up more than twice as wealthy as one who simply held the traditional growth index.

Arnott et al. (2026) also examine how portfolio concentration affects performance. When the universe is narrowed to the top 500, 250, or 100 companies by composite growth rate, annualised returns rise to 12.7%, 13.4%, and 15.3% respectively. The four-factor alpha for the most concentrated FG 100 version reaches 6.4% with a t-statistic of 4.9. Sharpe ratios remain broadly stable across concentration levels, suggesting that the higher returns at greater concentration come with proportionally higher volatility - a trade-off that practitioners must weigh against capacity constraints in their specific mandates.

Perhaps the most practically valuable finding of Arnott et al. (2026) concerns the strategy's behaviour during periods of market stress. Segmenting the sample by idiosyncratic volatility, VIX levels, financial stress conditions, and economic policy uncertainty, the authors find a consistent pattern: outperformance is significantly larger in high-stress environments. During periods of elevated idiosyncratic volatility, FG 1000 outperforms the cap-weighted market by 3.1% annually, compared with just 0.1% in calmer periods. This countercyclical property - often described as crisis alpha - is rare among systematic equity strategies and directly addresses one of the central criticisms of factor investing, namely that factors tend to underperform precisely when investors most need protection.

Arnott et al. (2026) further test the generality of their approach by applying the identical methodology to the United Kingdom, Europe ex-UK, and Japan over the period from 1991 to 2024. Fundamental growth portfolios outperform their cap-weighted equivalents in all three regions. The results are strongest in Japan, where the FG 85% portfolio delivers an annualised return of 5.8% against a cap-weighted market return of 2.7%, with a CAPM alpha of 3.1% ($t = 4.1$). Results in the UK and Europe

are economically meaningful but fall short of statistical significance, partly reflecting the shorter available sample and differences in accounting conventions around R&D capitalisation.

On transaction costs, Arnott et al. (2026) are thorough. The FG 1000 portfolio turns over approximately 17% of its holdings annually - only modestly higher than the 12% turnover of a conventional growth index. At realistic estimates of trading costs for liquid large-cap equities, the annual performance drag is well below 20 basis points, negligible relative to the strategy's alpha. Transaction costs would need to reach an implausible 9% per dollar traded before the advantage disappeared entirely.

The broader message is clear: if an investor wishes to own growth companies, they should define growth using the fundamental characteristics of the business, not the price the market currently assigns to it. Expensive stocks are not, by virtue of their expense, growing companies; and excluding cheap but fast-growing companies from a growth mandate serves no investor well. The data, across half a century and multiple geographies, suggest that reducing price dependence in both the selection and weighting of a growth portfolio is not merely a theoretical preference, but a practically superior approach to growth investing. Whether the structural mispricing that enables this advantage, partly sustained by the scale of passive flows into cap-weighted growth indices, persists as the investor landscape continues to evolve remains an important open question that merits further investigation.

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