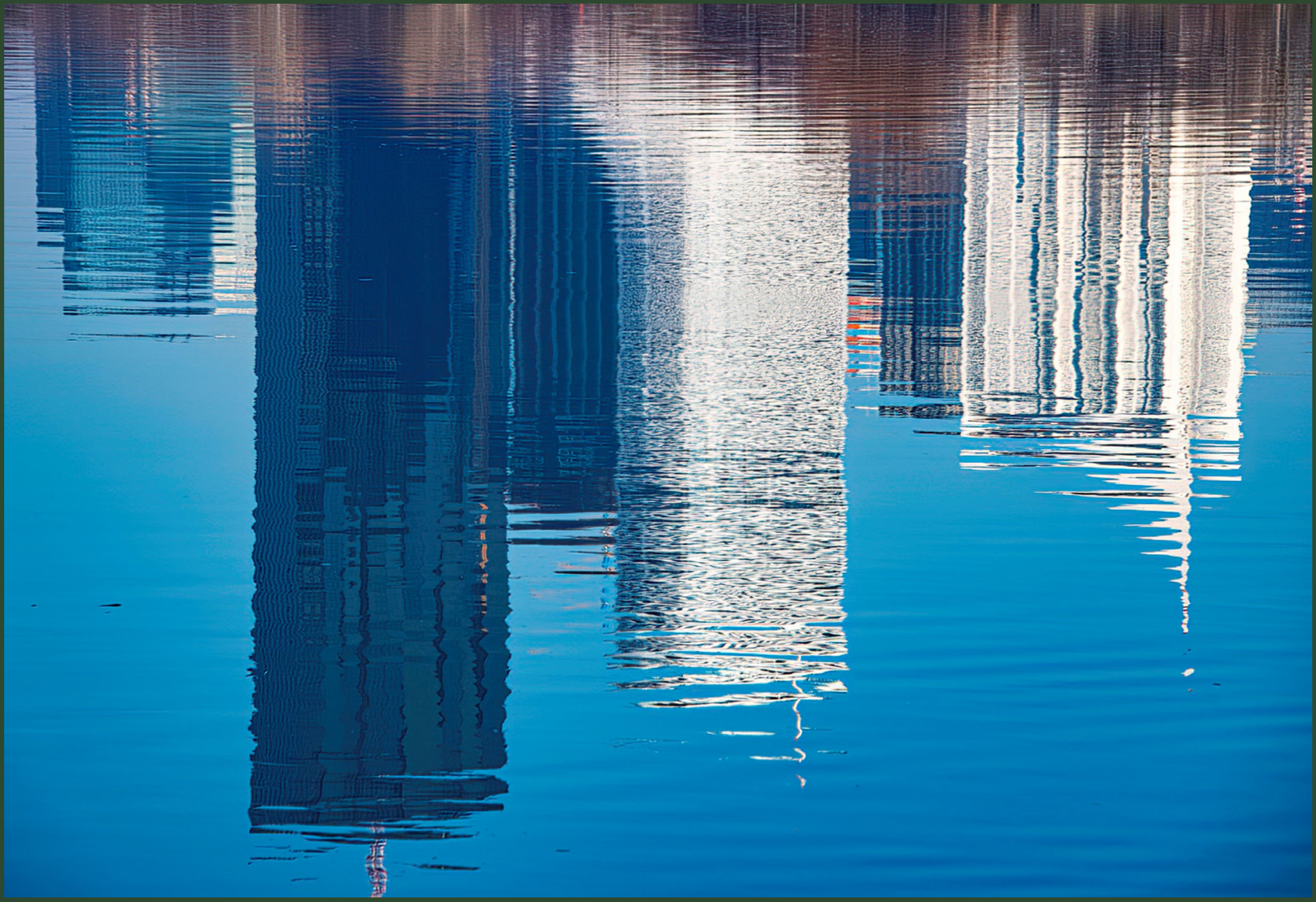
The Growth Trap: When Strong Narratives Meet Soft Returns

By Paul Ehrlichman

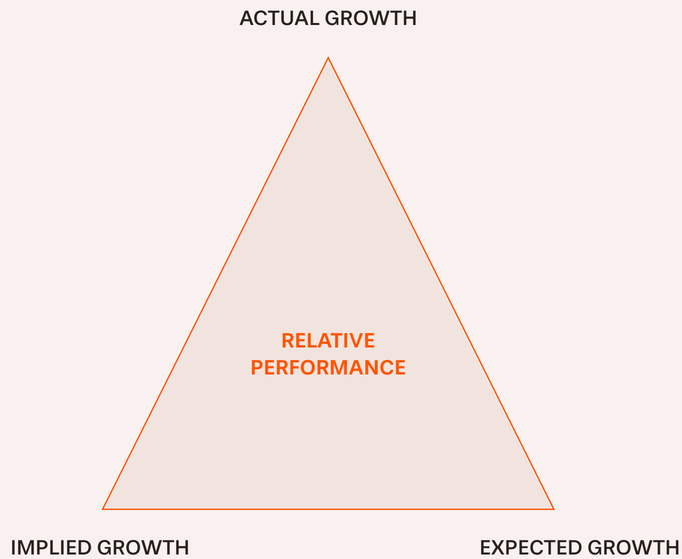


FLEXTION It's about *time.*

In a previous post, we explored how value investing can outperform in environments dominated by uncertainty and pessimism (When Doubt Reigns, Value Wins). In this month's post, we are highlighting the flip side: growth investing—and the less obvious risks that emerge, not from doubt, but from certainty.

When optimism is high and growth appears inevitable, investors are more likely to fall into what's known as a growth trap—**a scenario where expectations are so elevated that even great companies underdeliver relative to their share price.** These traps can last years, even decades.

Warren Buffett once reflected on such a moment with Coca-Cola. By 1998, the stock was trading at 11x sales and over 50x earnings. Despite continued earnings growth, it took 16 years for the stock to recover its peak price. The issue wasn't fundamentals, it was expectations. The market had already priced in perfection.



The Behavioral Dynamic: Actual vs. Expected vs. Implied

The Coca-Cola case reveals a crucial truth in investing: success isn't just about growth, but about how the market prices that growth shaped by the dynamic interaction of three forces.

- **Actual earnings:** what the company delivers.
- **Expected earnings:** what analysts and investors forecast.
- **Implied earnings growth:** what's already baked into the stock price valuation.

For a stock to outperform, actual results must beat expectations, which in turn increases market confidence and lifts implied growth assumptions. But when the reverse happens, the fall can be steep. As researchers Douglas Skinner and Richard Sloan stated in their landmark paper, *Don't Let an Earnings Torpedo Sink Your Portfolio*, "Inferior returns to growth stocks are directly linked to earnings surprises."

This is why understanding implied growth is so important. At Flextion, we use three valuation metrics to estimate it:

- **Price-to-Earnings (P/E)** – Reflects growth expectations.
- **Price-to-Sales (P/S)** – Signals margin assumptions.
- **Price-to-Book (P/B)** – Suggests return on equity assumptions.

Comparing these against peers, benchmarks and the broader market helps identify where high expectations may be setting the stage for disappointment.

The Current Growth Landscape: Cracks Beneath the Surface

From a macro lens, the case for cautious optimism around growth stocks is weakening. In Q4 2024, U.S. corporate profits hit a record $4 trillion, with net margins near 16%—a post-war high. But that strength was highly concentrated, dominated by the so-called Magnificent 7 tech firms. This level of earnings concentration is unprecedented. **Now, the tide appears to be turning:**

- Q1 2025 saw corporate profits decline by $118 billion.
- Over 350 companies in the S&P 500 have had earnings estimates revised downward.
- More than 35% of smaller companies remain unprofitable.
- Tech spending as a share of GDP has surpassed the 2000 dot-com peak.
- Key profit drivers from the last cycle—declining interest rates and tax cuts—are unlikely to be repeated.

In short, while growth remains compelling, the risk of falling short of expectations is rising.

The Flextion View: Broaden and Balance Your Growth Exposure

In this environment, it's not enough to chase compelling narratives; investors need to pay close attention to valuation, implied growth, and the likelihood of earnings surprises.

At Flextion, our manager selection process emphasizes diversified growth exposure across geographies, sectors and company sizes. Global, international and smaller-cap strategies can help mitigate the concentration risks and valuation pressures seen in U.S. large-cap tech.

As we enter what may become a more difficult phase for growth investing, avoiding the "growth trap" will require discipline, awareness and a willingness to question the consensus. **Here is a list of managers and strategies we believe are well-positioned to navigate this evolving landscape.**

- Alger Small Cap Growth
- Matthews Asia Growth
- American Century World: Focused Global Growth
- Fidelity Advisor Equity Growth
- Driehaus Emerging Markets Growth
- MFS Massachusetts Investors Growth Stock
- William Blair Institutional International Growth
- American Century International Growth
- Emerald Insights
- AB Large Cap Growth

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About the Author

Paul Ehrlichman, Flextion's CEO and CIO, has over four decades of experience in portfolio management, leveraging fundamental and quantitative research to develop investment processes and strategies that enhance client returns and manage risks in volatile markets. He has led equity teams focused on global and international value strategies, serving a diverse client base that includes individuals, pension funds, and endowments at several leading global asset managers.

Flextion is a breakthrough platform for evaluating fund strategy returns, helping investors identify managers at a pivotal turning point—those poised to outperform after a period of underperformance. Designed by seasoned portfolio managers, Flextion bridges the gap between "clock time" and "market time," empowering investors to unlock long-term value and uncover hidden performance potential.

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