The Risk of Investing in a High-Growth Stock

In the late 80s through the early 2000's, I trained security analysts in 11 different countries when then folks were preparing to sit for the Chartered Financial Analyst (CFA) exam. The CFA exam is a challenging exam administered over 2-3 years to candidates seeking to enhance their marketability in the financial services industry. Passing the exam provides candidates a solid base of knowledge in security analysis and portfolio management. My experience in teaching such highly technical subjects combined with my practical experience in working with clients over the past 40 years gives me valuable insights into how to evaluate risk.

This essay is a culmination of my training, experience, and research. Please do not think of me as an expert but instead, as a professional who knows what he doesn't know. As a side comment, I found the CFA exam equally as challenging as defending my PhD dissertation. With that caveat, let's jump into the topic at hand—that of analyzing the risk of a high-growth stock.

A little background Supermicro Computer (SMIC). SMCI develops and manufactures high performance server and storage solutions to enterprise data centers, cloud computing, artificial intelligence, and 5G and edge computing markets. The company's high-performance servers use Nvidia's GPU chips to power generative AI capabilities in data centers. Demand for those capabilities is strong for tech giants like Amazon, Meta, and Google. Analysts expect SMCI's revenues to exceed four times what the company produced just 2 years ago. The price of SMCI's stock has risen sharply as a result as shown in the following chart:

Financial theory tells us that projected earnings drive the price of any stock. Let's be clear. There is a big difference between published historical earnings and projected earnings. Financial statements such as the 10K show how much a company has earned over prior time periods, but these statements, compiled by accounting firms that specialize in gathering and publishing financial data for exchange-listed companies, do not include earnings projections. The Security Exchange Commission (SEC) encourages corporate management to give guidance on future earnings but does not require such. When they do, management typically give guidance when conducting earning calls at the end of each quarter with projections over subsequent periods.

Accounting firms employ Generally Accepted Accounting Principles (GAAP) when constructing historical financial statements. Since projections are for the future where earnings have yet to occur, management projections are non-GAAP. In the case of SMCI, their financials for year-end 2023 showed good growth of revenues, rock-solid earnings, and plenty of cash flow. Extrapolating historical trends into the future, which is a commonly used technique for some analysts, can lead to misleading conclusions. Here is where management's guidance takes on great importance depending on the analysts' credibility of that view.

In early 2024, SMIC management gave guidance projecting an unusually high growth rate for 2024 earnings. A well-known and respected analyst opined that the guidance was credible given his independent analysis and the extraordinary interest in AI across the world. Before long both sell side-analysts (individuals who work for hedge funds, pension funds, and mutual funds) as well as buy-side analysts (individuals who produce investment research that is circulated to the investing public) to jump on the bandwagon.

Prior to 2024, SMCI's financials had shown good growth, although not unusually high growth. This trend caught the attention of many analysts on Wall Street. Earnings retained (SMCI pays no dividends) for the purpose of investing in Research and Development combined with large cash allocations to new Plant and Equipment provided a solid foundation that supported management's high-growth projections. The table was set for management's optimistic subsequent announcement and the investing public picked up on it.

The market is incredibly efficient in absorbing information very quickly. Does this mean management's projections will prove to be sustainable? Maybe, but not necessarily! Non-GAAP projections could turn out overly optimistic in the face of headwinds including global economic troubles, US Fed policy keeping interest rates too high for too long that, in turn, choke off economic growth, or SMCI not being able to supply products to meet excessive corporate demand. Because of their high growth expectations, management expanded the company's balance sheet by issuing more stock and taking on significantly more debt. The risk of these moves is great.

Risk is also driven by various external factors. Professional investors could totally miss the boat and end up jumping into a pool with no water. Stocks like SMCI attract speculative investors looking to make a quick buck, and speculators often drive up the price of a high-growth stock to unreasonable heights. Remember the dot-com, boom/bust? Has this happened to SMCI. I don't know! Maybe! Can't tell ahead of time, only after the fact. A final word of caution is to keep in mind that high-growth stocks attract a host of competitors, and SMCI has plenty of them all wanting to grab some of SMCI's market share.

SMCI is a volatile, highly risky stock that has great potential. Investors looking to invest in a stock like SMCI need to approach their decision with a realistic sense of caution. Risk is the key ingredient; expected return is a result of that risk. Looking over their shoulder to see who is breathing down their backs keeps management nervous every day and every night. Constant pressure to grow or die is a tough challenge. From a total portfolio perspective, including a stock like SMCI in a client's portfolio depends on how that inclusion incrementally affects the risk of the overall portfolio. A risky stock viewed in isolation may not significantly affect the overall portfolio risk depending on construction of the remaining part of the portfolio. Making such decisions is why Justin and I have jobs.

I hope this short essay makes sense. Please do not hesitate to call me or Justin with your comments, questions, or just to discuss. All the best,,,,Ron