**Introduction**

**Beware of Growth from Investment**

* **Valuation Principle 4** – Growth that is valued does not come from earnings growth but from residual earnings growth.

**Beware of Earnings Growth and Profitability Generated by Leverage**

**Accounting for Leverage**

**Stock Repurchases and Growth**

**Accounting for Growth from Leverage**

* Although investors are often advised to “buy earnings” and earnings growth, do not buy earnings that simply come from investment growth. Buy residual earnings and residual earnings growth, for these add value.
* When focusing on residual earnings, be wary of leverage. Leverage increases EPS, earnings growth, and ROCE, and it also increases residual earnings. One needs a very good story to buy earnings generated by leverage for leverage typically adds risk but does not add value.
* To protect yourself from paying for leverage, unlever the accounting numbers. Employ an account for value based and net assets that pertain to the business operations rather than levered earnings and book value.
* Beware of levered PB and PE multiples. Leverage typically increases the PB and decreases the PE, but does not change price. Work with unlevered (enterprise) PB and PE ratios.
* Separate out growth from business and growth from leverage. Growth from business adds to value and it is this value that we can use to challenge the market’s speculation about growth.