CREDO WEALTH

Valuation: opportunity or threat?

As active investors, we believe that sometimes events can cause the market to fail to reflect the true value of a company. Over the long term, however, share price performance will always be driven by the underlying earnings. This philosophy is perhaps best summed up in Benjamin Graham's voting and weighing machines analogy: in the short term, the market acts as a voting machine, weighing up which companies are popular and unpopular, but over the long term, the market weighs the actual substance of a company.

One of the phenomena which we have seen in recent months, is just how narrow the band of "popular" stocks has become. These companies include pharmaceutical groups leading the race for a vaccine, consumer groups offering lockdown necessities and most significantly the technology giants which have been boosted by more time spent both working and playing at home. The result is that the S&P 500 is currently the most concentrated it has been since 1980, exceeding even the levels seen at the height of the tech bubble. The combined share price performance of the largest 5 companies, Amazon, Apple, Facebook, Google and Microsoft has been a major driver of the overall index, far outstripping the collective performance of the remaining 495 constituents. Additionally, a large part of this performance has come from rapidly expanding valuation multiples. At the time of writing, Apple's share price has increased almost 60% and its P/E ratio has expanded from 25 times in January to 35 times today. We must question whether, in these circumstances, the market is accurately reflecting the underlying value of the company.

Whilst the coronavirus has wreaked havoc with many companies' business models, the tech giants have thrived. However, we believe that investor enthusiasm has outpaced the fundamentals. The P/E ratio of a company should reflect investors' expectations regarding future growth, with a higher ratio reflecting higher growth prospects. If you believe that stock prices will over the long term reflect the underlying earnings performance, the implication of the ever expanding multiples of these companies is that either growth must continue to accelerate, or share prices must at some point come down so that valuations reflect the true growth rates.

It cannot be disputed that COVID-19 and the associated lockdowns seen across the globe have, in many cases, accelerated the adoption of technological solutions. However, the issue with expectations of faster and faster growth is that it ignores both the "law of large numbers" and any pull forward of demand. In finance, the law of large numbers refers to the fact that it is more difficult to grow as quickly as before from an ever-larger base. Simplistically, going from 1 to 2 customers would be a 100% increase; however, to grow 100% from a base of 1,000 would require another 1,000 customers to be acquired – clearly a much more difficult feat. Eventually, companies begin to run out of growth opportunities and often begin to compete directly with each other.

No opportunity is unlimited. For example, if we consider the total number of likely customers that Netflix may be able to acquire, the answer is not infinite. As time goes on and competition increases, winning each of those new customers requires something new, more advertising, new original shows, better movies. Any acceleration in the growth trend can often be followed by a pullback in subsequent quarters as those customers are not there to be acquired again. Indeed, we have seen Netflix give guidance for customer acquisition in the third quarter at less than half of consensus expectations. After 2 quarters of huge growth, the company warned that demand had almost certainly been pulled forward with subscriptions being taken out sooner than they otherwise would have due to the pandemic.

At Credo, we focus on buying stocks where our expectations for the growth of the company are higher than the valuation implies. We believe that in an ideal scenario, valuations should provide an opportunity for share price returns in excess of the underlying earnings as the stock rerates to reflect the actual growth rate. The valuation should also provide a margin of safety, providing some protection if the outcome is not as positive as we expect. At the present time, this is simply not the case for the majority of the stocks that have largely driven the market in recent months.

Over time, we have had the opportunity to purchase a number of stocks which we would classify as Tech Giants, including Microsoft, Alibaba and Facebook in the fund. Over the past few months, we have benefitted from owning these positions. Having said that, we, alongside many value investors, have been underweight the key names which have driven the recent market rally. This has made it a particularly painful period to be a value investor.

Despite this difficult period, we remain true to our principle of buying stocks where valuation is an opportunity rather than a threat. We see better investment opportunities in companies which are not priced to perfection but rather have an easier path to better than expected results.

Important notice