INVESTMENT BRIEF

Q4 2019

Strategic Investment Group®

Nothing Succeeds Like Excess

Signs of Froth

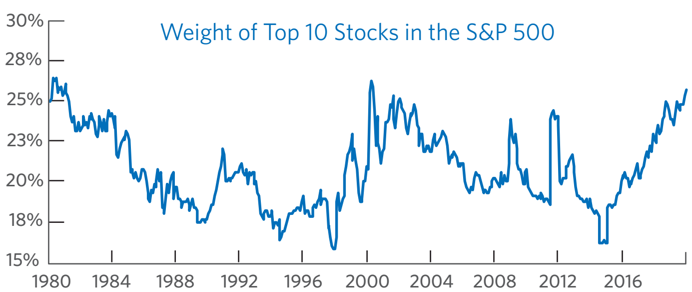
Virtually all assets rose sharply in 2019, with little regard to valuation or potential vulnerabilities. Across global equities, fully or richly valued markets enjoyed significant gains despite stagnant earnings. Multiples expanded and valuations deteriorated. In the U.S., a small number of mega-cap tech stocks have dominated returns in recent years. As a result, the concentration of the market is at levels not seen since the peak of the 2000 tech bubble (Exhibit 1).

A similar dynamic of prices disconnected from valuation is also evident in global bond markets. Bonds generated solid returns in 2019 – especially for longer maturity issues and those at the low end of the credit spectrum – despite real and nominal yields at secular lows, compressed credit spreads, high levels of corporate and sovereign debt, and deteriorating credit quality and creditor protections. The share of corporate bonds at the lowest rung of investment-grade credit is at record highs, accounting for 50% of the total.

EXHIBIT 1:

Market Concentration Near Tech Bubble Peak

Sources: Compustat and Strategic. Data through 2019.



Private equity funds, which have attracted massive inflows, are also showing signs of excess. Unicorns – private start-ups priced over $1 billion – are proliferating. Large IPOs priced with an eye toward revenue growth rather than profitability are commonplace. Uber, to take one example, went public in 2019 valued at $82 billion despite losses of $3 billion in 2018.

Last year set another near record for mergers and acquisitions. Easy financing, modest economic and earnings growth, and sharp disparities in corporate valuations are fueling merger activity.

In a market dynamic in which relatively expensive assets become ever more over-priced and momentum dominates market dynamics, disciplined, value-based active strategies suffer. The dominant performance of mega-cap tech stocks in the U.S. market has especially hurt strategies shunning overpriced growth stocks.

This dynamic, while painful, has also created opportunity. Value stocks – those with a relatively low P/E ratio – are now more than one standard deviation cheap relative to their growth counterparts. Value shares are the most attractive they have been since the tech bubble (Exhibit 2). Moreover, valuation dispersion across stocks – historically a predictor of good prospects for active management – has increased to levels exceeded only at the peak of the tech bubble.

Realizing Value

We are already witnessing moves to unlock the value created by recent market dynamics. The attractiveness of value stocks has reached such an extreme that active managers normally focusing on growth stocks have been enticed to stray from their natural habitats. Moreover, managers that actively adjust their style tilt have increasingly favored value stocks.

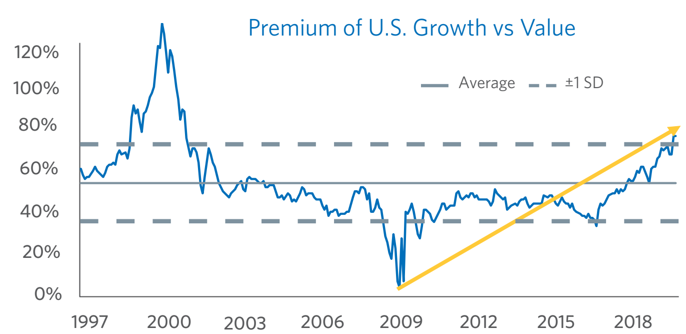
Recent trends in corporate activity also appear to be attempts to unlock value. The sharp increase in share buybacks reflects one way that firms whose shares are cheap are creating value. Walgreen's move to seek a private equity buyer is an extreme example of this dynamic. The recent spike in merger activity is also partly motivated by companies seeking to capitalize on mispricing. Xerox, for example, is using its fully valued shares to merge with Hewlett Packard, a competitor priced at a more attractive valuation, in the expectation that the combination will have a higher value.

Finally, recent developments in the IPO market suggest that investors are imposing stricter discipline. WeWork's decision to pull its planned IPO and the decline of Peloton's shares in response to disappointing earnings, despite unexpectedly strong revenue growth, are examples.

EXHIBIT 2:

Value Stocks Are Increasingly Attractive

Sources: Bloomberg and Strateggic. Data through 2019.



More Fundamentally Based Pricing Ahead?

The recent past has conformed to Oscar Wilde's adage that "nothing succeeds like excess". While such market dynamics can persist, they sow the seeds of an eventual reversion that restores fundamental values, at times violently. Indicators of the environment for active management – like the wide dispersion of stock valuations – point to improved prospects for active strategies focused on fundamental valuation. Recent moves to unlock value also point in this direction.

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