MARKETS INSIGHT

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Investors manic for ‘disrupter’ stocks

By Richard Bernstein

But frothy IPOs do not spell equities euphoria

Euphoria is a typical late-cycle signal. Investors throw caution to the wind and try to maximise upside returns. Pension funds overweight equities at the expense of prudent asset allocation, individual investors rush into hot equity mutual funds, Wall Street’s strategists recommend overweighting equities and hedge funds lever long positions substantially.

We can find no data that conclusively support the notion that the US stock market is in such a euphoric stage.

Credit Suisse data indicate US pension funds have among the lowest equity allocations in more than 30 years and remain focused on alternatives rather than conventional equities.

A Bank of America Merrill Lynch indicator shows Wall Street strategists are recommending an underweight of equities relative to the traditional 60/30/10 stocks/bond/cash benchmark. International Strategy and Investment’s hedge fund survey shows hedge funds are neutrally positioned. ICI data show net outflows from US equity funds for seven straight weeks.

The current IPO market certainly seems frothy, but that frothiness is unique and does not reflect investors’ sentiment towards the broader equity market. Whereas speculative IPO markets often mirror overall stock market valuation, the current cycle’s speculation, much like that during the late-1990s technology bubble, seems limited to a relatively narrow universe of stocks. Detailed valuation data continue to suggest considerable fear of traditional equities.

Bubble-like ‘disrupters’

Investors rationalised lofty valuations during the technology bubble with theories regarding the “new economy”. “Disrupter” companies are today’s rationalisation. Investors seem willing to pay outrageous valuations for disrupter companies because the companies are supposedly changing the world and have no relationship to the economic cycle, to Washington or to geopolitical events. It seems hard to fathom how an auto company, an energy company or a limousine service is not connected to the economy, but investors nonetheless appear giddy regarding disrupters’ potential returns.

Many of the disrupters sell at bubble-like valuations because of this enthusiasm. According to Bloomberg, Tesla Motors, perhaps the best known of the disrupter companies, sells for more than 850 times enterprise value to earnings before taxes, interest, depreciation and amortisation. The S&P 600 biotechnology index sells for 350 times. For comparison, the S&P 500’s enterprise value to ebitda is 11 times and the Russell 2000’s is about 15 times. One would think the deflation of the technology bubble would have taught investors the lessons of avoiding super-speculative stocks, but apparently not.

Beta is a standard measurement of a stock’s sensitivity to the movement of the stock market. A stock with a higher beta will tend to move in an exaggerated way relative to the movement in the market, whereas a lower beta stock’s movements will tend to be less pronounced. Most disrupter stocks are considered higher beta stocks.

An axiom of basic financial theory states that investors should pay a premium for safety, but demand compensation for taking risk. Investors should generally pay premium valuations for lower beta stocks as they offer relative safety and discounted valuations for higher beta stocks as compensation for accepting those stocks’ risk. Within this context, the disrupter group’s valuations seem especially speculative.

High beta cheap

Whereas disrupter stocks sell at huge premiums to the overall market because investors believe the stocks’

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successes are assured, traditional high beta stocks within the S&P 500 are selling at the cheapest relative valuations in the almost 30-year history of our data. Judging by these data, investors are historically scared about traditional market risk.

High beta S&P 500 portfolios were historically dominated by technology shares, but that is no longer the case. Currently, the quintile of S&P 500 stocks with the highest betas is a mixture of many cyclical sectors. Technology comprises only 15 per cent of today's high beta group. Financials are 23 per cent, consumer cyclicals are 24 per cent and industrials are 15 per cent.

Further, our research indicates earnings surprise statistics for the traditional high beta group are among the world's best. Only 17 per cent of the S&P 500's high beta quintile reported negative earnings surprises in the last reporting period. That compares with the S&P 500's 25 per cent, Europe's 48 per cent and emerging markets' 49 per cent. The IPO market seems very speculative, but one must take care in extrapolating those lofty valuations to the broader market. The enthusiasm for disrupter stocks seems manic, but the lack of enthusiasm for traditional equity risk presents opportunity.

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