Richard Bernstein Advisors

The Leaders In Pactive® Management

RBA Quick Insights

September 3rd, 2020

How should we interpret the stock market's high valuations?

Do not put your faith in what statistics say until you have carefully considered what they do not say[1]

As some valuation measures for the US stock market approach double their historical averages, we have been fielding more valuation questions from clients. Investors often focus on valuation metrics based on single point-in-time snapshots (e.g. price-to-earnings, price-to-book-value, enterprise value-to-EBITDA), but these only make sense if the chosen point-in-time is indicative of the asset's longer term potential. Recall that the forward P/E multiple of the S&P 500® was indicating the market was fairly valued in 2007, just before the biggest bear market since the Great Depression, as well as six months into the subsequent bull market in 2009, one of the biggest bull markets of our lifetimes. The issue with the P/E ratio in 2007 was that the denominator (EPS) was unsustainably high, boosted by overstated asset prices and leverage. In 2009, it was the opposite: earnings were depressed as the result of the recession and did not reflect the 14-fold growth they would experience over the next five years as the economy recovered. Investors should always keep in mind though, that valuation, no matter how you measure it, is a terrible timing indicator.

The market has gotten expensive for two distinct reasons

In addition to the normal lack of visibility coming out of a recession, there's been a huge bifurcation of the market that is distorting today's valuations. Since the pre-pandemic peak in February, the P/E multiples of the FANMAG stocks (FB, AMZN, NFLX, MSFT, AAPL and GOOG/GOOGL[2]) have expanded by roughly 20% while the valuations of the rest of the S&P 500® have expanded by a still respectable 15%+. But these two groups of stocks have gotten more expensive for completely different reasons. FANMAG's P/E has risen because their "P" (prices) has gone up faster than their "E" (earnings), while the P/E for the rest of the S&P 500® has expanded because "E" has gone down much more than "P" (see table below). There is no doubt that high growth Tech stocks have justified their outperformance over the past decade and in 2020 based on their superior profit growth. But there seems to be one critical question that investors should be asking themselves today: are the earnings of FANMAG so much more likely to beat the raised expectations (up 10% since February) than the slashed earnings expectations of the rest of the index (down 16%), such that their 100% valuation premium is warranted? Assuming the recovery is sustainable, FANMAG's improving secular growth would have to outweigh the rest of the market's operating leverage. To us, this seems like a very pessimistic bet against the recovery.

Table 1: Select metrics for S&P 500® vs. FANMAG* at pre-pandemic peak vs. August 31, 2020

	August 31, 2020			February 19, 2020			Change %		
	S&P 500®	FANMAG	Rest of S&P 500®	S&P 500®	FANMAG	Rest of S&P 500®	S&P 500®	FANMAG	Rest of S&P 500®
Market Cap ($billions)	30,249	7,199	23,050	29,174	5,398	23,776	4%	33%	-3%
Forward P/E	22.8	40.9	20.0	19.1	33.6	17.3	20%	22%	16%
Trailing P/E	27.3	60.5	23.3	22.2	51.0	19.7	23%	19%	18%
Forward Earnings ($billions)	1,326	176	1,150	1,531	160	1,371	-13%	10%	-16%
Trailing Earnings ($billions)	1,110	119	991	1,314	106	1,209	-16%	12%	-18%

Source: Richard Bernstein Advisors LLC, Bloomberg, S&P

*FANMAG: FB, AMZN, NFLX, MSFT, AAPL, GOOG/GOOGL

Note: market capitalizations of FANMAG stocks are adjusted to reflect their index weights rather than total market capitalizations.

[1]: Quote by William Whyte Watt in his book "An American Rhetoric" (Rinehart and Co.; 1958 3rd edition, page 382).

[2]: One or more of these names are currently held in RBA managed portfolios.

Dan Suzuki, CFA

Deputy Chief Investment Officer

Please feel free to contact your regional portfolio specialist with any questions:
Phone: 212 692 4088
Email: sales@rbadvisors.com

For more information About Dan Suzuki, please click here.

Recent & Related articles:

Perception vs. Reality: Valuations

What drives returns?

What should you own for the next decade?

What did I miss?

Better or worse?