Is This Time Different?

"The four most dangerous words in investing are: 'this time it's different.'" - Sir John Templeton

Such a Narrow Stock Market!

A few companies feast, while many beg.

John Rekenthaler
Apr 3, 2020

Virtual Reality
Corporate-income inequality isn't just rising, it's soaring. The American economy has become an iceberg. A few companies stand above the water, while the broad masses are submerged.

This story has frequently been told but as *parts* of the elephant rather than of the entire beast. One theme has been the struggle of retailers. Another, the continued expansion of the service economy at the expense of manufacturing. A third, the triumph of the FAANG stocks--that is, Facebook (FB), Amazon.com (AMZN), Apple (AAPL), Netflix (NFLX), and Google (GOOGL) (Alphabet). A fourth, the weak relative performance of small-company and/or value stocks.

It's not difficult to connect the pieces. Not only have companies that sell services replaced manufacturers in importance (with services now accounting for 80% of U.S. gross domestic product), but companies that offer virtual services, such as Netflix, Alphabet, Microsoft (MSFT), or Amazon (which has delivery trucks but which communicates with its customers at 186,000 miles per second) are supplanting brick-and-mortar rivals.

The competitive field has therefore narrowed. Consumers once dispersed their monies among hundreds of vendors. However, their supplier list has shrunk, because the major virtual-services companies have convinced them to simplify their purchasing lives. Need a spreadsheet application? No worries, Microsoft has added that to its bundle. Seeking art supplies? Amazon has plenty of those.

Traditionally, growing market share so aggressively would challenge corporate managements, who required time and money to ramp up factory production, build new retail outlets, and/or hire staff. What's more, they faced the possibility of financial ruin if the new customers did not repeat and sales subsided. But virtual-services companies are largely immune to such problems. They can quickly scale up--or down, if necessary.

Large Growth's Victory
In summary, FAANG stocks have thrived not because investors have overpaid but because those companies have met, or even exceeded, their aggressive expectations. Their stock market gains reflect their business success. For example, Alphabet has grown its revenues sevenfold over the past decade, while generating

high free cash flow and having low debt. It would be illogical for investors *not* to reward such behavior.

And reward they have. In the second half of last decade, large-growth mutual funds, which own the fortunate few companies, thrashed small-value funds, which invest in the broadest segment of the broad market. The former placed first among the nine sections of the Morningstar Style Box, while the latter was dead last.

This result contradicted academic theory, which expects small companies to outgain their larger competitors and cheaper stocks to outdo pricier growth companies. Such were the findings in the famous 1992 paper by Gene Fama and Ken French, "The Cross-Section of Expected Stock Returns," and such was the belief of the founders of Dimensional Fund Advisors, which had opened its doors a decade earlier.

Well, such things happen. Nobody claimed that academic factors will always hold. True, those five years treated the theory particularly harshly, with the cumulative return for large-growth funds registering 76%, as opposed to only 31% for small-value funds. That's a large gap. But such things happen. If investments always followed the same pattern, they would be risk-free assets, not investments.

The Trend Continues

Then came 2020. The news for small-value shareholders got worse. Much worse. Below are the year-to-date totals for mutual funds through Wednesday, April 1.

Year-to-Date Returns

(Through April 1, 2020)

Source: Morningstar Direct

Just brutal. With that 40.9% loss, small-value funds haven't made a penny in seven years. The average fund is worth what it was in spring 2013. Meanwhile, large-growth funds rest at early 2019 levels. Small-value funds have shed seven years' worth of gains; large-growth funds, a mere 12 months. If I had money in small-value funds (happily, I do not), I would ask the professors for a refund.

Unfortunately, for small-value shareholders, the stock market's behavior appears to be logical. The coronavirus crisis has only increased the prevailing trends. Millions of American businesses have been shuttered, including most retailers save for grocers and pharmacies. Consumer movement has been restricted. What else is available besides virtual services? The rich are becoming even richer.

To be sure, normalcy will eventually return, permitting sidelined businesses to re-emerge. However, one suspects that some habits will be permanently changed. For example, virtual-services companies won't immediately threaten the restaurant industry, but they will further erode retailers' positions. Some consumers who have grown accustomed to shopping online will continue to do so when the restrictions are lifted. Such actions would have ripple effects, including depressing the commercial real estate market.

Also affecting commercial real estate will be the increased tendency to work at home. Once again, this process was already underway; over the past few years, many employees (and their employers) have learned that not every job requires their physical presence in an office. After the current crisis, even more will share that belief. Demand for office space will slacken, as will the patronage of businesses that depend on commuters, such as trains, downtown shops, and business attire.

This Time Is Different
My point: Over the past several years, history has been a poor investment guide. Unfortunately for small-value investors, that failure can be blamed neither on investor fashion nor solely to temporary conditions. The sluggish performance of small-value funds, and the corresponding success of large-growth strategies, owes mainly to economic reality. A few companies are eating America’s lunch.

As the investment cliché goes, a rising tide lifts all boats. Thus, when the next bull market arrives, I would expect small-value companies to fare well, perhaps even lead the way. (They did so in 1988, following Black Monday’s crash. Twenty-one years later, in 2009, they weren’t the single best-performing investment style, but they nevertheless beat most rivals.) Tactically, small-value investing looks timely.

Strategically, not so much. Academic investment research implicitly assumes that the economic conditions that created those results will persist. There is strong reason to believe that will not be so.

*John Rekenthaler (*john.rekenthaler@morningstar.com*) has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John is quick to point out that while Morningstar typically agrees with the views of the Rekenthaler Report, his views are his own.*

An alternative view came from Verdad on 4/6:

What's Priced In?

Q2's Expectations Are Low, But Nobody Can Guess For 2025

By Nick Schmitz and Greg Obenshain

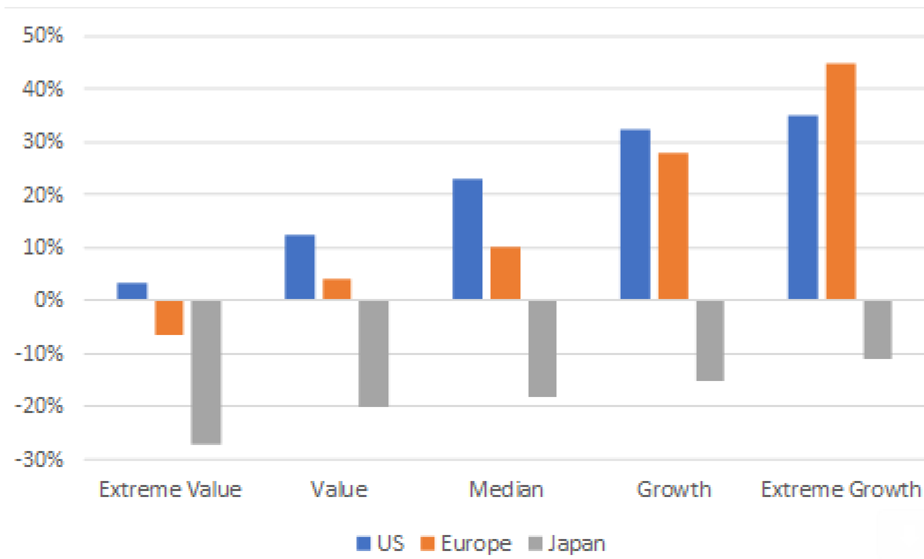
The pandemic rampaging across the globe has created all sorts of uncertainties about our future health, both physical and financial. This uncertainty has led to a sharp sell-off and plummeting valuations in stocks and bonds.

Dissonant, confusing information put out in a rapidly evolving environment can create massive uncertainty about potential outcomes. And given that stocks and bonds are worth the net present value of future cash flows, the uncertainty about the future translates into heightened volatility today.

While we can’t tell you which forecasts will prove to be correct, we can assess what the market is pricing in. And since investing is a game of meta-analysis, not analysis, we can then hope to make good decisions by assessing whether that pricing is too optimistic or too pessimistic.

Perhaps the best way to analyze and contextualize this recent market action is to compare where markets are as of 20 March 2020 relative to 30 June 2009, when valuations were near their lowest in the middle of the default cycle. This is how expensive global stocks are today relative to the depths of 2009 for value and growth stocks.

Figure 1: March 2020 vs. June 2009 TEV/EBITDA Multiples

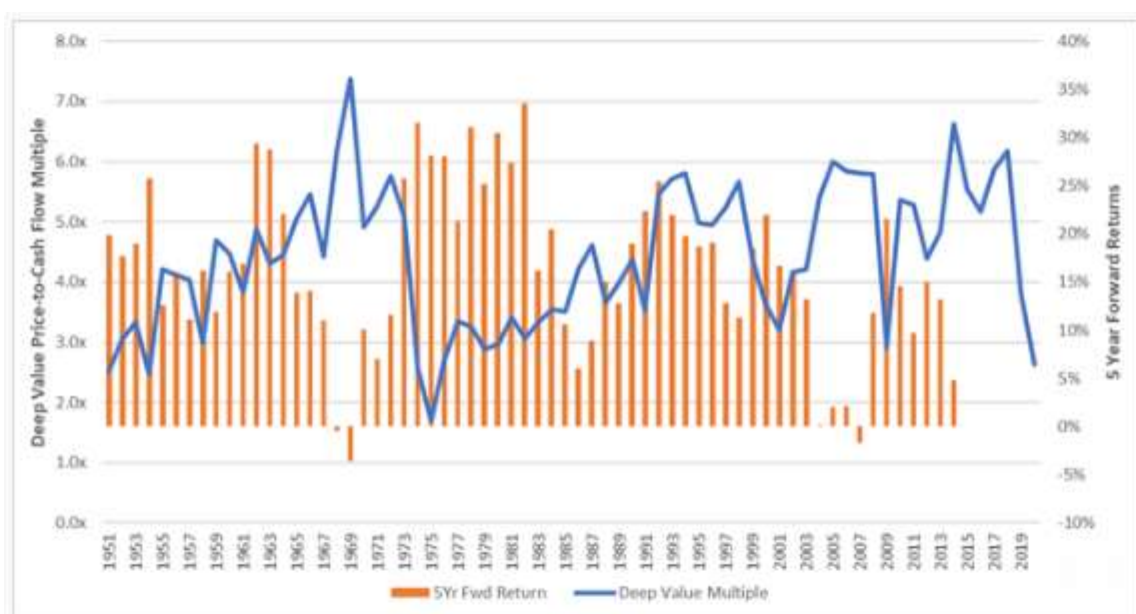


Source: Capital IQ. 10th, 25th, 50th, 75th, and 90th percentile valuation breakpoints shown in each market for extreme value through extreme growth respectively. All listed stocks excluding REITS and financials.

Growth stocks in the US and Europe are still 30–40% more expensive than 2009. By contrast, extreme value stocks are already at 2009 bottom levels in the US and Europe. According to Capital IQ, after the recent drawdown, Facebook, Amazon, Netflix, Google, Microsoft, and Apple still traded at 5.9x revenue and 12.6x tangible book value. By contrast, Japan's TOPIX index of 2,100 stocks traded at 0.85x revenue and 1.1x tangible book value.

We believe, based on our research, that purchase prices are one of the most important determinants of returns. In Figure 2 below, we show the historical returns to value stocks compared to valuations for the cheapest stocks for each year since 1951.

Figure 2: Historical Deep Value Price-to-Cash Flow Multiples and Value Returns



Source: Ken French, Verdad Analysis, pricing through 20 March 2020

The five-year forward returns from the Ken French data over the long term have closely tracked valuation multiples at entry. And, as you can see from the chart, today's valuations for deep-value stocks are at extreme lows relative to history. To get lower than this in 1975, it took these scary things: 10% unemployment, Watergate, the loss of Vietnam after the death of 60K GIs, an oil embargo, hyperinflation, JAWS (1975), Global Cooling, Dutch Elm Disease, Jimmy Carter, and scariest of all, Jane Fonda. We're not aware that any of these things impacted corporate financials five to ten years down the road. And these brief windows of extreme pessimism and low purchase multiples were all accompanied by really bad upsets to short-term GDP growth rates and employment figures.

Correctly predicting negative short-term GDP and employment outcomes and avoiding the market after it had sold off was a horrible investment strategy. We previously wrote about our friend Russell Pennoyer's idea of a Prosperity Index (GDP growth minus the unemployment rate). We found that the worse the prosperity index was, the better future stock return.

Figure 3: Stock Returns vs. the Prosperity Index by Quartile 1948–2018

Prosperity Index (GDP Growth - Unemployment)	S&P 500 1Yr Fwd Return	Small Value 1Yr Fwd Return	Small Value Premium
Q1 -12.9% to -4.2%	18%	29%	11%
Q2 -4.2% to -2.3%	11%	15%	4%
Q3 -2.3% to -0.6%	12%	17%	5%
Q4 -.6% to +9.2%	9%	11%	2%

Source: Ken French, Capital IQ, FRED

Trailing prosperity and future price returns were inversely correlated because the resulting purchase prices that accompanied those GDP drops and unemployment spikes were extremely low. This relationship between entry multiples and returns is one of the most robust historical patterns in stock investing over long horizons and has been replicated internationally. ...

So, while macro-economic analysts are correctly worried that GDP will contract, unemployment will increase, and corporate debt will enter a default cycle in the coming quarters, we do not need to know precisely how the economy will unfold. Really bad times are already priced in for the next quarter, with complete uncertainty for the decade after that. But the investment imperative at this point becomes relatively simple in concept if not execution. In our view, it's buying cheap securities that likely won't experience bankruptcy. ... In equity, we think the place to do that is deep-value equities that are also statistically unlikely to go bankrupt.

Given today's prices, even if you could correctly predict the next two quarters' GDP, unemployment and default rates to within a metaphorical inch, you could still misjudge the risk you are actually taking over the next five years, given today's prices, by a mile. When prices drop this much on short-term bad news, and nobody can tell you what 2025 will look like, we think it's a good window to invest long term with some basic prudence.

Supported by BCA Research | Daily Insights on 4/9:

Where Is The Value? A Sectors Ranking

* VALUE SCORE IS COMPUTED AT THE INDIVIDUAL STOCK LEVEL AND BASED ON 5 VALUE METRICS (P/E, P/FE, P/B, P/S, P/OCF). THE STOCK LEVEL SCORES ARE AGGREGATED WITHIN EACH GROUP TO GET THE AVERAGE VALUE SCORE FOR THE GROUP.

After the recent market drubbing, pockets of value have emerged in asset markets, including equities. In fact, famed value investors Howard Marks just argued that finally, from a value perspective, the risk-reward profile of the market has become positive.

BCA Research's Equity Trading Strategy (ETS) service is a quantitative tool that uses well-documented stock market anomalies to rank stocks across the world. Among the factors used by ETS, is value, defined using a variety of metrics employed in academia. Using a bottom-up approach, we can aggregate stock scores by sector to see which sector globally offers the most value. In this case, the higher the score, the more appealing the sector is.

For now, the best value seems to be in the very cyclical financials, energy and materials. The energy sector will likely stay dangerous in the short-term as the oil supply glut will remain in place for an extended period. Nonetheless, long-term investors should begin to focus on those sectors. Meanwhile, healthcare and IT offer the least attractive value.

Our thoughts

"Being a value investor in the F.A.N.G. era is no fun at all. - Patrick O'Shaugnessy

If you are going to win a bet that Growth stocks, and in particular FAANG stocks, are going to continue to outperform, then you are betting that investors, and in particular analysts, haven't already priced in that "FAANG stocks have thrived not because investors have overpaid but because those companies have met, or even exceeded, their aggressive expectations." HCM's IVA Stock Selection system's primary Valuation metric is PEG. From our website:

"The PEG ratio is calculated by dividing a stock's Price to Earnings ratio by analysts' projected average annual growth rate in earnings for the next five years. Using the trailing-twelve-month or current PE ratio is important so that earnings are not double counted. Also, using the five year projected growth rate in earnings is superior to using the growth rate over the past five years, as past growth is not as predictive of future growth.

The intuition behind using this ratio to value a stock is that low PEG stocks represent "cheap" growth companies that are undervalued relative to current earnings and expected growth. Unlike the ubiquitous PE ratio, PEG allows investors to compare companies with different growth rates. A stock with a low PE ratio may look cheap but has very few growth opportunities, whereas a stock with a high PE ratio may look expensive but has a multitude of opportunities to expand its earnings. The PEG ratio removes this problem by factoring growth in and allowing investors to determine how cheap a stock is relative to its growth potential. Investing in low PEG stocks takes advantage of investors' tendency to overpay for uncertain future growth.

The empirical data supports this intuition. The first major examination of the PEG ratio came in Donald Peters' book *A Contrarian Strategy for Growth Stock Investing*. In this work, he divided the companies comprising the S&P 500 into deciles based on their PEG ratios. Peters then analyzed each decile's return over 30 quarters starting in 1982 relative to the average. His study found that the lowest decile beat the S&P 500 for 21 out of the 30 quarters, with an overall performance of 15.36% versus 3.56% (as shown in the table to the right). ... Richard Bernstein's research indicated that PEG was the second best stock selection measure (narrowly edged out by EV/EBITDA) and one of four that beat the S&P 500 consistently. This research has been further corroborated by Asweath Damodaran from the Stern School of Business in "Growth Investing: Betting on the future?" which looked at how PEG faired from 1991-2010. This study divided stocks into quintiles based on PEG and found that the lowest quintile provided the best returns."

Growth of $1 Invested in PE/Growth Ratio Decile Portfolios

	Compounded Returns
	January 1982 – June 1989
1	15.36
2	6.69
3	4.77
4	3.66
5	3.00
6	2.02
7	1.82
8	1.55
9	1.31
10	1.38
S&P 500	3.56

Note: The portfolios with the lowest PEG ratios are listed first.

The current Decile ranks for the FAANG stocks is also shown to the right. As Quantitative investors, none of these stocks are on our Buy/Watch list. However, that doesn't mean we are unaware of some of the risks that each face.

Stock	Symbol	PEG	Decile
Facebook	FB	1.04	3
Amazon	AMZN	1.45	4
Apple	AAPL	1.92	6
Netflix	NFLX	1.86	5
Google*	GOOGL	1.40	4
*Alphabet			

FB - The political risk of a Democratic Administration & Congress to Facebook should be clear. From the NYT's "Facebook Says It Won't Back Down From Allowing Lies in Political Ads" on Jan. 9, 2020: "Donald Trump's campaign can (and will) still lie in political ads," Bill Russo, the deputy communications director for Mr. Biden, said in a statement. “Facebook can (and will) still profit off it. Today’s announcement is more window dressing around their decision to allow paid misinformation.” According to C|Net on March 17, 2020, Biden has indicated that the tech companies need "more regulation and that some companies might need to be broken up."

AMZN - With a current P/E of 88.8, how will Amazon even come close to meeting its estimated 5 year annual earnings per share growth rate (LTG) of 34.9%. Buying another Whole Foods? From Investopedia: "The term “tenbagger” was coined by legendary fund manager Peter Lynch in his book "One Up On Wall Street." While tenbagger can describe any investment that appreciates or has the potential to increase ten-fold, it is usually used to describe stocks with explosive growth prospects. ... Peter Lynch identified and invested in numerous tenbaggers when he was the manager of the Fidelity Magellan Fund from 1977 to 1990. ... Over this period, Lynch achieved a 29.2% average annual rate of return ...." With a current market cap of over $1 trillion, is a onebagger even possible?

AAPL - Apple reduces its U.S. tax bill by artificially shifting large amounts of its domestic profits into tax havens. This allows Apple to avoid paying U.S. taxes on these profits while also paying very little in foreign taxes. Will this continue under a Democratic administration that is determined to raise taxes on corporations? The accelerating retreat from Globalization resulting from COVID-19 is another risk, as supply chains have been disrupted. Apple's costs will rise, and its sales could be negatively impacted if trade barriers continue to climb.

NFLX - On Wednesday it was announced that Disney Plus has surpassed 50 million subscribers in the five months since it launched. The list of services continues to grow from the "old days" of just Netflix, Amazon Prime Video (accelerating its content) and Hulu (Disney's other platform), with Apple TV Plus, and new services such as NBC/Comcast's Peacock and AT&T's HBO Max just around the corner. Add to the competitive risk the potential long-term impact of COVID-19 on production.

GOOGL - With a current market cap of $831 billion, a P/E of 25.2, an Est. LTG of 16.1%, and maturing core search growth, Alphabet needs to answer the same question as Amazon. You Tube and Cloud will help, but enough to justify its current valuation?

Low interest rates favor Growth stocks by decreasing the discount rate on their future profits. The Trump administration was running massive deficits even before the COVID-19 Bear Market. Interest rates will eventually resume climbing. From 2 of our past Worth Sharings that addressed Values underperformance:

Does Value Still Matter? - 6/25/17

Why Value Stocks Have Disappointed

By John Rekenthaler | 05-19-17

Trend Fighters

Value investors are creatures of habit. Whereas growth investors cherish the improbable, envisioning companies that achieve what their predecessors could not accomplish, value investors expect what previously occurred to happen again. Grantham's lines are symbolic, but they represent the bedrock faith of a value investor: That which excels (or stumbles) will inevitably head back from whence it came. ...

Historically, value investing succeeded for two reasons:

As a rule (there were always exceptions), the weaker companies weren't quite as bad as they seemed. If they were priced the same as the stronger companies, of course you would prefer the latter, but that was not the case. The laggards were steeply discounted--too steeply, as it turned out.

Conversely, the stronger companies weren't as good as they seemed. Their prospects were overstated. To be sure, they ended up growing their sales and profits faster than the norm, but not as rapidly as their stock prices had forecast.

In short, stock investors typically overreacted in both directions. They accurately gauged that some companies were better than others, and for the most part sorted the sheep from the goats, but they misjudged the magnitude. The good weren't that good and the bad weren't that bad.

The New Era

This time, the mean did not revert (so far). True, the bad companies have remained not so bad. (Setting aside the companies that did not survive the 2008 crisis, that is.) That part value investors continue to get right. However, they have missed the fact that the good companies have indeed become that good. For 20 years, Apple (AAPL) has confounded even the optimists. Apple is the most extreme of cases, but across the technology and healthcare industries, leading firms enjoy margins as they never have before. ...

Our thoughts

According to legendary investor John Templeton, **"The four most dangerous words in investing are: 'this time it's different.'"** To the extent that the Value Factor's historical outperformance is attributable to investor's behavioral biases, we are not in a "New Era". However, as we have previously shared and will continue to do so, how you measure Value and construct the resulting portfolio matters a great deal. Fama and French used book value to define Value. Subsequent academic research has shown the valuation metrics we use (PEG, EV/EBITDA and the closely related EV/EBIT) to be superior. In addition, dividing the investable universe in half between Growth and Value is far removed from the long/short portfolios used by academia to determine a Factor's validity or optimized portfolio construction which requires concentration and more frequent rebalancing, as previously shared. ...

Is the Value Factor Broken? - 9/22/18

Our thoughts

From our website: "Although academics still use Price/Book (also formulated as Book/Market), research has demonstrated that P/B is one of (if not the) weakest measures of Value. ... Another way to improve on the Value Factor is to invest in funds that use more than one metric to determine Value." We are currently using 4 of BlackRock's iShares Edge MSCI Factor ETFs for clients. They calculate the Value Factor from "forward and trailing share price to earnings, share price to cash earnings, share price to book value and enterprise value to earnings before interest & taxes (EBIT)". In February Vanguard finally joined the Factor-based Fund Parade with 6 ETFs and 2 OEFs. Their U.S. Value Factor ETF (VFVA) uses "measures such as book to price and earnings to price ratios".

While the above article and study address how Value should be measured, they don't answer the question of how best to take advantage of it. Again, from our website:

Exhibit 1 - Returns on Portfolios Sorted by Size and Book/Price

	Low 1	2	3	4	High 5	5-1
Large	9.89	10.29	10.68	9.75	11.51	1.62
Mid	10.58	11.00	12.35	14.44	13.72	3.14
Small-Mid	8.64	13.22	12.95	14.91	16.12	7.48
Small	8.04	12.40	14.46	15.16	15.33	7.29
Micro	4.39	12.11	12.92	16.03	16.96	12.57

Source: French Data Library. Data from July 1963 through May 2018.

Historically, the greatest extra return from the Value Factor has come from Small-Mid, Small, and Micro Cap stocks. Hence, HCM aims to provide clients with exposure to Small Cap Value, both Domestic and International.

BY COREY HOFFSTEIN

ON JUNE 11, 2018

In particular, the disciples of price-to-book have suffered greatly as of late, with "expensive" stocks having outperformed "cheap" stocks for over a decade. The academic interpretation of the factor sits nearly 25% *below* its prior high-water mark seen in December 2006.

... broadly accepted factors – e.g. value, momentum, carry, defensive, and trend – have all been demonstrated to generate excess risk-adjusted returns across a variety of economic regimes, geographies, and asset classes, creating a great depth of evidence supporting their existence. ...

To explore this question, we ran a simple experiment for each factor. Our goal was to estimate how long it would take to determine that a factor was no longer statistically significant. ...

Based upon this experience, sixty-seven years is median number of years we will have to wait until we officially declare price-to-book ("HML," as it is known in the literature) to be dead. ...

We performed this experiment for a number of other factors – including size ("SMB" – "small-minus-big"), quality ("QMJ" – "quality-minus-junk"), low-volatility ("BAB" – "betting-against-beta"), and momentum ("UMD" – "up-minus-down") – and see much the same result. It will take decades before sufficient evidence mounts to dethrone these factors.

	HML	SMB[7]	QMJ	BAB	UMD
Median Years-until-Failure	67	43	132	284	339