Stirling Bridge
Wealth Partners, LLC

MARKET COMMENTARY – JULY 1, 2020

What is a cynic? A man who knows the price of everything, and the value of nothing. ~ Oscar Wilde, Lady Windermere's Fan

Or

Price is what you pay. Value is what you get. ~ Warren Buffett

Last month we observed that returns for investors have come from an increasingly narrow set of growth companies. Today, we hope to deepen our understanding of this phenomenon.

Since the Great Recession of a decade ago, traditional value companies (energy, financials, etc.) have underperformed their sexier growth peers (technology, communications, etc.). The underperformance has intensified in recent years. In fact, the market volatility set upon us from 2020's lockdowns has only exacerbated the trend.

In some ways, this diverging performance can be easily explained using traditional techniques. It turns out that back then, growth companies had just endured a rather rough go of it for almost a decade. Their prices had been abating, off and on, since the Internet boom of the 1990s. And so, especially from 2009 to 2015, the price increases experienced by growth stocks were simply reflections of normalizing valuations.

However, they have just kept on marching higher as investors seem willing to pay more dollars per dollar of anticipated earnings. These events beg a question. Are investors being rational or are they repeating past mistakes and chasing momentum that will end the same way it always does?

Lately, investigators at JP Morgan have begun to dig into the data. They've wondered if there are other causes for the differing performance. They further wonder if there are non-traditional explanations that might justify the disparity.

Causes. Certainly, the normalization of traditional valuations spent itself years ago. So why would valuations continue to expand with PEs, PBs, or PCFs on growth companies getting bigger each year? Like Wilde's cynic, are investors missing the true value of what they are buying? Are expectations just too rosy?

There actually seem to be several convincing reasons. First, for two decades there has been structurally low inflation across the world. The low inflation has been the result of globalized trade, technological disruption, & fracking (lots of oil). In turn, the low inflationary environment has meant that real assets have stagnated in price while financial assets have bloomed.

Second, regulators the world over have been unable to utilize the anti-trust powers they successfully wielded in previous generations. Therefore, the companies already in the lead, stay there. They then innovate technologically, and with each step make it even more difficult for new players to enter. And related to the very nature of technology industries, they are highly scalable. This means that in a very short period of time, entire industries can be created, old industries destroyed. Tech has become a winner-take-all environment like none before it.

Third, passive or index investing in 401(k)s and the like foster a status quo or big-get-bigger tailwind as the lion's share of investment dollars funnel into the most familiar mega-caps.

And finally, since 1990 the amount of intangible assets (trademarks, copyrights, patents, R&D) on balance sheets has exploded from 18% to 39%. Said another way, today, only 61% of big company assets are tangible (factories, inventories). That is a massive shift. Over this same period, accounting rules have had a difficult time keeping up with the innovations. The lagging nature of accounting has forced analysts and portfolio managers to tweak and invent new metrics for determining whether a company is "cheap" or "expensive."

Which brings us to how at least <u>some</u> (perhaps not all) of the pricing disparities between value and growth companies <u>might</u> be justified. We'll give just one brief example.

Currently, the S&P 500 trades at a Price to Book ratio north of 3.3, compared to the average of 2.8 times for the past twenty years. However, when difficult-to-value intangibles are added into the mix, the current Price to Book ratio falls to 2.9. Furthermore, if one looked at the Price to Book for the highly intangible-dependent technology sector, the ratio falls from 8.2 times using traditional means to a reasonable 3.4 with the adjustments.

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The upshot of the P/B analysis and a myriad of others like it is that they can account for much of the price performance from technology and communications. Ah, hindsight…

But we must invest today, and in the future, for the future. We cannot rely on the fact that growth technology companies have done well as investors came to realize the true value of intangibles. It would be reckless to concentrate heavily in the glamorous sectors today at the expense of the more mundane in the mere hope that history can double up. For growth companies to produce another decade like the one past, all else being equal, as a share of total assets, intangible assets would have to become almost 60% of all assets. Possible, but unlikely.

Therefore, we plan to take the insights provided by the studies we've cited above and put them to use. For our clients, that means we mustn't feel compelled to eliminate all the high-fliers because they look expensive based on traditional measures. However, these new findings do nothing to discard the age-old maxim that trees don't grow to the sky. There are always unloved, low-hanging opportunities for those willing to take a walk off the beaten path.

In short, we must avoid becoming Wilde's cynic. It is essential for us to understand the value of what it is we are buying. Otherwise, we risk bumping up against another of Wilde's quotations from Lady Windermere's Fan.

Experience is the name everyone gives to their mistakes.

Stirling Bridge Wealth Partners, LLC is fortunate to count many of you as clients. In the good times and bad, we remain committed to providing customized investment solutions and robust financial planning wrapped in a package of exceptional service. We thank each of you for your dedication to us and for your trust.

Sincerely

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