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No, This Time is not Different (We Still Prefer to Buy Low/Sell High)

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Snapshot

- In rising markets, investors can become hyper-focused on past performance.
- Overpaying for even the most profitable companies is risky, as shown by the tech bubble experience.
- Unfortunately, 'my bubble is smaller than yours' is not a valid argument for overpaying.

In rising markets, investors can become hyper-focused on past performance—even more so during bubbles and other anomalies. With headlines declaring 'Goldilocks' tech stocks as the new defensives[1], market concentrations reaching the 99th percentile on a historical basis[2], and pronouncements of the death of value investing, we re-examine the basic principles of 'buying low' as well as the inherent risks of 'buying high'.

Risks of Ignoring the 'Margin of Safety'

The founders of value investing, Benjamin Graham and David Dodd, noted that 'the margin of safety is always dependent on the price paid'[3]. In other words, paying a low price generally increases an individual's odds of making a profitable investment.

The risk of ignoring this basic principle was vividly illustrated during the tech bubble of 1999-2000. To make the comparison more relevant to today's market, we examined the seven most profitable[4] companies of the time within the US Large Cap Technology sector (the 'FANGs of 2000'), namely Microsoft, Cisco, Intel, Oracle, EMC, Applied Materials and Texas Instruments. We deliberately avoided frothier 'dot-com' segments; the stocks we chose were recognised leaders in their field, with strong earnings and sales growth, high barriers of entry, and innovative edges.

Of course, greatness alone is not a sufficient characteristic for a successful investing strategy. With valuations 2-3x of the broad equity market, a lot had to go right for those firms—and a lot had to go wrong for others—to justify such premium pricing. Indeed, a lot did go right. 20 years later, these companies are still around and, arguably, are still thriving.

Exhibit 1: What Goes Up Must Come Down

	Estimated P/E[5] in March 2000	Estimated P/E in March 2005
Most Profitable Tech Stocks (7)	60.7	17.5
US Information Technology Sector	49.0	19.5
S&P 500 Index	25.3	16.1

Source: SEI, based on data from FactSet and S&P. Data as at 31/3/2000 and 31/3/2005.

[1] CNBC, 16 July 2020
[2] The weight of the top five names by market capitalisation in the S&P 500 index
[3] The Intelligent Investor, Benjamin Graham
[4] Profitability is assessed by operating profit margin; other metrics do not alter the conclusion
[5] We use the sum of the next two years of forecasted earnings, to account for growth differentials

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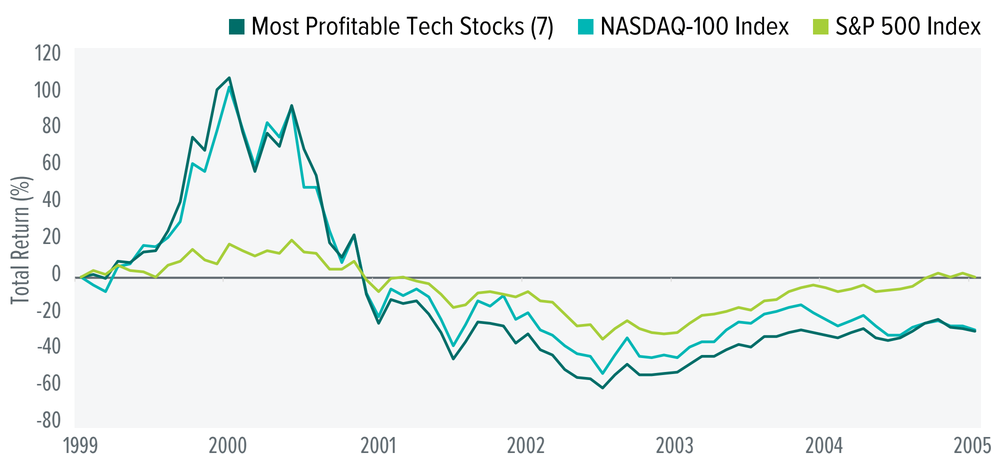
As shown in Exhibit 2, the same could not be said for the fortunes of investors in these companies. During the five years that followed the bursting of the tech bubble, valuations of these stocks came down to a reasonable premium and inflicted severe losses on investors who bought at or near the top of the market. Even when a lot went 'right', chasing performance by overpaying led to poor outcomes for the investors.

Exhibit 2: Bubbles Burst



Source: SEI based on FactSet, NASDAQ and S&P. Data for the period from 31/3/1999 to 31/3/2005. Returns in USD, gross of any transaction costs. Group of most profitable tech stocks includes: Microsoft, Cisco, Intel, Oracle, EMC, Applied Materials and Texas Instruments. Profitability is assessed by operating profit margins as at 31/3/2000. Indexes are unmanaged, and one cannot invest directly in an index. Past performance is not a reliable indicator of future results.

History Rhymes

As the old saying goes, history doesn't repeat itself, but it rhymes. What parallels can we draw from the tech bubble experience? Plenty. For starters, today we are witnessing almost verbatim media headlines. 'Dot com' has been replaced with 'cloud computing', while 'growth' has been augmented with 'quality'; 'value' now appears to be relegated to 'junk'. These are all plausible, in fact, reasonable arguments. Except for one little problem: What might happen when prices for greatness revert to a more typical premium?

Looking at the valuations in Exhibit 3 below, we can see both good and bad news. We include the SGIF Global Select Equity Fund—a portfolio currently criticised for its adherence to undervalued securities. First, we note that at 19x the next two years' earnings, the equity market now is not as expensive as it was in March 2000[6]. Likewise, the 'greats' of today are expensive but not as bad as their peers 20 years ago. Unfortunately, 'my bubble is smaller than yours' is not a valid argument for overpaying. A bubble is still a bubble.

Exhibit 3: A Bubble by Any Other Name ...

	Estimated P/E[7]	Long-term Average P/E
FAANMGs+Tesla[8]	35.5	18.0[9]
Global Select Equity Fund	12.4	12.7[10]
MSCI World Index	18.9	14.7

Source: SEI based on data from FactSet, Russell and MSCI. Data for the period from 31/8/2000 to 4/9/2020.

[6] Looking at the S&P 500 Index in March 2000 and the MSCI World Index today

[7] Weighted harmonic average P/E ratios, using the next 2-years earnings estimate

[8] FAANMGs+Tesla group of stocks includes: Facebook, Amazon, Apple, Netflix, Microsoft, Alphabet and Tesla

[9] 20-year average valuation of US information technology sector within Russell 1000 Index

[10] Weighted average of 20-year historical valuations of SEI alpha sources, applying current allocations, namely 63% Value, 16% Momentum, 10% Stability and 11% Low Volatility.

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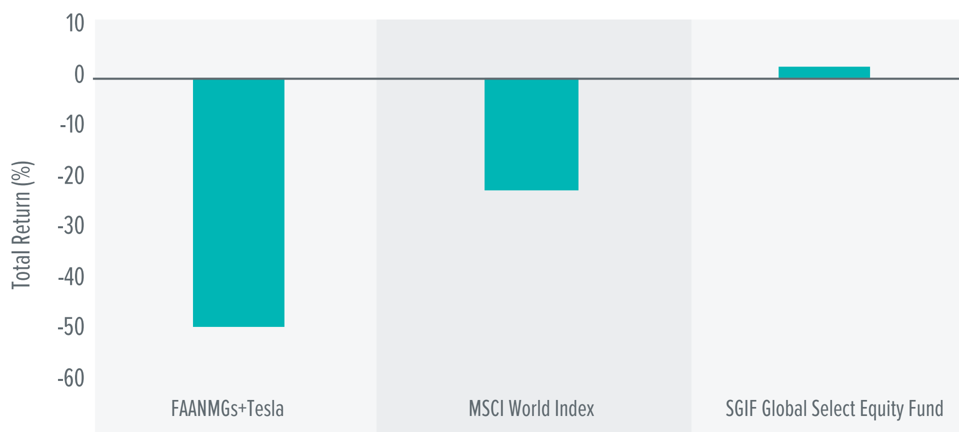
The Cost of Greatness

Let's examine what might happen when we return to normal. By 'normal', we don't mean that the COVID-19 crisis will dissipate. We mean that optimistic earnings forecasts will be realised, regulatory scrutiny will remain scarce, and innovation in the rest of the economy will disappear. We'll assume that the Yahoo of today will not face competition from the Google of tomorrow. And we'll deliberately disregard inevitable competitive threats, a foolish conjecture as investors in Nokia, Intel and IBM would likely attest. Making all of these unreasonably rosy assumptions, we then analyse what might happen if multiples for the same good earnings revert to more reasonable premiums.

Exhibit 4: Return to Normal



Source: SEI based on data from FactSet, Russell and MSCI. Data for the period from 31/8/2000 to 4/9/2020. Past performance is not a reliable indicator of future results. Return for Global Select Equity Fund is gross of fees.

The picture implies that, either earnings growth over the following few years will significantly surprise on the upside (over already generally optimistic projections from the analyst community), or returns are going to be disappointing, not just for FAANMGs but the broader MSCI World Index as well. Relying on the US Federal Reserve to further reduce the price of money and elevate valuations is also less plausible in a zero-interest-rate environment.

A More Prudent Approach

There is no silver bullet for long-term investment success. The unwinding of today's bubble is unlikely to follow the precise pattern of the 2000s. We recognise relentless competitive forces at play, not only at the single-stock level but also at the alpha source and style level. In a world of ever-evolving 'unknown unknowns', diversification is the only prudent solution, as cliché as it sounds. To avoid the damage that Yahoo, Nokia and IBM saw in the 2000s is to ensure sufficiently broad allocations to other stocks, industries and asset classes. Whenever the fashion of the day favours a few, we remain sceptical and look elsewhere.

Our active strategies are based on processes that don't rely on heroic assumptions. Our earnings advantage, or, to quote Benjamin Graham, 'margin of safety', is likely to cushion some of the blow when the normal becomes normal again. And no, we don't believe that this time is different.

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