

IS A VALUE REVERSAL DUE?

KEY POINTS

- The claim of Tech valuations nearing the late 1990's Tech bubble levels appears flawed.
- Growth has led value for years, and the economic impacts of COVID-19 have increased the spread between growth and value, leading some analysts to speculate whether a reversal is "due".

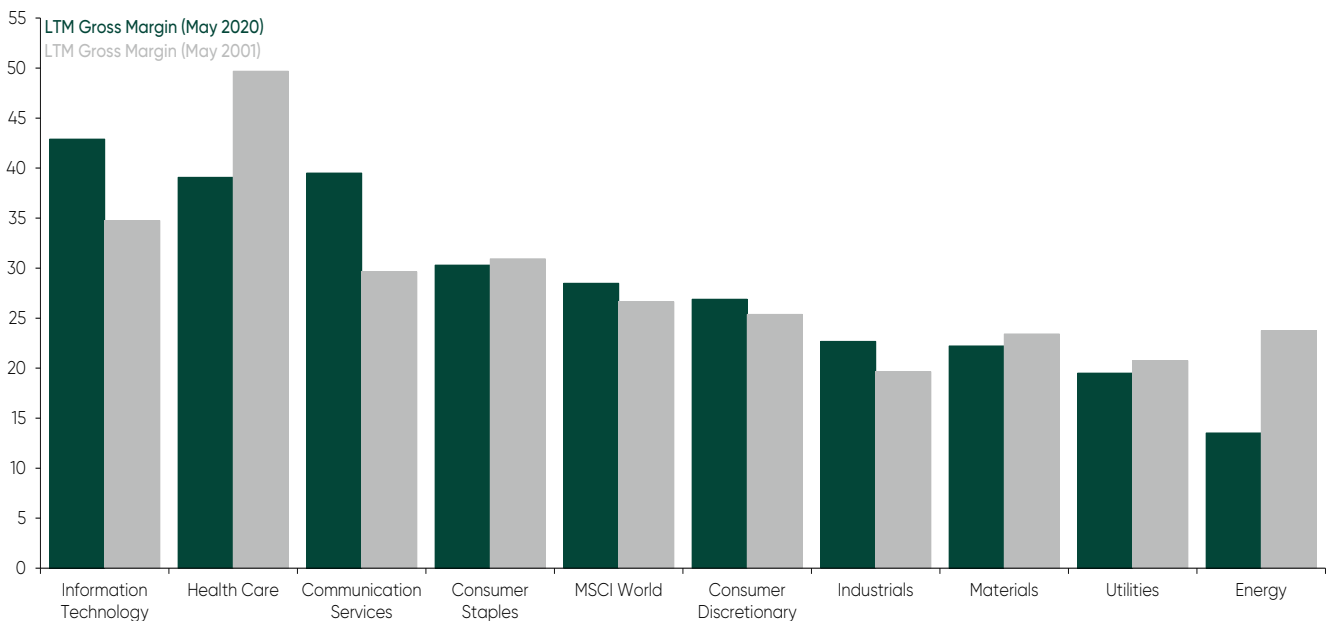
BACKGROUND

While COVID-19 has been a disaster for the global economy as a whole, it has hit smaller value equities harder than larger well-capitalized growth equities. There are numerous reasons for this growth outperformance. With arguably the most earnings uncertainty in the near-term vs. longer-term, it is cyclicals, with thinner margins and inconsistent growth profiles that have seen their prospects change most dramatically. Growth companies typically are better capitalized and thus able to deal with earnings uncertainty. Additionally, a smaller subset of growth stories have seen their business models benefit from COVID – e-commerce, parts of Healthcare as examples – whereas parts of value have seen their industries struggle mightily (parts of consumer sectors, as well as Airlines, certain REIT categories, and others). A combination of these factors led to sizable growth leadership during the bear market, surprising many investors.

VALUATIONS VS. FUNDAMENTALS

The claim that Tech valuations nearing the late 1990's Tech bubble levels appears flawed. Strong margins and sales growth are translating to higher earnings growth. Information Technology and Tech-like Communication Services can boast the highest gross profit margins of all sectors – a key differentiator from Tech in the late 1990s, when investors were willing to pay for unprofitable firms with unclear business plans.

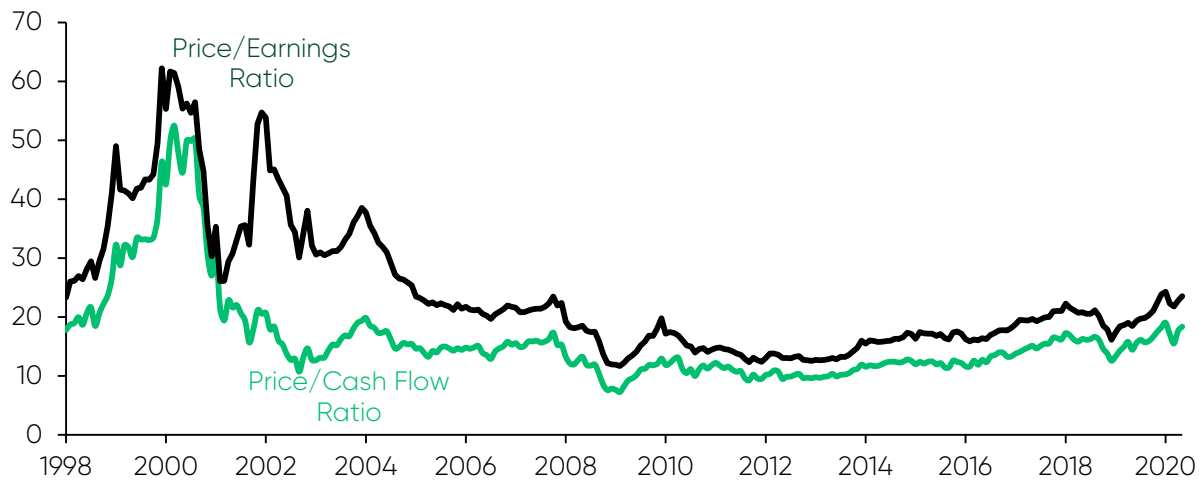
Exhibit 1: Last Twelve Month average Gross Margins (%)



Source: FactSet, Inc. as of 31/05/2020 using monthly data.

Measures such as forward P/E and price-to-cash flow indicate that Tech valuations—though slightly elevated above recent years—remain a far cry from prior peak levels.

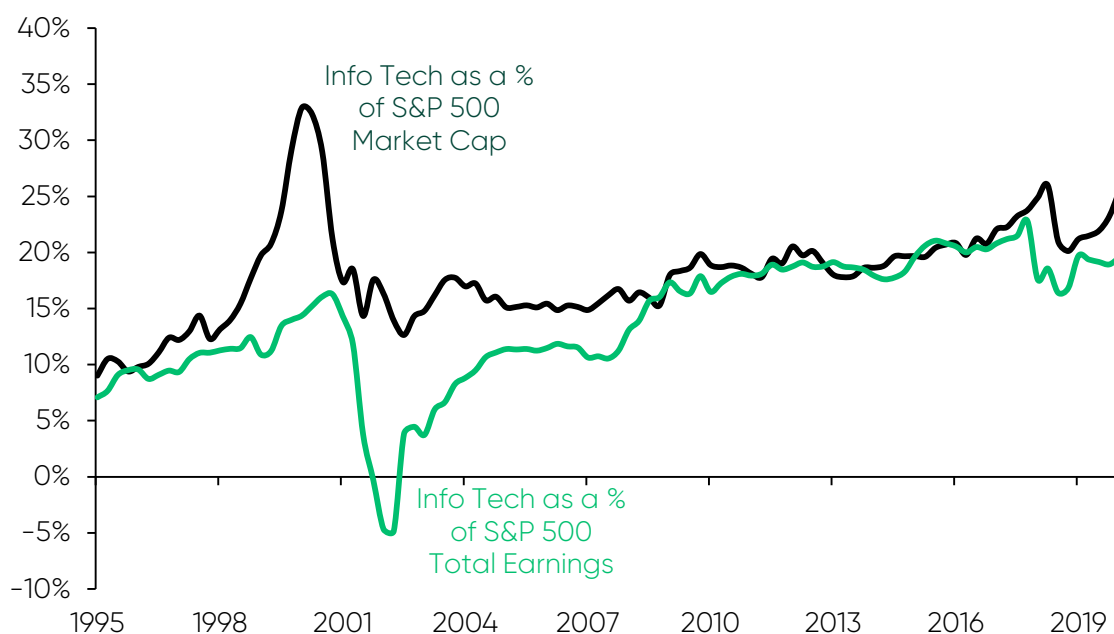
Exhibit 2: S&P 500 Technology Price-to-Earnings and Price-to-Cash Flow



Source: FactSet, Inc. 31/12/1997 – 31/05/2020 using monthly data. Price/Earnings ratio references the 12 month forward P/E.

Some investors caution that Tech is a rapidly growing share of the overall market—over 25% of the S&P 500's market capitalization, for example. This is true, but it is also true that Tech earnings have grown considerably as a percentage of S&P 500 earnings. Contrast this to the disconnect between euphoric prices and deteriorating fundamentals in the late 90's Tech bubble, when profit-starved Tech companies reached nearly 35% of the S&P 500's market capitalization. Overall, earnings and market capitalization have essentially moved in lockstep during the previous bull market, suggesting investor enthusiasm for the growth-orientated category may be warranted.

Exhibit 3: Info Tech Earnings and Market Cap as % of the S&P 500



Source: FactSet, Inc.; S&P 500 and S&P 500 Information Technology (Sector) Indices Market Value and Trailing 12M Net Income from 31/03/1995 to 31/03/2020.

CONCLUSION

In our view, mean reversion shouldn't form the basis of a tactical investment decision – valuations can stay persistently high for a long time, and its arguable they are currently justified. While we continue to favor larger high quality growth companies in this market environment, this is not a permanent bias, and we monitor style and factor changes closely. At different points in the market cycle, we will look to shift between small value-orientated firms and larger growth-orientated firms.

Whitepaper written as of June 2020, Fisher Investments' views may be subject to change in the future.

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