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Market Overview: High Valuations Reflect High Expectations

This article by Matthew Haynes is excerpted from a letter of 1949 Value Advisors, an absolute return-oriented global value investment firm based in Mahwah, New Jersey. Matt is a valued contributor to The Zurich Project.

Global equity markets generally rose (in local currency terms) during the second quarter, but the strengthening US dollar reduced unhedged returns to a modest decline in all but a few foreign markets.

It continues to be a difficult environment for global value investors, evidenced by the MSCI World Growth Index outperforming its value index complement by 3.7% during Q2 and by 7.4% year-to-date. The cumulative outperformance of growth over value since the start of 2017 has been severe at +19.3%, using the MSCI indices. Though not as severe as the eighteen month period preceding the peak of the internet bubble in March of 2000, the two periods are remotely similar.

First, both time periods were marked by narrow market leadership of richly valued technology stocks. One big difference, however, is that the “FAANG” stocks of today (Facebook, Amazon, Apple, Netflix and Google) command a large share of their respective (and more mature) markets and their business models have since been proven successful – very successful, in fact, even if long term sustainability amidst serious competition remains a question for some. A similar class of technology giants exist in Asia known as the “BATS” (Baidu, Alibaba, Tencent and Samsung), with comparable perceptions of invincibility driving already high valuations higher there too.

Valuation is a proxy for investor expectations: high valuation = high expectations of business performance. With many technology company valuations already implying great expectations, there is risk if analyst forecasts fall short. (with two exceptions: both Apple and Samsung valuations are very reasonable today. We have owned shares in both Apple and Samsung in client portfolios since the inception of the 1949 Global Value Strategy in July 2015.)

Another similarity worth mentioning is that both periods followed a prolonged advance in equity markets. Perhaps typical for a late stage bull market, investors have favored the perceived certainty of prevailing market leadership to the detriment of inexpensive stocks of companies with temporary issues. The behavior can be self-reinforcing, for a while, and the catalyst for a change in regime is elusive except in hindsight.

Many differences between these two periods exist, and while valuation and investor behavior are not mutually exclusive, their significance shouldn’t be dismissed. After all, history has a tendency to rhyme.

Value investing has proven the test of time, despite occasional periods of prolonged underperformance. Our approach to global value investing is designed to deliver both safety of principal and attractive absolute returns over the long term.

We believe that the best long term investment track records are as much about preserving capital during market downturns as they are about participating in market upturns. We strive to achieve this by building a portfolio of high-conviction securities that we believe are trading at large discounts to intrinsic value, with each holding’s financial strength and discounted valuation mitigating aggregate portfolio risk.