What does the new tech bubble and Covid-19 lockdown imply for value investors?

When will value make its long-awaited comeback? Vitali Kislenko, partner head of research, Europe at Research Affiliates, analyses why the unique market environment makes the value factor an extremely attractive proposition.

By Vitali Kislenko
5 October 2020

The Covid-19 lockdown is a unique event that will be studied in textbooks decades after the fact. Record unemployment, broken supply chains, unprecedented government spending, and a significant drop in GDP are just some of the events the world has experienced so far in 2020.

After an initial drop of more than 30% in February and March of this year, the developed equity markets have recouped that loss, racing higher, seemingly disconnected from the global economic reality.

A handful of tech companies has fueled this unprecedented equity growth. The tech-dominated Nasdaq Composite closed nearly 17% higher on August 24 than its pre-crisis peak, up almost 27% from the beginning of the year, and amassing an enormous cumulative gain of 410% over the preceding 10 years. As of July 31, the US equity market valuation has reached the bubble-level valuation of 29.6x in terms of price to cyclically adjusted most-recent 10-year earnings (also known as the Shiller P/E ratio) and 3.5x in terms of price-to-book ratio (P/B).

The growth [many of them, tech] companies today are priced at some of the most expensive, bubble-like levels in history. At the same time, crisis fears have pushed value companies’ valuations to some of the cheapest levels in their history. Both growth and value have hit these extreme valuation levels before, but never at the same time—the spread between value and growth valuations is the widest it has ever been.

Past experience has shown that the resolution of crisis uncertainty has been the best time to be invested in risk strategies. If history is an accurate guide, a return to economic stability combined with the historically unprecedented spread in valuations implies a very attractive value investment opportunity.

The new tech bubble?
his co-authors in Yes, It’s a Bubble. So What? defined bubble conditions as occurring when the gap between current valuation and historic average valuation of a stock or asset class is at an extreme.

The market constantly creates single-asset microbubbles, isolated examples of extreme mispricing. Wider bubbles are much rarer occurrences. The tech bubble in 1999–2000 falls into this category. Chart 1 shows current P/E valuations for growth companies (left axis, in orange) and value companies (right axis, in blue). The current P/E valuations for growth companies are on par with the tech bubble period of two decades ago.

Today, a handful of tech stocks, what we call the FANMAGs (Facebook, Apple, Netflix, Microsoft, Amazon, and Alphabet/Google), have collectively appreciated more than tenfold since 2007, representing about 24% of US stock market capitalisation (as represented by the S&P 500) and 60% of the Fama–French growth portfolio as of July 31, 2020. The FANMAGs’ valuations are responsible for the record-high growth valuations. Without these six stocks, the S&P 500 over the same period would have been lower by a cumulative 3,000 basis points.

Applying our definition of a bubble to the FANMAGs, Microsoft and Apple do not fit the strict definition, because only aggressive, rather than implausible, assumptions are necessary to support their high valuations. Others, however, present a more nuanced case as Rob Arnott and his colleagues explain in Bubble, Bubble, Tall and Trouble. Nevertheless, these six stocks are largely trading at valuations nearly as rich as they have ever traded—as is true of the US equity market as a whole, whose current Shiller P/E of 29.6x compares to its historical average of 17x. We would recommend not betting on the momentum’s continuing or trying to score a big win with a short position!

The extreme concentration caused by these and other highflying bubble-territory tech stocks impacts market cap-weighted indices. These indices are moving into bubble territory too as they take on increasingly larger positions in these stocks, replicating the concentration of the indices they track. Investors should be wary.

The value end of the bubble?

After nearly 16 years of value’s underperformance compared to growth, value investors are understandably re-examining their commitment to value investing. The corollary to this, however, is that value companies (whose valuations are shown in blue in the chart) are trading today at some of the most depressed valuations in history.

Rob Arnott, Campbell Harvey, Juhani Linnainmaa, and I in Reports of Value’s Death May Be Greatly Exaggerated explore several common narratives offered as explanations of value investing’s death as a robust investment strategy. We conclude that this time is not different. Because growth companies are trading at their most expensive valuations in history and because value companies are trading as
largely explained by widening valuations.

Of course, today, we are in the middle of one of the worst crises in recent history. The sectors hit by economic hardship and uncertainty have depressed valuations. To learn how factors may react in the forthcoming economic recovery, my colleague, Ari Polychronopoulos, and I analysed factor performance in recessions and subsequent recoveries. We considered the performance of the five most popular factor strategies — value, low volatility, quality, small-cap, and momentum — over the six bear-market recesions and recoveries (measured as two years after the market’s trough) in the United States since 1963.

Smart Beta outperforms traditional strategies, delivering a significant premium in their prices. As economic uncertainty is resolved, however, the prices for these strategies tend to spring back, heavily rewarding the patient investor.

Today’s unique environment combines fear-driven depressed valuations for value companies and the widest valuation spread between value and growth companies ever seen. Wide dispersions are not new. In the past, the valuation gap was mean reverting, narrowing to levels that drove value’s outperformance. As economic uncertainty around the current crisis is resolved, and if history is an accurate guide, these unique circumstances may prove to be very attractive for value investors.

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This article first appeared in the Q3 2020 edition of Beyond Beta, the world’s only smart beta publication. To receive a full copy, click here.

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