Capital Risk

GLOBAL EQUITY MARKETS

Requiem for Value Investing

Photo: Riccardo Annandale on Unsplash

Value investors are asking themselves, will the promise of value investing return to prominence? The answer is multi-faceted. Indeed, value investors experienced underperformance versus the broader market and growth stocks for the last *thirteen years*. A secular change transpired that gave life to the dominance of growth stocks, which may persist. Capital consumption and intensity are declining. Intellectual property investment is approaching equipment investment in amount. The result is unprecedented corporate profits. In a service dominated world where global trade, value resides in the income statement and not on the balance sheet. Caveat emptor for traditional value investors.

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Value is in the income statement, not the balance sheet. In a service-based business, people are the value proposition, not the invested capital.

Traditional financial measures of book value do not adequately measure value. Focus on cash-flow and the income statement instead.

- Jason Prole

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Highlights

- **Fixed capital** consumption and intensity are declining.
- **Intellectual property** is nearly equal to equipment in terms of value.
- **Corporate profits** are historically high as fixed capital investment declines.
- In the US, **growth** stocks are at an extreme versus value stocks.
- Globally, plenty of room remains for **growth** stocks to recoup the thirty-five-year outperformance of value stocks.

The Long View

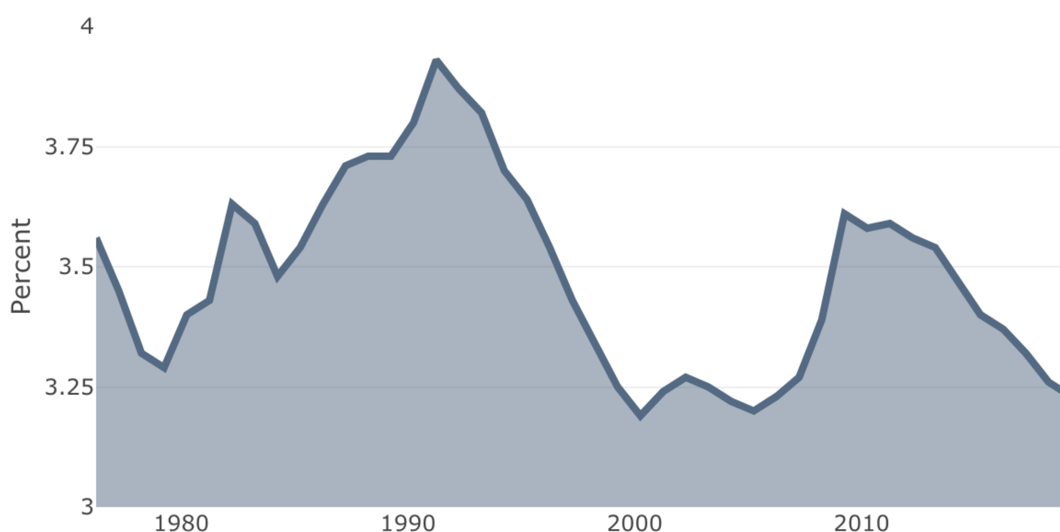
Growth has beat value for *thirteen* years.

Value investing expired over the last thirteen years as growth investing dominated. Investors look at the high multiples for growth stocks, particularly in US technology and see a reversal in the making. These investors see a bubble in technology stocks that mirrors 1999, which popped and brought the return of value investing for the following decade. The argument for value investing endures. Buy assets at a fair price. What if the asset changed from a capital good to people and intellectual property? In an economy dominated by services, not goods, the argument is compelling for changing *how to measure value.*

In the world of value investing, understanding the intrinsic value of a company is paramount. This evaluation uses the price-to-book, price-to-earnings, and price-to-sales measures to assess the value. A company must invest in some capital equipment, which impacts the first two measures. Over the last two decades, fixed capital consumption declined and peaked in 2009 at the prior 50-year average (exhibit 1). Companies are using less fixed capital to deliver their sales.

Capital utilization is declining.

Exhibit 1. Fixed Capital Consumption as Percent of Net National Product



Source: Federal Reserve Economic Database

The Long View

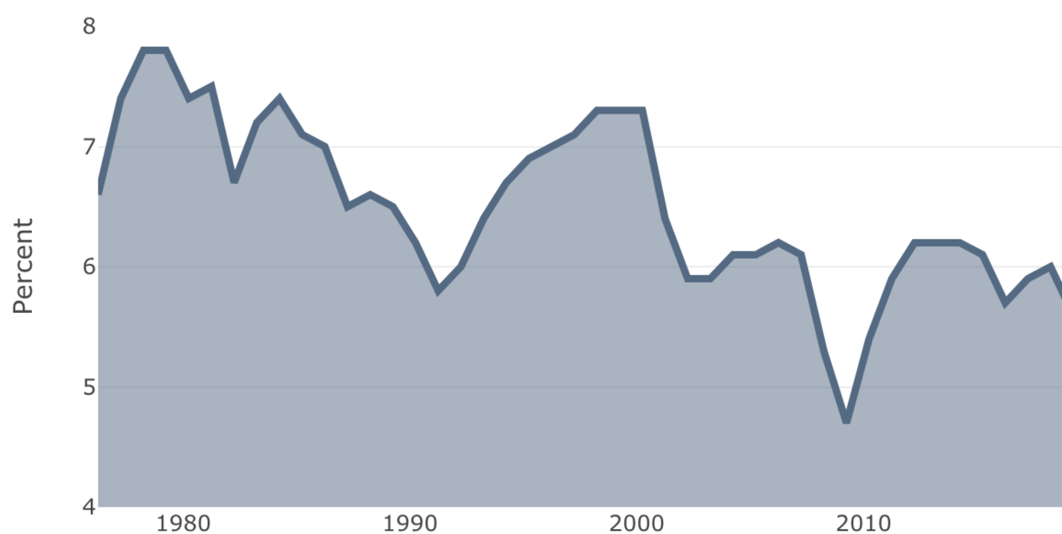
Capital assets are now *expenses*.

The cause linking this outcome is two factors. First, increasing global trade permits companies to outsource manufacturing, which is a well-documented feature of the US economy over the last twenty years. A capital good on the balance sheet is now an expense on the income statement. Thus, the level of capital investment decreases.

A decrease in capital expenditures implies that assessing value is inherently more difficult because fewer assets to value exist. Equipment investment in the US declined from about 7% of the economy to less than 6% over the last two decades (exhibit 2). The relevance of book value declines in this environment. Earnings could increase as investment costs decline for the same level of sales. The increased costs of purchasing the required goods may make this outcome less impactful. The result is declining ability to assess tangible value

Exhibit 2. Equipment Investment as Percent of Gross Domestic Product

Capital intensity is declining.



Source: Federal Reserve Economic Database

Second, the increased efficiency of capital goods permits companies to invest less for more. In an increasingly service-based economy, it is the people and the intellectual property that dominates investment. The former is a variable expense on the income statement, and the latter is notoriously hard to value.

The Long View

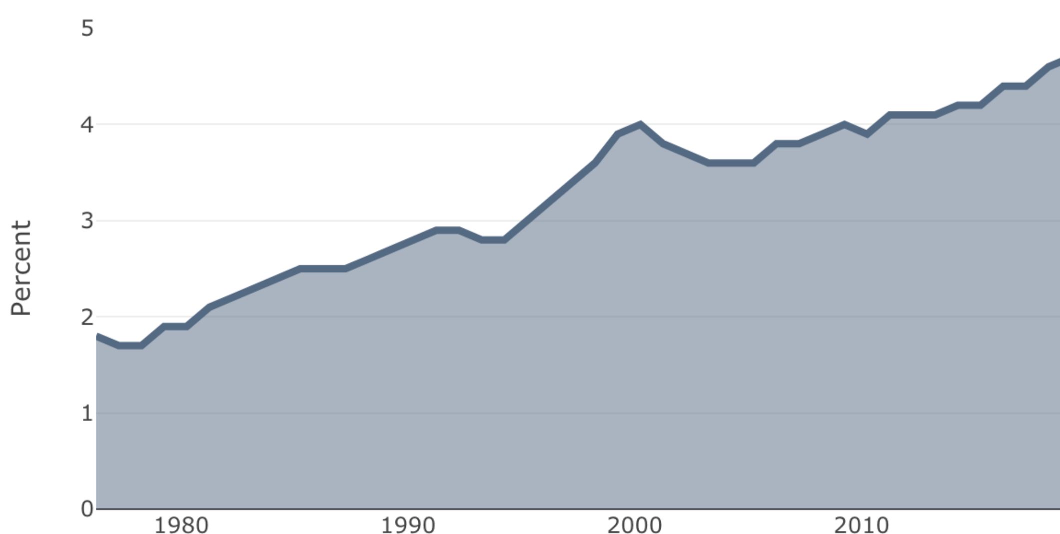
Valuing intellectual property is difficult.

Intellectual property may not even appear on the balance sheet for internally generated ideas. For example, Apple's iOS for its mobile phones contains value created close to fifteen years ago. It's not evident that this value was ever recorded on the balance sheet because the derived code came from people's work, not capital. It is no longer what you own that provides value. Instead, it is what you *know*.

The growth of intellectual property investment is steadily upward (exhibit 3). This outcome is the expectation in an economy dominated by technology and service. Companies increasingly invest in intangible items, rather than tangible goods. This action is particularly relevant when the intangible items need only reflect the historical cost. Apple could reflect the intellectual property of its iOS at the cost in 2006 when it's smart-phone market share was minuscule compared to the market leader, Blackberry. The implication is that even if the value reached the balance sheet it was a trivial value.

Investments are increasingly intangible.

Exhibit 3. Intellectual Property as Percent of Gross Domestic Product



Source: Federal Reserve Economic Database

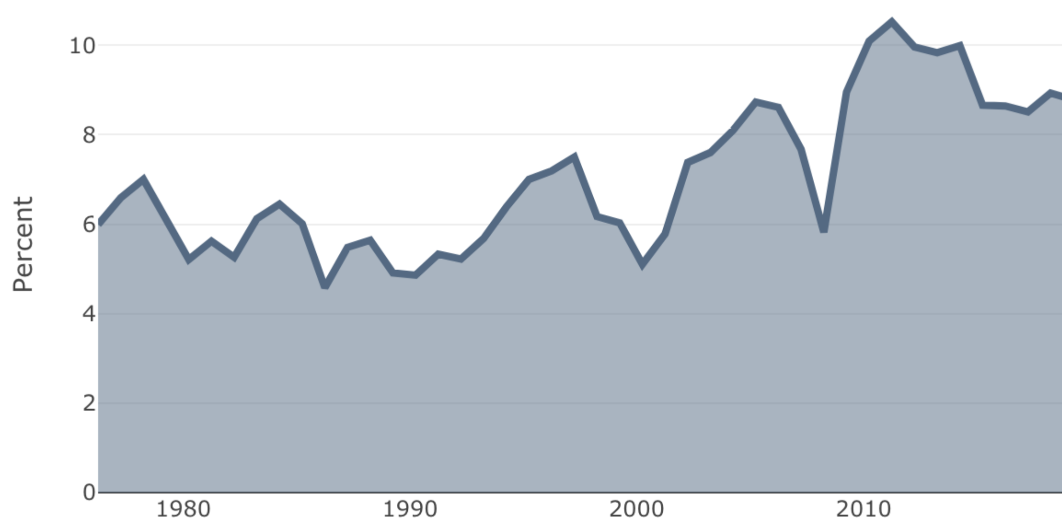
Value investors face an unenviable task. They must evaluate assets that are increasingly a smaller proportion of the business, and the assets that remain

are fiendishly hard to value. In an efficient market, these outcomes would suggest that there should be more value from the exercise of evaluating companies. The performance shows otherwise.

This outcome is surprising given the profits for US companies, which is about two percent higher for the last two decades than the average over the *prior fifty years* (exhibit 4). Companies are more profitable than ever. Yet, value remains elusive, and growth dominates.

As profits increase a third over the average.

Exhibit 4. Corporate Profits at a Percent of GDP



Source: Federal Reserve Economic Database

Technology monopolies harvest profits.

The problem is where growth occurs. Trillion-dollar technology companies dominate the provision of critical sectors (e.g., advertising and web services) that other businesses require. Their unrivaled profits indicate that they possess pricing power. So, even as other companies move assets from the balance sheet to the income statement, they do not necessarily capture all the potential value. The value resides in the income statement of the service providers, particularly in technology. Thus, unless there is a credible action for anti-trust against the technology monopolies, an investor is well served by focusing on the intangible value embedded in their income statements.

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The global equity markets rebounded strongly from the low in early March. The risk-on trade saw money plow into large caps stocks with the relative security of more diverse operations than their smaller siblings (exhibit 5). The rebound is unquestionably looking through the turn to the economic recovery. With some valuations *higher* than they were before the economic collapse, the valuation problem persists. When the economy is enduring a contraction exceeding the Great Depression, the case for higher equity valuations makes even the most bullish among us blush.

The small size premium is gone.

Exhibit 5. Relative Performance Global Equities by Size (Large/Small)

Source: MSCI. Capital Risk calculations. Ratio increases reflect large cap outperformance.

Monopolies are less sensitive to the economy.

There are a few business models that are mostly insensitive to the underlying economic forces. These businesses possess a unique attribute: they are technology monopolies. Where does an advertiser go when targeting specific customers when other distribution channels are non-existent? Google and Facebook. Where to go when people are sequestered at home watching TV? Netflix. Want more gaming entertainment on your phone? Apple's app store. Indeed, the pandemic is highlighting the strength of their monopolies.

For investors, the choice of growth over value is increasingly easy. Equipment is depreciating, and the business faces the uncertainty in terms of timing and

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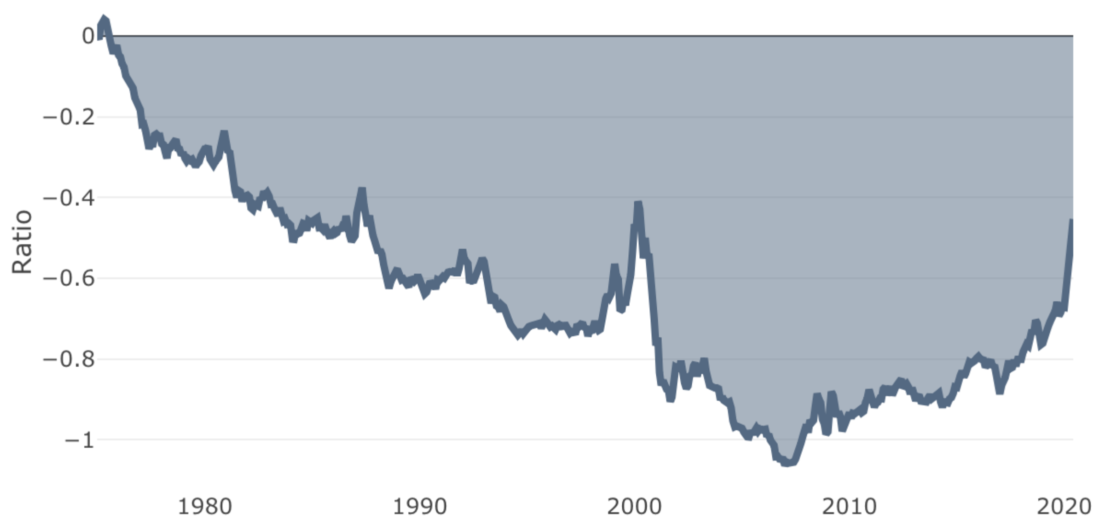
the definition of the new normal. While equities are the domain of returns that are uncertain in timing and amount, owning depreciating assets in this environment is not palatable.

The difference is earnings growth.

Affirmation for this statement needs to look at only the performance of growth stocks. Since the equity market bottom, growth stocks climbed about 20% higher than value stocks (exhibit 6). This trend is a continuation of the prior decade's out-performance by growth stocks. Still, the strength of global growth stocks is only half of the previous thirty-year outperformance of value stocks. The current rush into growth looks a little frothy and is not that different from the rush in 1999. While "this time is different" are investing's most expensive words, the difference this time is the earnings growth, the core metric of valuation.

Secure monopolies will enable growth stocks leadership.

Exhibit 6. Relative Performance Global Equities by Growth/Value



Source: MSCI. Capital Risk calculations. Ratio increases reflect growth outperformance.

Increasingly, the income statement is the place where value resides. Value investors assess the tangible assets or compare the relative strength of earning levels. These measures do not analyze the growth of earnings, which is the traditional measure of growth stocks. This distinction is not trivial. A growth

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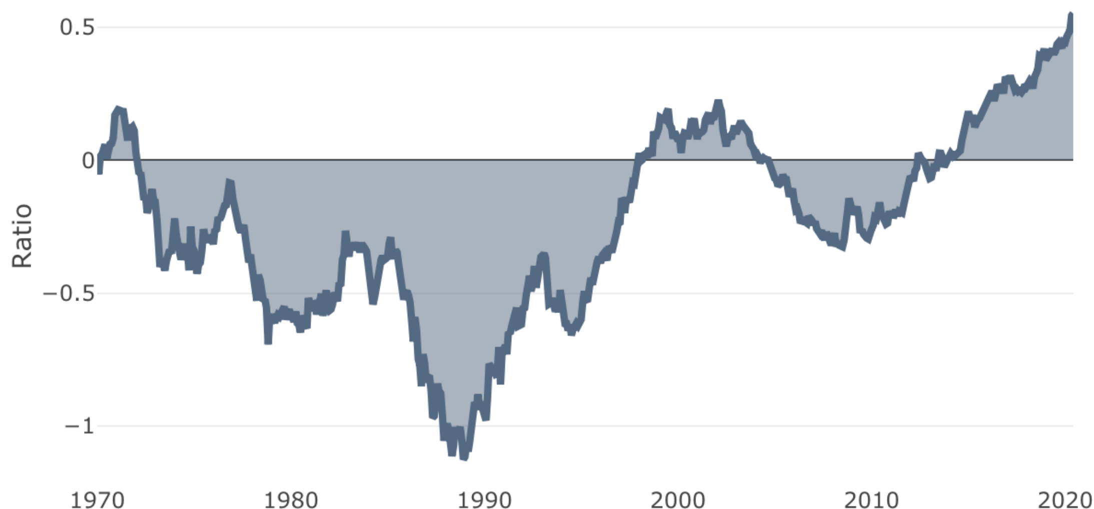
rate that is double another is more valuable to the investor than a low multiple on *current* earnings.

Earnings growth is the new value metric.

The ability to continue to generate above-average earnings growth is *a value measure*. The question is sustainability. The location of the dominant stocks provides an answer. The site of these companies in the United States, where monopolies, while not explicitly supported, are implicitly immune to anti-trust endeavors under the guise of consumer benefits. Highlighting this situation is the enduring out-performance of US stocks versus the rest of the world (exhibit 7). If not for the massive equity bubble in Japan during the late 1980s, US equity outperformance would be approaching *four decades*.

The US support of monopolies is unlikely to change soon.

Exhibit 7. Relative Performance of Equities by US/Non-US



Source: MSCI. Capital Risk calculations. Ratio increases reflect US outperformance.

Capital goes where the highest return resides. The US is that place with comparably low taxation and favorable accounting treatment of non-US earnings. Aging populations in Japan and Europe exacerbate this outcome with low growth rates that supports the US dollar. If country diversification is beneficial for a global portfolio, then you *must* own the most valuable market

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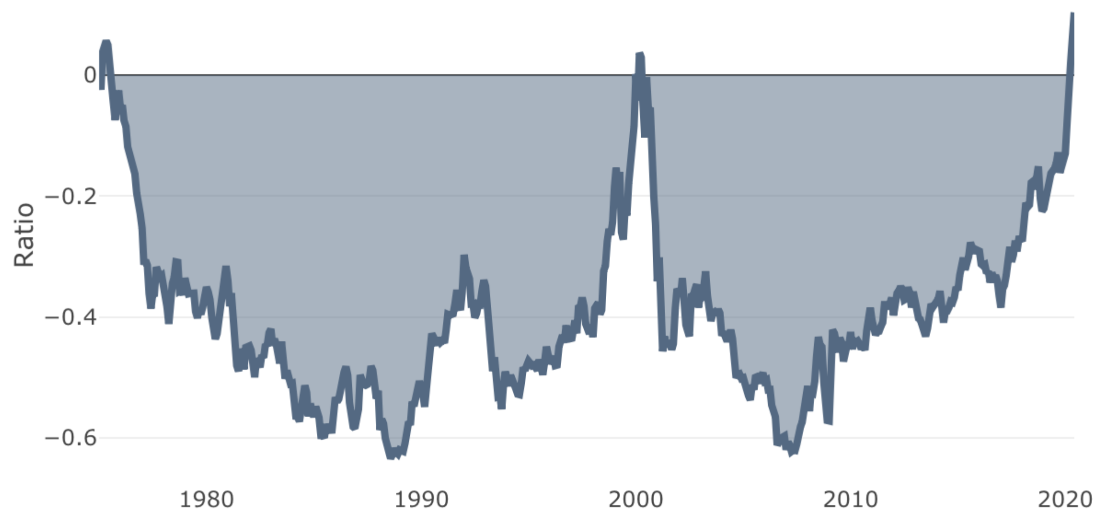
(the US). Otherwise, the investors face diminished global value of their investment in local currency terms.

The incentive for a US investor to diversify is minor.

US investors enjoy the 'exorbitant privilege' of having global trade and commodities denominated in the US dollar. This benefit results in them not necessarily needing to diversify their holdings. They are in an equity market than accounts for half the global total and a currency that handles the majority of global trade. Thus, for US investors, diversification is mostly a question of modest risk reduction with lower expected returns. Most US investors need not take this poor trade.

Growth is at an extreme versus value.

Exhibit 8. Relative Performance of US Equities by Growth/Value



Source: MSCI. Capital Risk calculations. Ratio increases reflect US outperformance.

The primary decision for a US investor is assessing value. The market is sending a strong signal that the end of growth over value is nigh (exhibit 8). The challenge is establishing *why* an investor should prefer value to growth. The dominance of the massively profitable technology growth stocks is a barrier that needs scaling to conclude that value is the next leader. This situation is where the problem elevates to one of defining value. Returning to the long establishing dividend growth model, earning growth relative to the price sets value.

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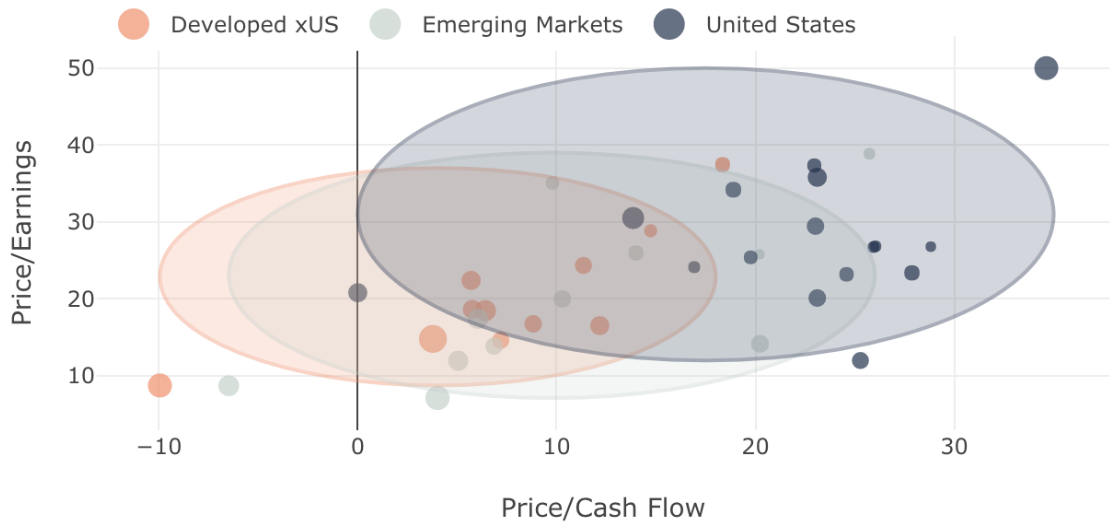
Cash flow reigns supreme.

This definition makes cash flow a more effective means of establishing value for simple reasons. A companies only financial goal is to generate cash flow from the business. Further, cash flow is a consistent measure *across* companies. Cash is cash. Thus, the comparison is more useful than earnings that are susceptible to manipulation and assets values that are difficult to assess.

This circumstance is where an obstacle arises for investors in the US. The US sectors are generally all higher than the developed markets and emerging markets by a *multiple of two* (exhibit 9). The implication is that all US sectors are the global leaders and will experience growth rates double their peers. There is a credible case for US technology titan, but this seems unfathomable for the rest of the US sectors.

US markets are richly valued.

Exhibit 9. Global Equity Valuations by Region and Sector



Source: S&P Indices. Size of marker reflects the dividend yield (larger is higher).

The US appears a crowded trade. The currency of last resort drove investors in the US as the Pandemic swept the globe. This action inflated US valuations relative to their siblings. While a premium should be attached to some US companies because of their global monopolies, it certainly does not justify *this*

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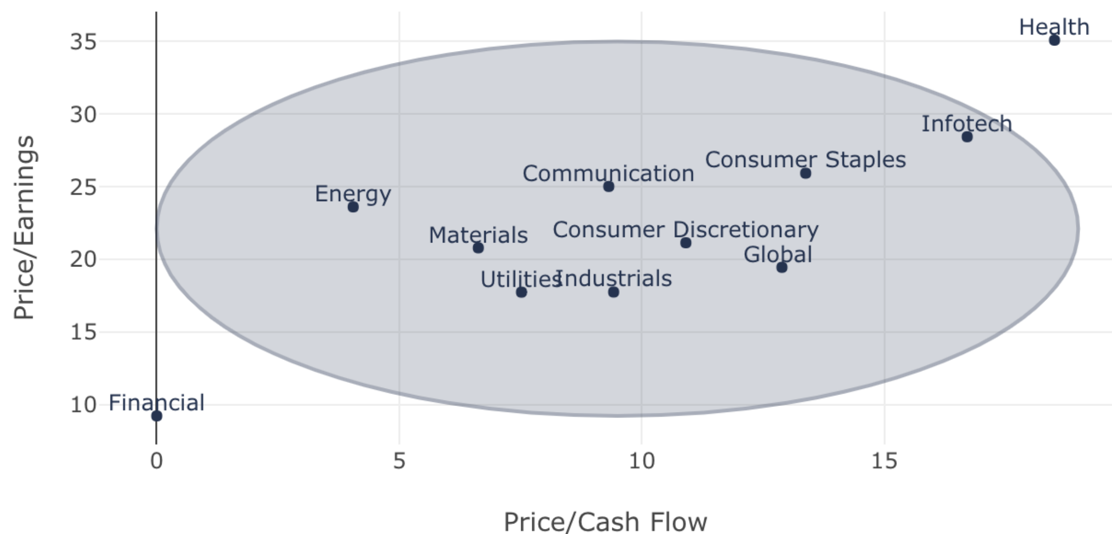
Beware non-Tech US sectors.

valuation gap. For example, US consumer staples are double their counterparts in the Emerging and Developed Markets. This discrepancy lacks any coherent argument. Thus, outside of the titans of technology, investors should seek value in non-US sectors and regions where cash flows are sustainable.

Among the global sectors, two outliers exist. First, Health Care is at an extreme valuation, even in the presence of a pandemic (exhibit 10). Paying a premium of about a third relative to other sectors for pandemic induced earnings seems an unrealistic position. Conversely, a value trap may exist in the Financial sector. Uncertainty remains to the length of the pandemic and the economic devastation that is occurring globally. Financials may face losses not seen in a *hundred years*. Or not. Until some economic clarity arises, the return-to-risk dynamic is unpalatable.

Health Care is too high and Financials too risky.

Exhibit 10. Global Equity Valuations by Sector



Source: S&P Indices.

By region, the US is moving further away from its global peers. Paying double for the cash flows of major US companies is a stretch by any measure (exhibit 11). A similar argument occurs for Emerging Markets Asia, where the

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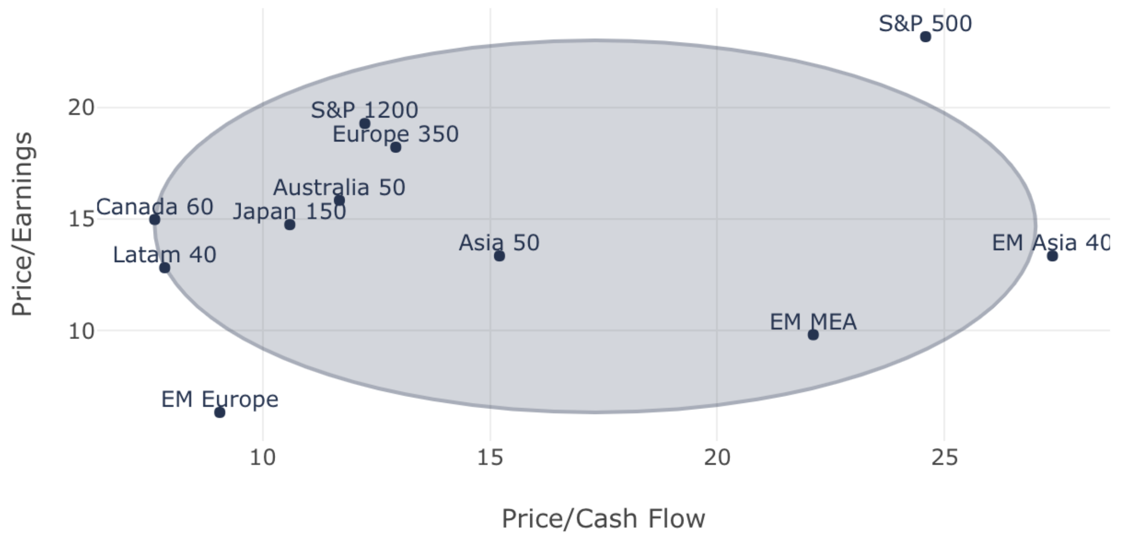
valuation is double the developed Asian markets, particularly when the developed Asian markets *exclude Japan*.

Exhibit 11. Global Equity Valuations by Region



Source: S&P Indices.

Commodity countries are risky.

The argument of where not to invest is contingent on commodities. Canada, Australia, and LATAM offer lower valuations. Their investment requires a positive outlook for commodities and expanding global trade. This argument is difficult given the economic uncertainty. Thus, caveat emptor.

Private equity can support US valuations.

Positioning is difficult at the best of times. During a worldwide pandemic, only more so. Relative value is the operating principle. US market valuations are too high relative to European and Japanese markets. While the dominance of the US technology sector can persist in the absence of anti-trust initiatives, the other sectors' high valuations are unlikely to endure. The private equity markets are the wild card. With more than a trillion dollars to deploy, they may be valuation indifferent as they seek the next technology titan. Thus, valuations gaps may ignore reality for an extended period.

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