



ARIA | CAPITAL

INVESTMENT INSIGHT

A weekly look inside the investment world.

“ *If you play a tune and a person don't tap their feet, don't play the tune.* ”
Count Basie

Friday, 10 July 2020

In this week's Investment Insight

Striking a fair price

There is much chatter among the investing classes about the high price (in valuation multiple terms) of many stocks at present, particularly in the technology sector. As to whether they are overpriced or not, well that depends. In general, particularly for large and mega cap stocks, the availability of extensive data and research means that there is almost 'perfect information', so the market is highly efficient. In theory at least, this should result in stock prices that reflect intrinsic value. Investors who view high-multiple companies as overvalued or low-multiple companies as undervalued are implicitly assuming that financial markets are biased most of the time, implying significant and frequent market inefficiency. While it is undoubtedly true that markets sometimes do get carried away and periodically price assets inefficiently, it is a relatively rare occurrence, as strongly suggested by the difficulty of systematically beating the market. So what is a fair price? In this week's *Inside Track* we delve into the matter.

Party like it's 1999

Will the debt funded EPS growth trick ever run out of steam? Will the party ever end? Of course it will, eventually somebody has to pick up the tab...and guess who that will be?! In *Pic of the Week* we look at just how big the party has gotten.

News wire

Some interesting nuggets from this week's newswires.

Market view

A visual snapshot of recent market performance.

The Inside Track: Striking a fair price?

Following on from last week's look at instances when paying an apparently high price is a sound investment decision, this week we consider what constitutes a 'fair' price and how it might be determined.

So what is a fair multiple when it comes to assessing whether a share is worth buying or not? Some of

the most successful fund managers we invest with argue, only partially in jest, that the price of a stock is fairly irrelevant to the assessment of its investment worthiness. Of course there are others, who in recent years have been less successful but who may yet prevail, that adopt quite a different approach. If a company is generating steadily compounding earnings growth then, mathematically speaking, there's more than a grain of sense to the price-indifferent approach, although of course it needs some qualification.

As was discussed in last week's *Inside Track*, investors should be willing to pay a seemingly astronomical multiple at the start of this company's life, justified by the prospect of years of profitable, value creating growth ahead. As the company moves through time and steadily consumes its growth opportunities, the justified multiple slowly converges to a steady-state multiple reflecting the shrinking prospects for profitable growth ahead.

The intrinsic value of a company is essentially the discounted value of all of its future cash flows to shareholders. No more, and no less. However, calculating that figure and translating it into the shorthand of a price earnings ("PE") multiple can require a lot of crystal ball gazing. How great is the company's competitive advantage that will enable it to sustain its margins? How capital efficient is it? What structural opportunities and threats does it face? Etc, etc. Then there's the predictable inherently unpredictable factors such as technological breakthroughs (Nokia who? Blackberry what?), paradigm shifts (whadaya mean we could never work from home?), new cultural norms (dating without tinder...was that a thing?), to name but a few.

A very common practice among investors is to use average historical multiples for estimating what a reasonable current or future multiple is or should be. The life-cycle perspective of what constitutes a justified multiple illustrates the inherent danger of relying on average historical multiples as a yardstick for valuation. Given the normally downward-sloping shape of the justified multiple trajectory through time, it is obvious that extrapolating from historical averages can easily lead to upward bias in valuation. A modification of this approach is to use a cyclically adjusted price-earnings PE ratio, often referred to as the Shiller PE. However, that too has its limitations.

Another ubiquitous practice is comparing the multiples of two companies without properly accounting for differences in underlying growth fundamentals. For example, if company A trades at a PE multiple of 20 and grows its earnings at 8%, while company B grows its earnings at 10% yet trades at a multiple of 'only' 15, which is more attractively valued? Most would opt for company B. However, the correct answer is that you don't know without examining the underlying value drivers. Perhaps company B is much more capital intensive and has lower returns on its capital than company A, or perhaps it is much closer to its steady state than company A. Investors cannot afford to ignore questions like these without running the risk of being led astray by superficially persuasive arguments based on multiples. Although it's not all that widely used, a very simple variant on the PE ratio, the PEG (PE divided by the growth rate) overcomes some, but not all, of the limitations of the PE ratio.

And so it seems, somewhat unhelpfully perhaps, that determining a 'fair' price is only part science, with art, experience and even luck making up the rest of the equation. PE multiples provide a shorthand to valuation, not a shortcut, so use with care and spread your bets.

Pic of the Week: Party like it's 1999

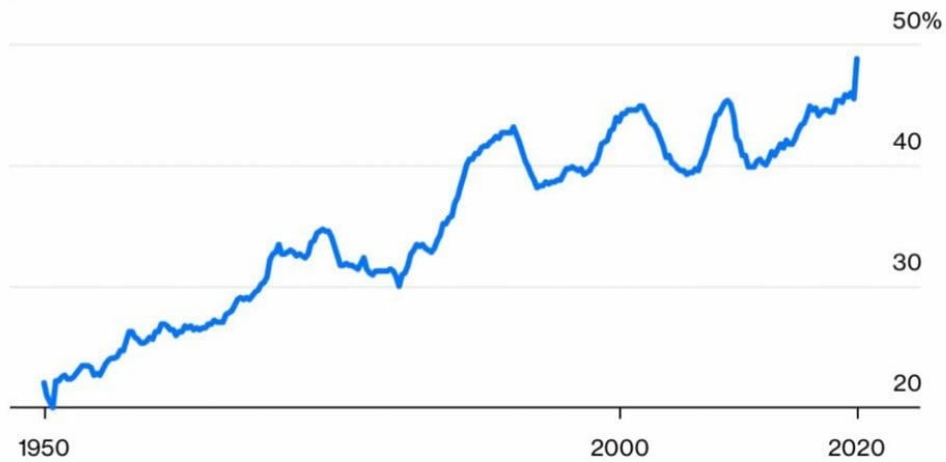
Much has been made of the US Federal Reserve entering the corporate credit market, even its legality has been questioned. The reality is that without it doing so, there would probably have been a complete seize-up in credit markets this year which would have seen a very different outcome for corporates than what has emerged so far from the pandemic. In fact, notwithstanding (or perhaps more correctly, due to) this intervention, US issuers are on track for a record-breaking year of investment grade bond issuance.

Of course, borrowing is one matter, paying it back is another, especially when revenues and earnings are under pressure. Regrettably, remuneration structures for executives, particularly in US corporates, motivate this behaviour, rewarding the EPS growth that debt-funded share buybacks delivers. The focus on issuing debt to buy equity has often resulted in capital projects and R&D investment being overlooked, meaning organic growth will likely be lower in the future. Management and shareholders continue to party like it's 1999, but eventually the music stops, at which stage it's all on the shareholders.

Record Leverage

U.S. companies are more indebted than at any point since at least 1950.

Non-financial corporate debt, percent of GDP



Source: Bloomberg, Federal Reserve

Newsire

...on Monday

China's blue-chip index, the CSI300, closes up 5.7% on Beijing's capital markets reform policies.

...on Tuesday

US markets fall after a strong rally as COVID-19 cases rise.

...on Wednesday

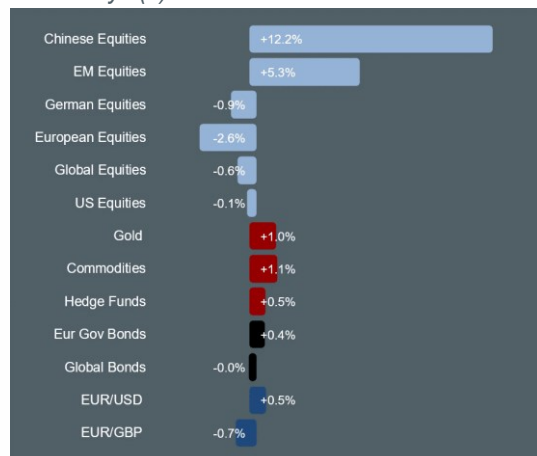
The US Dollar weakens against most currencies as investors favour risk assets.

...on Thursday

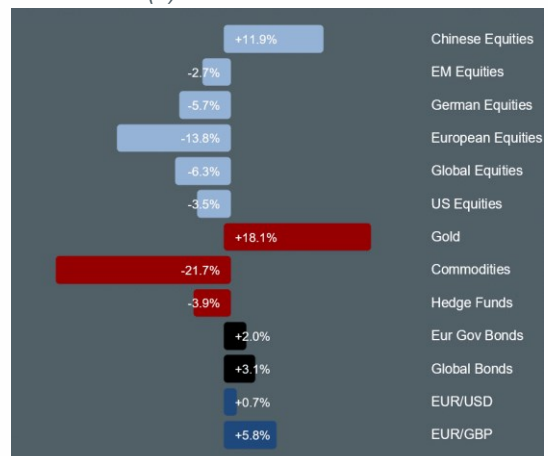
German exports rebound less than expected in May.

Market View

Last 7 days (€)



Year to date (€)





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