

---

# Taking Stock: What Were You Thinking?

**Barry Glavin, CFA**

Chief Investment Officer, Fundamental Value Equity

“There can be few fields of human endeavour in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of the memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present.”

— JK Galbraith, *A Short History of Financial Euphoria*

Equity markets have been led back to record highs by an increasingly narrow and richly-valued cohort of stocks. It's not the first time such a scenario has occurred, and it seems an appropriate time to dust off the history books to see how past experiences have played out. The MSCI World Index is currently trading at a price-to-book ratio of 2.5 and a price-to-earnings multiple of 21. We would consider these levels high, but while they are well above average, they are not off-the-charts. Given what seems to be an unusually uncertain time in terms of economics and geopolitics, a top-down investor might question the appropriateness of this level of optimism. However, what intrigues us, as bottom-up stock pickers, is the wide range of valuations across the market.

The polarisation of valuations among publicly traded equities is at record extremes, and these particular types of market conditions tend to present a lucrative opportunity for investors who are selective: a subset of the market is trading on extremely stretched valuations, while the rest is valued attractively. It is this spread of valuations that we are interested in examining.

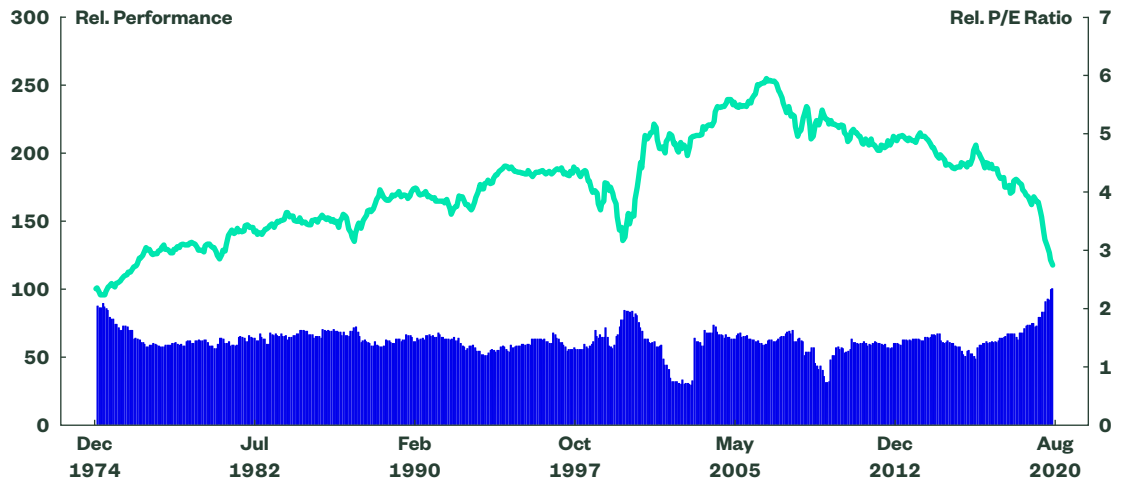
---

## How Did We Get Here?

To illustrate just how much valuations have moved over time, we have charted the relative performance of the MSCI World Value Index versus the MSCI World Growth Index since inception in 1974 (Figure 1). The shaded area represents the P/E premium, or the difference between the price/earnings ratio of the Growth Index and that of the Value Index. This chart captures quite well the underlying excesses in the current market regime and places the last decade in a very clear historical context. The current underperformance of value is the most dramatic on record in terms of both depth and duration, and the result is a valuation spread at record levels. We have only witnessed two market regimes in the last 50 years or so that come close: the Nifty Fifty in the early 1970s and the DotCom Bubble in the late 1990s.

Figure 1  
**MSCI World Value vs. Growth: Relative Performance (Value/Growth) and P/E Premium (Growth/Value) — (Dec 1974 – June 2020)**

■ Ratio of MSCI World Growth PE/World Value PE  
 ■ Relative Perf. of MSCI World Value vs Growth



Source: State Street Global Advisors, MSCI, as at 31 August 2020. Past performance is not a guarantee of future returns.

## The 1970s — The Nifty Fifty Era

In a 1970 essay, ‘The New Era for Investors’, legendary growth stock investor T. Rowe Price Jr. warned that the age of post-war great prosperity was probably drawing to a close, driven by higher inflation and eroding social cohesion, which he expected would eventually temper economic and earnings growth:

*“However, it seems likely that there will be a very limited number of blue chip premier growth stocks with an annual rate of earnings growth of more than 10%. Therefore, the increasing demand from institutional investors will greatly exceed the supply. Consequently, these stocks may be expected to command even higher premiums (price-earnings ratio) in the future than in the past. It is expected that they will be overpriced in relation to their intrinsic worth most of the time. They should be purchased only when they are available at reasonable price-earnings ratios.”*

This was amazing foresight, but the final sentence doesn’t seem to have attracted much of an audience. The stock market soared, driven by a group of US stocks known as the Nifty Fifty. The Nifty Fifty related not to a performance index, but instead to a select group of companies with powerful fundamentals: innovators that were uniquely positioned to benefit from long-term secular shifts in demand, with strong balance sheets, dominant market positions and very strong competitive moats. Among the line-up were Avon Products, Coca-Cola, Digital Equipment Corp, Eastman-Kodak, General Electric, IBM, Johnson & Johnson, McDonalds, Merck, Polaroid, Texas Instruments, Walmart, Walt Disney and Xerox.

The US stock market peaked in January 1973, with the subsequent collapse seeing it bottom out some 50% lower in October 1974. For the Nifty Fifty stocks, the share price experience was even worse.

## The IBM Experience

The IBM experience is illustrative. It was the largest stock by market capitalisation in the world at the 1973 peak, trading at a PER of about 40. Its stock price collapsed through 1973 and 1974 and it took until 1982 before it recovered to its pre-crash heights. In the intervening nine years, the company delivered earnings growth of c.11% per annum.

---

Despite the fact that many Nifty Fifty companies went on to thrive and deliver above-average earnings growth through the 1970s and beyond, like IBM their share prices fell dramatically and recovered only slowly. In other words, the businesses remained great, but the share prices had discounted too much, too soon, and were simply too high. The outperformance during the boom was driven by multiple expansion rather than earnings growth and once that peaked, value stocks went on to outperform growth, with one or two speedbumps, for most of the next 25 years (Figure 1).

**“ Since it’s obvious that investing in great companies works, it gets horribly overdone from time to time. In the Nifty Fifty days, everyone could tell which companies were the great ones. So they got up to 50, 60, 70 times earnings. And just as IBM fell off the wave, other companies did too. Thus a large investment disaster resulted from too high prices. And you’ve got to be aware of that danger”**

— Charlie Munger, Poor Charlie’s Almanac.

---

## The Late-1990s/ Early-2000s — Goldilocks and the DotCom Bubble

---

In the late 1990s, Greenspan’s Goldilocks economy — strong global growth with low inflation — proved a very constructive backdrop for equities. Markets withstood several setbacks to power through the turn of the millennium. But it was the emergence of the internet and related technologies that really captured investor imaginations, and one of history’s most notorious speculative episodes unfolded; the Nasdaq Composite Index rose from 1000 in 1995 to over 5000 in March 2000, with other indices following to varying degrees.

Growth outperformed value dramatically in this period as investors piled into the “new economy” stocks. Good technology businesses became significantly over-valued, while bad technology businesses — IPOs with no profits, no business model and often de-minimus revenues — attracted astronomical valuations. The market overall became exorbitantly valued and — similar to the 1973 experience — as the bull run entered its final phases, leadership narrowed and the spread of valuations widened to record levels (Figure 1). The bubble burst. The Nasdaq fell over 80% during the next couple of years and took 16 years to recover to those early-2000 highs. Value outperformed growth for the next seven years as the massive valuation premiums unwound.

What’s worth bearing in mind about that episode is that the technology bulls were largely right. These technologies did change the world, and probably to a greater degree than even the most evangelical could have foreseen. But if you paid too high a price for stocks to gain exposure to these trends, you lost a lot of money. The reflections of the CEO of a large technology company of the day sums it up neatly.

**“ ...But two years ago we were selling at 10 times revenues when we were at \$64. At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at \$64? Do you realize how ridiculous those basic assumptions are? You don’t need any transparency. You don’t need any footnotes. What were you thinking?”**

— Scott McNealy, CEO of Sun Microsystems. Interview with Bloomberg Businessweek, 1 April 2002.

## Post GFC — Echoes of Past Bubbles

Each market regime may have a different verse but the chorus is often very similar. The current regime has seen value underperform growth since 2007. For the majority of that period it was a headwind that we, as stock-pickers with concentrated portfolios, were able to overcome. However, trends have accelerated since August 2016, such that Growth has outperformed Value by 14% p.a. The earnings per share (EPS) of the MSCI World Growth Index have grown at 2.8% p.a., which is higher than the 0.5% p.a. growth rate delivered by the MSCI World Value Index, but what's the value of that superior growth? The P/E premium (the difference between the Price/Earnings ratio of the Growth and Value Indices) has jumped from 30% to 130%. As with both periods under review, the outperformance of Growth versus Value is almost entirely attributable to rating. The result has been a widening of the valuation spread to levels that now exceed those seen during both of the earlier periods discussed.

To our minds, the current market has echoes of both the Nifty Fifty and the DotCom Bubble eras. We have a group of highly profitable, dominant, innovative companies leading the market higher, and these are now trading on Nifty Fifty valuations:

Name	Market Cap (USD, m)	Net Income (USD, m)	Price/Earnings Ratio
APPLE ORD	2,294,818	54,346	42.2
AMAZON.COM INC	1,752,673	10,348	169.4
MICROSOFT CORP	1,719,900	43,465	39.6
ALPHABET INC	1,127,604	32,350	34.9
FACEBOOK CL A ORD	841,654	18,288	46.0
BERKSHIRE HATHAWAY INC	521,691	25,864	20.2
VISA INC	453,980	12,259	37.0
TESLA INC	442,656	-77	-5,751.0
WALMART INC	417,968	14,297	29.2
JOHNSON & JOHNSON	398,925	23,265	17.1
<b>Total</b>	<b>9,971,870</b>	<b>234,405</b>	<b>42.5</b>

Source: Refinitiv, State Street Global Advisors as of 31 August 2020.

Apple is a terrific example. It is obviously a great company. It is the most profitable company on the planet and therefore it's reasonable that it should command the highest market capitalisation. But the risk for investors is that the market capitalisation is too high. Its market cap first hit US\$1 trillion in August 2018. Profits of US\$59bn were reported for the full year to September of that year. Since then the market cap has more than doubled to US\$2.2 trillion, while profits for the full year to September 2020 are expected to be c. US\$57bn. It is clear that Apple's extraordinary share price appreciation has been driven not by profit growth but by multiple expansion. One wonders if the recent stock split will prove to be a gesture that retail investors will ultimately be grateful for.

There are also a significant number of companies trading at, or in excess of, the "ridiculous" valuation decried by Scott McNealy in 2002. As of 31 August 2020, there were 187 constituents of the MSCI World Index with a market capitalisation amounting to more than 10 times their annual sales. Their combined stock market value is over ten trillion US dollars. The largest ten companies in this group are set out in the table below:

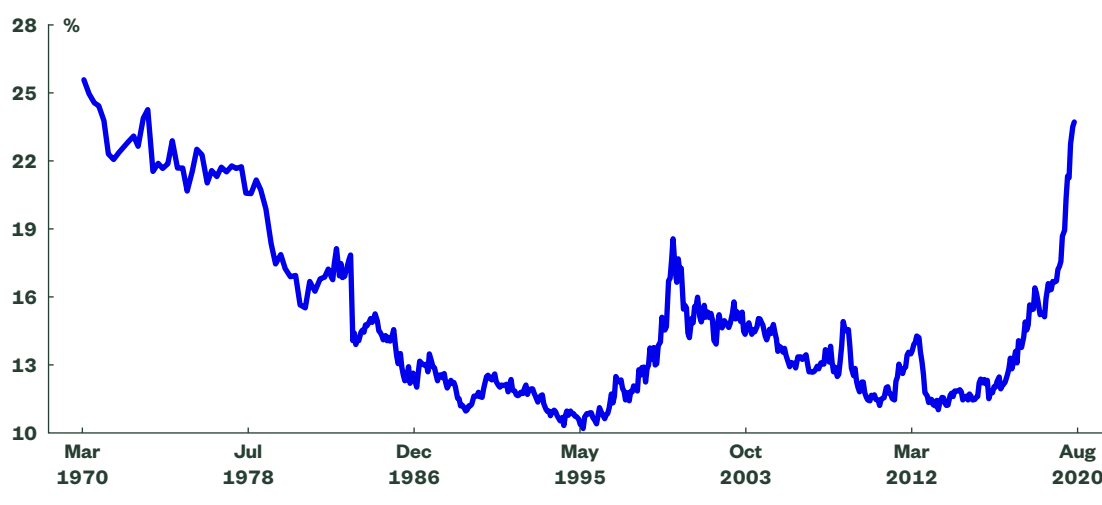
Name	Market Cap (USD, mn)	Sales (USD, m)	Price/Sales
MICROSOFT CORP	1,719,900	143,015	12.0
FACEBOOK CL A ORD	841,654	70,697	11.9
VISA INC	453,980	22,977	19.8
TESLA INC	442,656	24,578	18.0
MASTERCARD INC	357,279	16,883	21.2
NVIDIA CORP	341,102	10,918	31.2
SALESFORCE.COM INC	255,938	17,098	15.0
ADOBE INC	253,239	11,171	22.7
NETFLIX INC	245,447	20,156	12.2
PAYPAL HOLDINGS INC	245,280	17,772	13.8

Source: Refinitiv, State Street Global Advisors as of 31 August 2020.

A mention must also go to both Shopify and Zoom Video Communications, which sit just outside the top ten. With profits of US\$18m, Shopify is now the largest company on the Toronto Stock Exchange. Its current market capitalisation is US\$136bn. It has revenues of US\$1.6bn. Zoom's market capitalisation of US\$129bn compares to last reported annual sales of US\$623m. Even if we annualise the latest quarter's huge jump in revenues, it is trading at about 50 times sales.

As mentioned at the beginning of this article, the overall market is overvalued, but not excessively so despite the elevated valuations of these high-flying stocks. The explanation for this lies in the polarisation of valuations across equity markets. The winners are very expensive, while many of the laggards are quite cheap. In Figure 2, we chart the aggregate market capitalisation of the largest five companies in the S&P 500 Index as a percentage of the total over the last 50 years. This is a measure of concentration, or indeed a measure of the faith the market puts in a very small subset of companies, usually late into a rally. Again, we can see that there are three clearly identifiable periods where investors attributed exceptional powers to a select few stocks; the Nifty Fifty phenomenon during the 1970s, the DotCom bubble in the late 1990s, and the current period. And the chart clearly illustrates just how violent and unprecedented the recent level of concentration has become. This chart suggests that the market has made an unusually hasty decision about the relative worth of the five companies against the fundamental strength of the other 495 in the index.

Figure 2  
**S&P 500**  
**Concentration —**  
**Top Five Stocks By**  
**Market Capitalisation**  
**(Mar 1970–Aug 2020)**



Source: State Street Global Advisors, S&P, as at 31 August 2020. Past performance is not a guarantee of future returns.

---

The top five stocks on the S&P 500 now account for almost 25% of the index — a level of concentration not seen since the Nifty Fifty days. They have a combined market capitalisation of US\$7.7 trillion and combined profits of US\$159bn — this equates to a P/E multiple of 49 or an earnings yield of 2%.

One way of thinking about value investing is to set a target of securing the most (sustainable) earnings available per dollar invested. With that framework in mind, we can compare the profitability available in the market for the same market capitalisation as these top five names. If we imagined for one crazy moment that the secret to success was to buy low and sell high, these are the opportunities that this very distorted market is offering:

- Apple's market capitalisation is now approaching that of the entire FTSE 100 Index (US\$2.5 trillion). That diverse group of leading companies generate almost four times the profits of Apple: US\$207bn.
- The market value of Microsoft and Amazon is approximately US\$1.7 trillion each. Each one is worth about the same as all 82 European financial stocks in the MSCI World Index, which generate US\$182bn of profits — that is four times the profit made by Microsoft and about 18 times that of Amazon.
- The market capitalisation of Alphabet (Google's parent company) is now close to the value of Germany's Dax Index. Acquiring all 30 companies in that index would secure US\$95bn of earnings power — three times that of the very profitable Alphabet.
- The US\$842bn required to buy Facebook could buy you loss-making Tesla twice over (on 18 times sales). Or, you could buy the other 21 auto manufacturers in the MSCI World Index, which earn US\$88bn (versus Facebook's US\$18bn), and still have US\$120bn of "walking-around money".

---

## A Pin Awaits Every Bubble

---

As long-term investors, we've sought to avoid speculative excess and focus our portfolios on stocks that offer the possibility of long-term capital appreciation. Typically, we find these opportunities in regions outside the US and in sectors other than the likes of technology and consumer discretionary. In doing so, we believe we've been able to assemble diversified portfolios of well-managed, well-capitalised businesses that the market is valuing at significant discounts to intrinsic value. The fundamentals of these businesses are generally tracking in line with our expectations, but the multiples remain depressed as capital flows into the hot parts of the market.

Momentum is a powerful thing, and when it is in full flight it is difficult to determine when it will end. But, invariably, it does. How far can this run? When might this change? What might the catalyst be? The honest answer to each of these questions is the same: we don't know. Indeed, the answers may be unknowable and as such distract from the more important questions investors should be asking: What set of circumstances are required for the momentum trade to deliver a good return? Is this scenario plausible given what history tells us? What's the downside if things go wrong?

In the previous episodes, something unexpected happened: an oil price shock, an interest rate hike, an anti-trust investigation, a geopolitical event, a spate of frauds etc. And this is a constant — unexpected things happen. The future is always uncertain, and investors should demand to be compensated to assume that uncertainty.

**“ A pin lies in wait for every bubble and when the two eventually meet, a new wave of investors learns some very old lessons.”**

— Warren Buffett.



## About State Street Global Advisors

For four decades, State Street Global Advisors has served the world's governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we have become the world's third-largest asset manager with US \$3.05 trillion\* under our care.

\* This figure is presented as of 30 June 2020 and includes approximately \$69.52 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

### ssga.com

#### State Street Global Advisors Worldwide Entities

**Abu Dhabi:** State Street Global Advisors Limited, ADGM Branch, Al Khatem Tower, Suite 42801, Level 28, ADGM Square, Al Maryah Island, P.O. Box 76404, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. T: +971 2 245 9000.

**Australia:** State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services License (AFSL Number 238276). Registered office: Level 14, 420 George Street, Sydney, NSW 2000, Australia. T: +612 9240-7600. F: +612 9240-7611.

**Belgium:** State Street Global Advisors Belgium, Chaussée de La Hulpe 120, 1000 Brussels, Belgium. T: 32 2 663 2036. F: 32 2 672 2077.

**SSGA Belgium** is a branch office of State Street Global Advisors Ireland Limited. State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Canada:** State Street Global Advisors, Ltd., 1981 McGill College Avenue, Suite 500, Montreal, Qc, H3A 3A8, T: +514 282 2400 and 30 Adelaide Street East Suite 800, Toronto, Ontario M5C 3G6. T: +647 775 5900.

**France:** State Street Global Advisors Ireland Limited, Paris branch is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Paris Branch, is registered in France with company number RCS Nanterre 832 734 602 and whose office is at Immeuble Défense Plaza, 23-25 rue Delarivière-Lefoullon, 92064 Paris La Défense Cedex, France. T: (+33) 1 44 45 40 00. F: (+33) 1 44 45 41 92.

**Germany:** State Street Global Advisors GmbH, Briener Strasse 59, D-80333 Munich. Authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). Registered with the Register of Commerce Munich HRB 121381. T: +49 (0)89-55878-400. F: +49 (0)89-55878-440. **Hong Kong:** State Street Global Advisors Asia Limited, 68/F, Two

International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288. F: +852 2103-0200. **Ireland:** State Street Global Advisors Ireland Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered Number: 145221. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300. **Italy:** State Street Global Advisors Ireland Limited, Milan Branch (Sede Secondaria di Milano) is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Milan Branch (Sede Secondaria di Milano), is registered in Italy with company number 10495250960 - R.E.A. 2535585 and VAT number 10495250960 and whose office is at Via Ferrante Aporti, 10 - 20125 Milano, Italy. T: +39 02 32066 100. F: +39 02 32066 155. **Japan:** State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan. T: +81-3-4530-7380. Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association. **Netherlands:** State Street Global Advisors Netherlands, Apollo Building, 7th floor Herikerbergweg 29 1101 CN Amsterdam, Netherlands. Telephone: 31 20 7181701. SSGA Netherlands is a branch office of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2.

**Singapore:** State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore). T: +65 6826-7555. F: +65 6826-7501. **Switzerland:** State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16. **United Kingdom:** State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority.

Registered in England. Registered No. 2509928. VAT No. 577659181. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350.

**United States:** State Street Global Advisors, One Iron Street, Boston, MA 02210-1641. T: +1 617 786 3000.

The information provided does not constitute investment advice as such term is defined under the Markets in Financial Instruments Directive (2014/65/EU) and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell any investment. It does not take into account any investor's or potential investor's particular investment objectives, strategies, tax status, risk appetite or investment horizon. If you require investment advice you should consult your tax and financial or other professional advisor. All information is from State Street Global Advisors unless otherwise noted and has been obtained from sources believed to be reliable, but its accuracy is not guaranteed.

There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.

Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

Diversification does not ensure a profit or guarantee against loss.

Investing involves risk including the risk of loss of principal. The views expressed in this material are the views of Barry Glavin through the period ended 31 August 2020 and are subject to change based on market and other conditions.

This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

**The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the Markets in Financial Instruments Directive (2014/65/EU) or applicable Swiss regulation. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.**

This communication is directed at professional clients (this includes eligible counterparties as defined by the appropriate EU regulator) who are deemed both knowledgeable and experienced in matters relating to investments.

The products and services to which this communication relates are only available to such persons and persons of any other description (including retail clients) should not rely on this communication.

Equity securities may fluctuate in value in response to the activities of individual companies and general market and economic conditions.

The trademarks and service marks referenced herein are the property of their respective owners. Third party data providers make no warranties or representations of any kind relating to the accuracy, completeness or timeliness of the data and have no liability for damages of any kind relating to the use of such data.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without SSGA's express written consent.

© 2020 State Street Corporation.  
All Rights Reserved.  
ID295470-3233777.11.GBL.RTL 0920  
Exp. Date: 30/09/2021