Value Investing's Dark Hour

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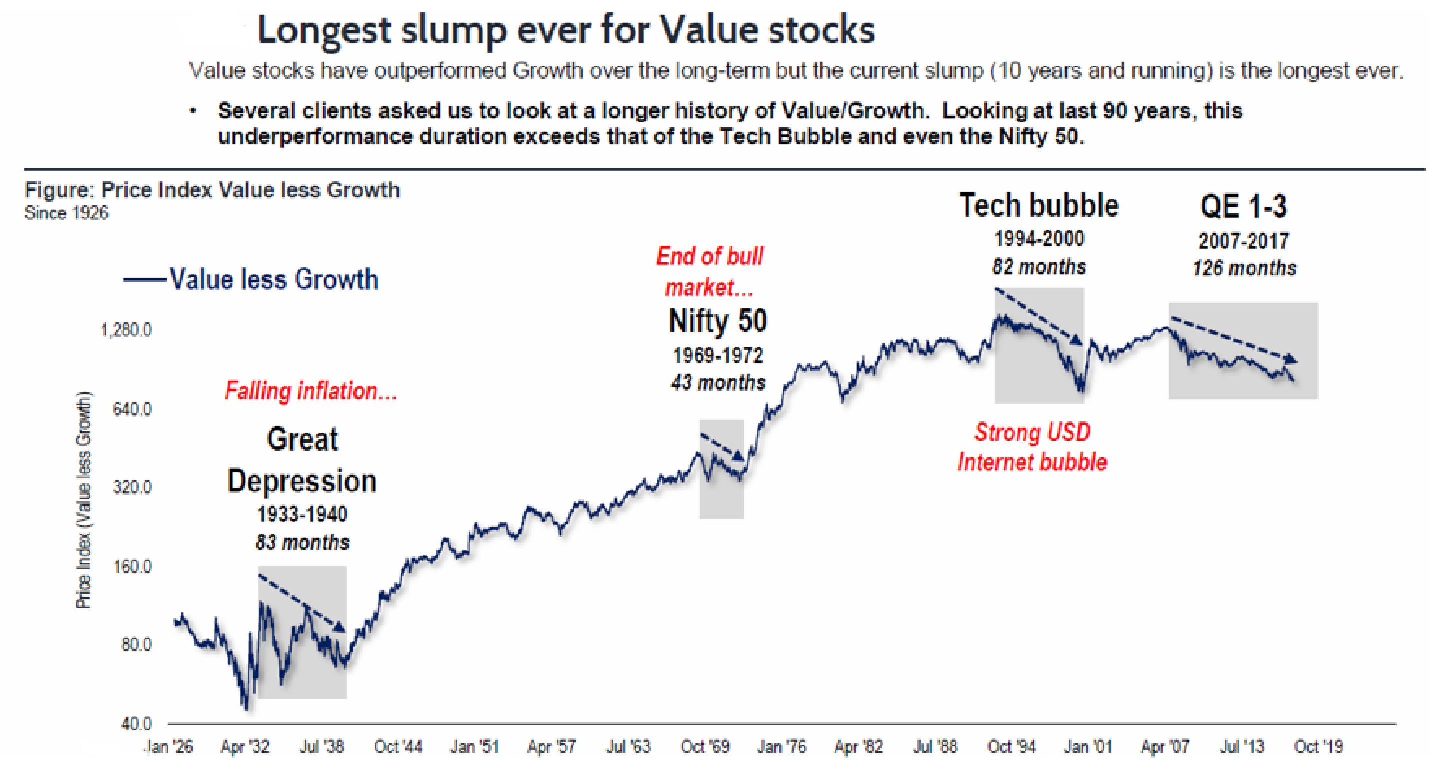
Is the underperformance by most large-cap value investing strategies in this lengthy bull market the "darkest hour" for value investors? As the chart below shows, this is the longest underperformance stretch of four relatively poor stretches for value in the last 80 years:[1]



We recently saw the new movie about the change in British leadership at the lowest point of World War II called, "The Darkest Hour." Britain had attempted to appease Nazi Germany via diplomacy and compromise. The allied countries found their military trapped in Dunkirk after the German forces drove the opposition to the sea. It was a seemingly hopeless situation for the countries allied against the totalitarian evil which was perpetuated against Continental Europe.

The best estimates were that 30,000-50,000 of the troops trapped in Dunkirk could be rescued. It took incredible leadership from Sir Winston Churchill to encourage the British people and the European resistance against tyranny.

This is a “dark hour” for value investing after many years of relative mistreatment. However, in my 38 years in the investment business it has been much worse. It was much darker from April 6th of 1998 to the 9th of March in the year 2000. Let us take you for a walk down memory lane to be reminded of what the most extreme growth-stock investment insanity looked like.

Tech stocks had done well from 1995 through the spring of 1998, but so had the broader market and large-cap value strategies. It is our opinion that the demarcation line where tech/growth stocks and value disciplines completely disconnected was when Travelers and Citigroup merged in a $140 billion transaction. Sandy Weill, the CEO of Travelers, was the architect of the merger and caused an explosion to the upside of both stocks. This merger also effectively broke down the Glass-Steagall Act, which had kept a barrier between the investment business and the deposit-taking banks. It proved to be the peak in financial stocks and domestic non-tech stock price performance.

Using the Russell 1000 Growth and Value Indexes as the comparison, the growth index clobbered the value index by 65.7% from the day of the big financial company merger to the day the tech bubble broke on March 10, 2000. My memory reminds me of losing around 10% of our portfolio value from January 1st of 1999 to the March 2000 market peak, while the S&P 500 Index (heavily-weighted in tech) rose 24.0%.

This historical extremity culminated in some of the goofiest pricing I’ve ever seen among growth stocks. My favorite from that era was eToys. They had very little in sales and were bleeding red ink, but they topped out at a $7.7 billion stock market capitalization. Northern Telecom, a Canadian tech stalwart, peaked in 2000 at 33.5% of the entire capitalization of the Toronto Stock Exchange. At the same time, numerous solid non-tech companies were trading for 10-times earnings and were offering generous dividends. Few investors cared.

How is this “dark hour” today similar to the “darkest hour” in early 2000 and how is it different? The similarity starts with the biggest and most popular tech stocks. In the late 1990’s it was Microsoft, Cisco and Intel who had the largest capitalizations and the most momentum. Another tier was led by Sun Microsystems and Lucent technologies. Today, the stock market has made Facebook, Amazon, Apple, Netflix and Google (FAANG) the kingpins with other tech companies filling the tier just behind them.

Secondly, the most profitable of today’s glamour tech stocks sell at price-to-earnings (P/E) multiples similar to 1999, but Amazon and Netflix trade for P/E ratios reserved for only the most futuristic glams back then. Some days Amazon looks like Microsoft did in 1999 and some days its money-losing divisions remind me of eToys.com.

The two biggest differences in the “dark” periods for value investing are the effectiveness of the monopolies held by the FAANG companies and the dearth of Initial Public Offerings (IPO) of common stock in the current episode of tech financial euphoria. By 1998, Microsoft’s monopoly in operating systems and software was challenged by the U.S. government. It does not appear that the politicians of today understand how powerful and anti-competitive these popular tech companies are.

Tied to the power of Facebook, Google and Amazon is a lack of new public companies being brought to the stock market. All the market growth is being sucked into these monopolistic stalwarts which leaves investors to pursue a narrow list of favorites. It all reminds us of the Nifty-Fifty one decision stocks of the early 1960's.

What ends these "dark" eras for value investors? Unfortunately, it is usually a bear market in growth stocks and many times the bear market drags the whole stock market down with it. Periods of euphoric growth stock outperformance die by running out of buyers. Our job as portfolio managers in these situations is to get our portfolio out of Dunkirk.

Warm regards,
William Smead

[1]Source: FundStrat 30 September 22, 2017.

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