Bubblicious?

COVID-19 and related counteractive policies have had an extremely negative impact on domestic and global economies. Whether or not you believe that the policies weren't strong enough, or if they were overzealous, we are where we are.

Consequently, this all has created a great deal of short and intermediate-term uncertainty, and introduced more ambiguity than most market participants have ever experienced. Even Warren Buffett himself seems a bit befuddled by it all. Here is an excerpt from his recent annual meeting (cast to a live audience of about five people, but a streaming audience of over five million):

> *"We do not know exactly what happens when you voluntarily shut down a substantial portion of your society. In 2008 and '09, our economic train went off the tracks, and there were some reasons why the economy (?) was weak in terms of the banks and all of that sort of thing. But anyway, this time we just pulled the train off the tracks and put it on a siding, and I don't really know of any parallel in terms of the very most important country in the world; the most productive, with a huge population, in effect sidelining its economy and its workforce and obviously and unavoidably creating a huge amount of anxiety and changing people's psyche and causing them to somewhat lose their bearings in many cases, understandably."*

There has also been much discussion in the financial press regarding the relative strength of the stock market in light of the terrible damage that is being done to the economy. Some opinions range from bewilderment to downright consternation. Of course the market is discounting the future, not the past or present; and surely the trillions of dollars and other currencies that governments are dropping into the global economy will have a countervailing effect. However, it is still hard for many to reconcile the market's insouciance today given all that has happened.

Through Friday, May 29, the S&P 500 generated YTD losses of just 5%. This is hard to square with a US unemployment rate that jumped from less than 4% to nearly 15% in the space of three months. Notwithstanding all this, however, there actually *is* something incredible brewing just below the surface[i], something that is not just reflecting a lot of bad news, but maybe even too much of it.

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1) Growth and Value

So far in 2020, while the market-cap weighted return of the S&P 500 may be -5%, the equal-weighted return is -12%. This reflects the underperformance of small caps, which we will discuss below.

If we take the equal-weighted approach, and construct a portfolio consisting of the most expensive 50 companies at the start of the year (at the time on a forward P/E of 32.7x) we discover it is up an average of 8.7% YTD.

We also learn that these high-multiple stocks have experienced 38% multiple expansion this year.

Meanwhile, a 50-stock portfolio of the cheapest companies at the start of the year, a basket which started with a P/E of just 8.9x, is down 21.5% in 2020.

In other words, cheap stocks have underperformed expensive stocks by over 30% this year.

Consequently, the most expensive decile has an average 2021 P/E today of over 45x. The cheapest decile has an average P/E of just 10.7x.

This divergence seems particularly unusual to the investor that determines fair value based on many years of future cash flows rather than just current operating metrics. In most states of the world, deep-value cyclicals should not trade on trough P/Es at trough earnings. The trough P/Es are reserved for the peak fundamentals, because we know that the cyclicality will mean-revert. Meanwhile, the peak P/Es are reserved for the trough fundamentals, because – again – we know that cyclicality will eventually mean-revert.

Not this time, at least so far.

Some readers might immediately counter with "yeah, sure, but this time it is different, these winners are actually benefitting from the pandemic, as it is revealing their stability, and defensibility."

We would suggest that, sure, in some individual cases, this may be true. But we are talking about groups of 50 here. We're trying to move beyond the cult of the FAMANGs and into broad market behavior. We have a group of 50 already-expensive stocks at the start of the year, and a group of 50 already-cheap ones; and - believe it or not - the fundamental differences of the two groups is not nearly as stark as one might expect.

These deep-value cyclicals, many with huge balance sheets and high operating leverage, are naturally very exposed to an economic downturn. Everyone knows this. They've consequently experienced 28% downgrades to forward earnings expectations. Notwithstanding the question about what to pay for these things, perhaps that's the right number in terms of this quick hit to fundamentals in 2020 and into 2021.

And surely - the bulls may argue - the expensive names were not only more insulated, but benefitted from secular growth drivers that stimulated improvements in fundamentals, and propelled earnings upgrades.

But they didn't. The expensive names that are up another 8.7% this year have seen earnings downgrades of over 20% too. So basically there is a bear market this year, and a strong negative reaction to the pandemic, but it is only in the names that were cheap to start with. Fundamental developments have been similar for each group, yet the ones that people already liked beforehand are actually up YTD, and thus are not only camouflaging the poor treatment of the value names, but holding up the broader index. They're making things look better than they really are.

2) Large Caps

The ten largest companies started the year with a total combined market capitalization of $6.6 trillion. Today, those same stocks have a market cap of $7.3 trillion. This means that during COVID-19, these ten companies have seen their total market cap increase by $700 billion. Their average market cap is $732 billion, up from $664 billion at the beginning of the year. If we stretch it out to the largest 50 companies, they started with an average market cap of $278 billion. At the same time, the smallest 50 had an average market cap of just $6.6 billion.

Those smallest 50 are down 21.1% this year. The largest 50 are up 4.7%. And the largest 50 trade at an 80% P/E premium to the smallest 50.

Sure, larger companies should be larger than smaller ones. That's a tautology. But should larger companies necessarily have a larger P/E? If so (hint, they shouldn't) should they command an 80% premium?

3) Quality

The low-quality names have indeed experienced heavy downgrades this year (of over 32%). But the high-quality[ii] names have not been entirely immune from the pandemic, and in fact have experienced over 17% downgrades themselves.

Despite fundamental downgrades for these fan favorites, the high-quality names - with the market down 12% - are up 11% this year. They are outperforming their low-quality counterparts by over 30%.

Of course the other way of saying this is that names that were initially tagged in the "low-quality" factor buckets are underperforming their counterparts by over 30% (and are down nearly 20% in absolute terms).

4) Momentum

At the beginning of the year, the 2019 winners were already capturing an average forward P/E of 21.4x, a 58% multiple premium to the 2019 losers, which were trading on 13.5x.

Those 50 best performing S&P stocks in 2019 (the winners) were up 76.4% on average. So far in 2020, these stocks are only down 3.1%.

The 50 worst performing S&P stocks in 2019 (the losers) were down 8.0% last year, and are down another 12.0% this year.

The EPS downgrades or upgrades of the average 2019 loser this year? Down 22.6%.

The EPS downgrades or upgrades of the average 2019 winner this year? Down 22.3%.

The old losers have not had worse fundamentals than the winners, yet the old winners have seen multiple expansion of 33%, and now trade at a forward multiple of 28.4x, a level which has now blown out to a 70% premium over the losers.

5) Low-Vol and Low-Beta

The most volatile decile of companies in the S&P 500 as of December 31, 2019 is down 11.5% YTD. The decile of the 50 least volatile is down just 6.9%. The decile of the 50 companies with the highest market betas in the S&P 500 as of December 31, 2019 is down 10.1% YTD. Meanwhile, the decile with the lowest beta companies is down just 5.4%. This just adds insult to injury. It's Mr. Market kicking you when you're down.

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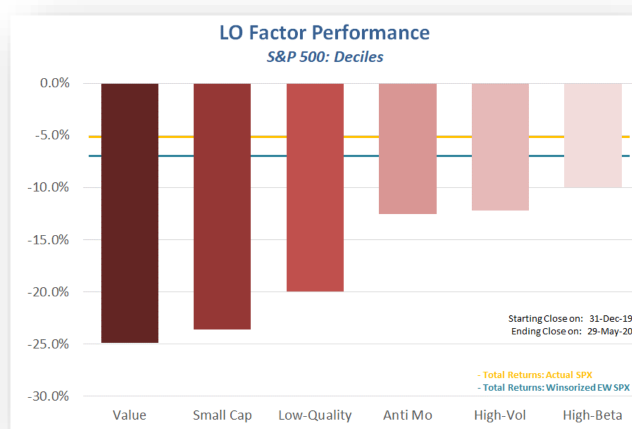
So, it is true that the share prices of many companies have done very well out of the pandemic. At least some of this was deserved, and the big debate is about how much of it wasn't. It's at least possible that flows to these "winners" or "large-caps" or "growth" have been without much regard to expected returns down the road. Meanwhile, companies that fit into the classifications noted above may be holding up the index to some degree, and camouflaging the true underperformance of a great swath of companies.

Indeed, the most economically sensitive of them have been trounced in favor of those that were already broadly admired coming into the pandemic. The chart below shows the YTD performance of long-only portfolios holding these "contra-factors".

It isn't good.



Some out there have claimed that value (and other "hairy" factors) actually aren't historically cheap and have performed well; and that growth and momentum and the "pretty" factors have just been that much better. But this analysis shows this just isn't true. If anything, these contra-factors have essentially been discarded, and the outperformance of their evil twins is just masking the unpleasantness of it all.

The bottom line is that long-only portfolios of small-cap, low-quality value names (that were already down to start with) haven't just been beaten with the ugly stick, they've been crushed by an avalanche carrying a smothered, broken forest of ugly-stick trees.

It isn't out of the realm of possibility that if the market narrative ever switches to one of recovery, some of these beatings may abate, potentially alongside the lifting of quarantines.

Sure, we'll probably get future waves of COVID-19, but each will have a lower amplitude, and eventually, it'll be dead.

It's just something to consider, especially if you own the names that are fun to discuss with your friends and peers; and are not exposed to the ones that are embarrassing to debate, even with your own team.

The Future of COVID-19? (x-axis not necessarily to scale)

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[i] *For this analysis, we started with constituents of the S&P 500 and then excluded all companies with a GIC classification in Financials or Real Estate, and then winsorized by removing any other securities that were potentially spurious outliers that might engender misleading results. This included eliminating securities with negative earnings, earnings downgrades exceeding 70% during the sample period, blended forward P/Es over 70x (starting or finishing), and blended forward P/Es less than 4x (starting or finishing) from the dataset. After cleaning things up, we were left with 360 securities from the S&P500 from which we performed the analyses above.*

Through May 29, 2020, the overall performance of the S&P 500 is down 5.0% with dividends included, whereas the equal weighted returns are lower, and down 12.0% YTD. The equal-weighted return YTD of our winsorized dataset is down 6.9%.

[ii] *We go with Novy-Marx here and lean heavily on gross profitability (gross profit to assets) to determine quality metrics. We also weight on gross margins, EBIT margins, RoE, and Debt-to-Market Cap. For more on how we think about how to define quality, try this: https://www.albertbridgecapital.com/post/peak-quality*

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