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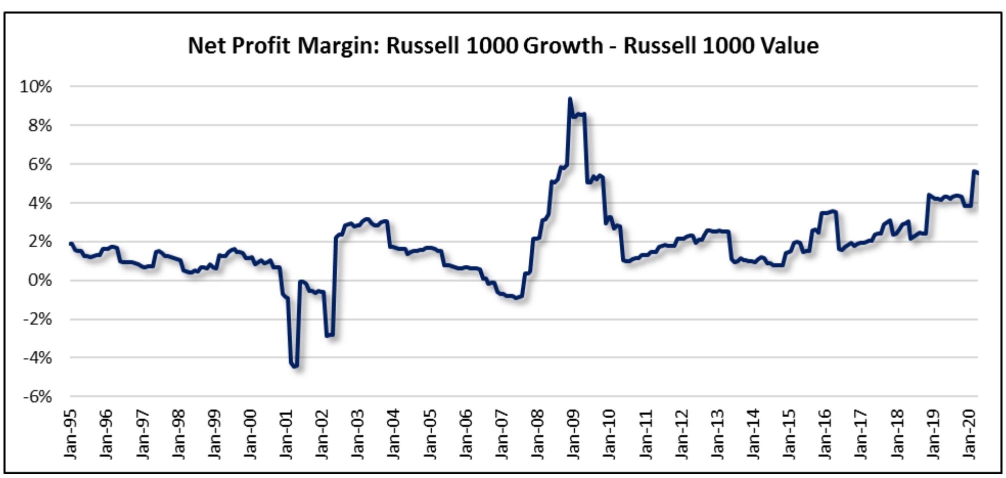
Are Growth Stocks Really That Expensive?

By Bo Brownlee, CFA

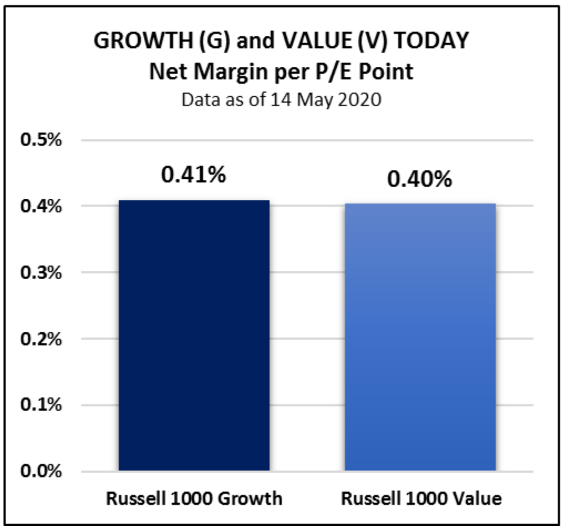
Value investors are once again being put to the test, their faith in the long-term premium earned by stocks with low prices relative to various fundamental measures such as earnings or book value shaken by the long running performance drought they have endured relative to their Growth investor counterparts. Growth stocks (Russell 1000 Growth Index) in the US have outperformed Value (Russell 1000 Value Index) stocks by nearly 6% annually over the decade ending 30 April 2020 as measured by the Frank Russell 1000 style indices. Such a wide gulf in relative performance coupled with widening valuation differences between the two styles in the US has invited comparisons to the Technology-Media-Telecom (TMT) bubble two decades ago.

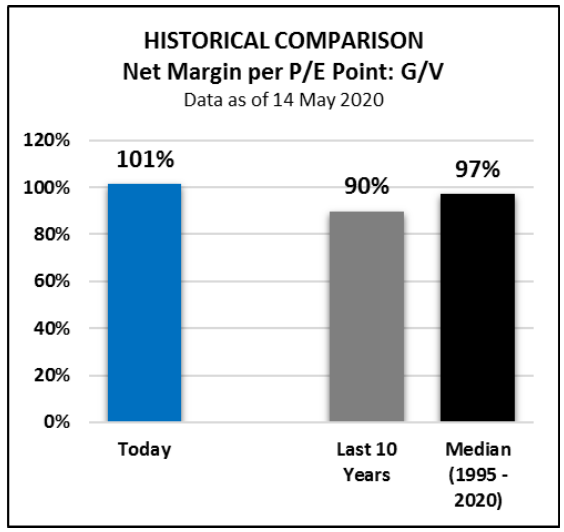
But perhaps there is an alternative explanation to the contention that another Growth stock bubble is being formed - the almost heretical assertion to many proponents of the Value style - that these wide spreads in performance and relative valuations have been justified by the exceptional fundamental performance of Growth stocks. While there are undeniable similarities in the relative valuations today between Growth and Value stocks with those of the TMT bubble era, the relative profitability of the two styles is markedly different. The net profit margin advantage for Growth stocks has widened to levels last observed during the Great Financial Crisis when earnings for the Financial-heavy Value indices collapsed. This widening of the difference in net profit margins, shown below, helps to explain a large part of why Growth stocks have performed so well during the current cycle.



When the superior profitability of Growth stocks is taken into consideration in conjunction with their expanding valuation ratios, a more complete picture emerges. By scaling the valuation of Value and Growth stocks by their respective profit margins we can obtain the amount, say in Price-to-Earnings points, that an investor is currently paying for a percentage point of profitability, or perhaps more intuitively to look at the reciprocal of that ratio to measure the profitability per Price-to-Earnings point.

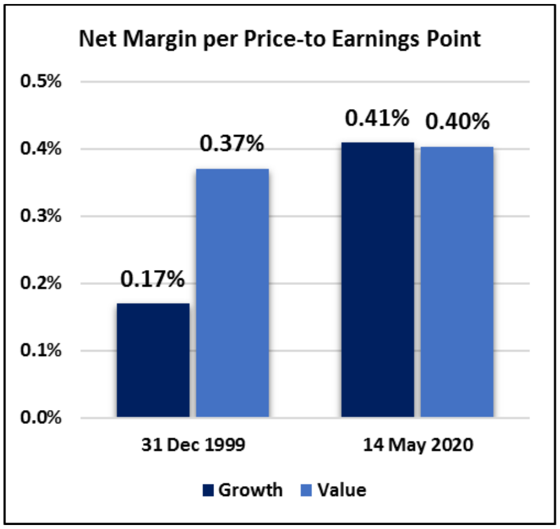
Growth stocks today sport relatively high valuations with a 28.3x Price-to-Earnings ratio versus only 15.0x for Value stocks. Growth stocks also enjoy much higher profitability with an average net profit margin of 11.6%, nearly double that for Value stocks at 6.0%. When measured on a profitability per Price-to-Earnings point, Growth and Value stocks currently provide nearly identical amounts with Growth at 0.41% and Value at 0.40%; this current relationship is also consistent with the last twenty-five years where both styles have delivered similar amounts of profitability per Price-to-Earnings point, shown below.

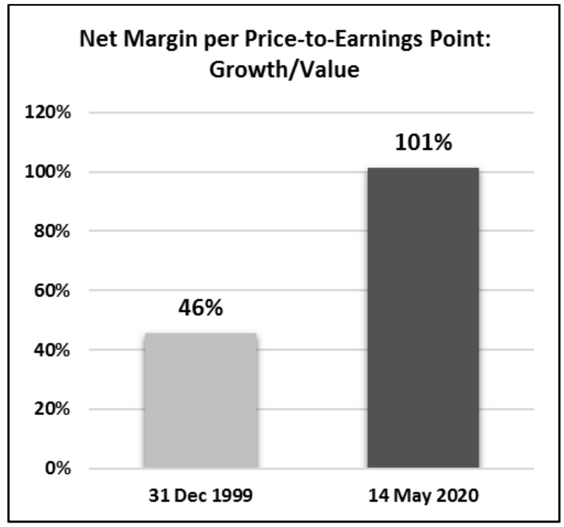




If we assume there is no change in relative profitability, we can solve for the difference in relative returns between styles that would bring this relationship back to its long-term median. The result is a modest outperformance by Growth stocks of %; in other words, on a profitability-adjusted valuation basis, Growth and Value stocks are currently trading near equilibrium, far from bubble territory.

Speaking of bubbles, how does today's market environment compare to the TMT era of the late 1990s, to which it is frequently compared? Using this profitability-adjusted valuation framework we can see that at year-end 1999 Growth stocks sold at 48.0x earnings with a net margin of 8.1% while Value stocks sold at 18.9x earnings with a 7.0% net margin. In terms of percentage point of profit margin per Price-to-Earnings point, Growth stocks provided just 0.17% per point versus 0.37% for Value stocks at year-end 1999, or less than half that of Value stocks. Today, by comparison, Growth stocks are delivering profitability on par with Value stocks as shown on the following page. The vast difference in relative profitability between time periods is the main driver of this result, whereas margins for Value stocks trailed those of Growth by just 1.1% at the end of 1999 - today that gap has widened to 5.6%.





The exceptional profitability of the largest Growth stocks today is the key differentiator relative to the market environment of the TMT bubble. Where many of that era's Growth companies were valued on potential alone with little or no underlying profits, today much of that potential has been transformed into the high margin, scalable businesses envisioned by optimistic investors twenty years ago. The stocks that currently dominate the Growth indices embody this description.

Today Microsoft, Apple, Alphabet, Amazon and Facebook comprise approximately 20 percent of the market capitalization of broad US indices (and roughly one-third of the Russell 1000 Growth index). On a market capitalization basis, these five companies boast an eye-popping net profit margin of 19%, the remainder of the index just 6%. Their business models appear to have insulated them from the worst of the current crisis and they have arguably expanded the already wide moats around their businesses. A narrowing of the spread in profitability is a necessary ingredient in turning the tide in relative performance; however the near-term outlook for the more cyclical-laden Value indices is much cloudier.

It is not all bad news for Value investors, however. Outside of the US, Growth stock valuations appear much richer than their US counterparts versus long-term medians using this framework, the subject of a future follow-up note to this one. Value proponents can also hope that today's titans will ultimately succumb to competitive forces that erode their dominance as with the index behemoths of decades past. Today's giants have enjoyed a cost of capital advantage bolstered by their track records for innovation and have stubbornly resisted the tendency to mean-revert. But a nudge in the form of government regulation to expedite this process is certainly within the realm of possibility.

Aggressive government actions in the form of the Fed's response to recent market disruptions may have also played a part in the performance run of Growth stocks by suppressing interest rates and providing a tailwind to longer duration Growth stocks. In light of the Fed's response to the current crisis, this situation is also unlikely to be reversed in the near-term. No matter the means and despite Value stocks' Price-to-Earnings discount versus Growth stocks, Value stocks appear unlikely to regain the upper hand in performance without narrowing the current profitability gap versus Growth stocks. Until that happens, the idea that another bubble has formed in Growth stocks appears increasingly dubious.

Bo is a portfolio manager at SECOR, responsible for public equity, private equity, and equity-related alternative beta manager research at SECOR. He has over 30 years of investment management industry experience, including time at General Motors Asset Management as Director of Global Equity Strategy and Trading. Bo holds a BA in Urban Studies and an MBA in Finance from the University of Pittsburgh.