Emotional Unease Creates Generational Wealth Opportunity

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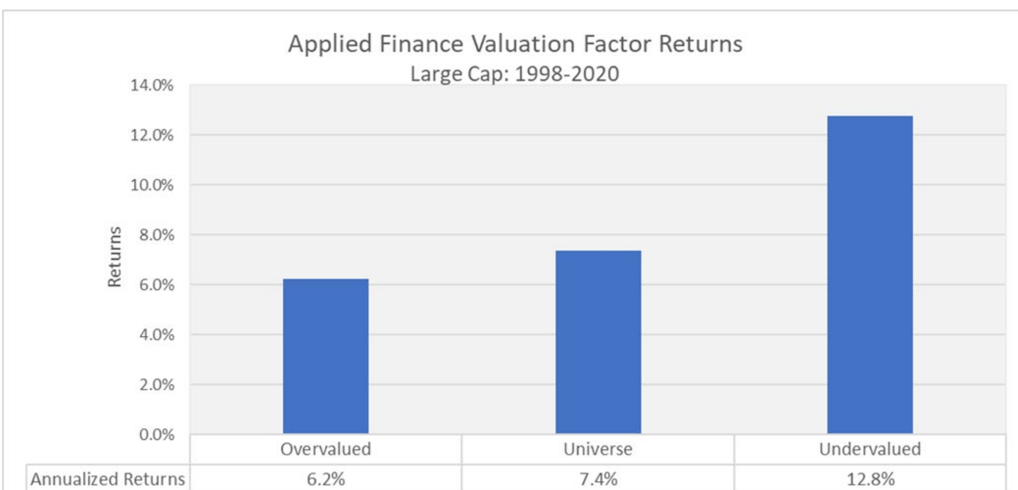
The stock market today is trading at valuation levels last seen in 2008, before an unprecedented wealth creation bull market sweep away the fear of the Great Recession. Then as now, it's always about the expectations built into market prices.

In 2000, our firm issued a report saying Cisco was worth $18 per share, when it was trading at $80 and was one of the largest market capitalization firms in the world. The response to that report was succinctly summarized by an email reply that simply said- "You guys are idiots." In fairness, he could have been right for many other reasons, but not on our estimate of Cisco's value!

Every stock price has embedded a set of future performance goals a company must meet to justify its price. In 2000, the expectations embedded in Cisco's price were unachievable, and subsequently its price dropped from $80 to our $18 estimated value, around which it stayed for years.

Since 1998, Applied Finance has calculated weekly intrinsic value estimates for virtually every publicly traded US company using our Economic Margin® framework. Each intrinsic value estimate incorporates forward looking estimates of cash flow, investment growth, competition, and risk. The end result is an estimate of a firm's value which we compare to its traded price. The validity of our approach is transparent as we publish our intrinsic values on 20,000 companies weekly. Scoring our work from 1998 through 2019 reveals that buying a basket of our most undervalued companies significantly outperforms a basket of those that we identify as most overvalued. As displayed in Chart 1, the annual difference is approximately 680 basis points a year, enabling our Valuation 50 and Valuation Dividend strategies to be ranked by Zephyr in the top 5% of their respective categories since inception.

Chart 1



While we have consistently demonstrated our ability to understand the value of individual stocks, on occasion the market allows us to identify periods of extreme over and under valuation. This is quite rare, as usually some parts of the market are overvalued and others are undervalued effectively canceling each other out from an overall market valuation perspective. Consequently, since 1998, we have only made two market calls, an overvalued call in 2000 and an undervalued call in 2008.

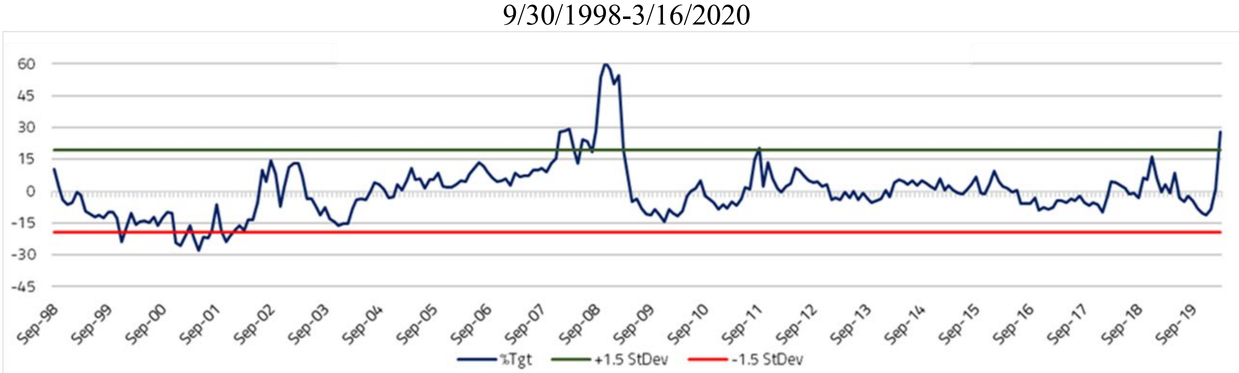
In 2000, while we chose Cisco as our villain during the .com boom, we could have picked almost any large cap stock at the time as the market was grossly overvalued. Ironically, it was emotionally very easy for people to buy into the market then as the headlines and even cabbies screamed – Buy! Buy! Buy! Sadly, the cost of such emotional comfort was a stock market priced for failure. In March of 2000, large cap industrial firms were priced to deliver 22% annual sales growth, compared to the 4% to 6% these firms typically deliver. Financial disaster ensued, as "blue chip" stocks such as Cisco lost over 80% of their value and many others went bankrupt. It took ten plus years for the NASDQ to recoup its losses. Buying a jubilant market is emotionally easy, but financially disastrous.

In contrast to our 2000 overvalued market call, we believed the Great Recession of 2008 was an extraordinary buying opportunity. The collapse of the housing industry and the breakdown of the financial system had investors panicked. Their frenzied selling ultimately led to a set of future performance expectations that implied in October 2018 that for the average industrial firm in the SP500, its total sales would decline 15% over the next five years, versus what would typically be a 20% to 30% increase. While it was nerve wracking to buy equities in 2008, such abysmally low expectations set up a historic market run as firms handily exceeded those expectations.

Until last week, those were the only times a bottom up aggregation of equity values provided an unambiguous signal about the overall market. Including the sell off on March 16, the market once again is extraordinarily undervalued. Chart 2 illustrates market valuations from 1998 through March 16, 2020.

Chart 2

Applied Finance: Large Cap Valuation Levels
9/30/1998-3/16/2020



Only in 2008 have valuations been as attractive as now. Today, the market is essentially pricing in 0% sales growth over the next five years, not as harsh as the -15% priced in during the 2008 lows, but very harsh compared to the expected 20% to 30% growth these firms have typically delivered over a five year period. Unlike 2008 there will not be liquidity issues driving economic decisions and panicking investors. This is a confidence crisis similar to 9/11. As medical policy catches and surpasses the virus, confidence will return and economic activity will march forward. Already, in China, restaurants have reopened to crowds, and society is returning to business as usual.

With all the uncertainty surrounding COVID19, it's understandable an investor's first reaction is to sell, especially as a popular theme entering 2020 was "investor fatigue" after watching the market rise so much over the past three years. Whether the market was overvalued entering 2020 is a different discussion, today the market presents the opportunity to buy at historically low levels relative to the likely financial performance of most publicly traded stocks. We also understand that the incredible market volatility of the past few weeks creates tremendous unease to make new or continue holding existing investments. However, as in 2008, that unease has set the stage for another spectacular market run.

COVID 19 is getting much more press than H1N1, but ultimately COVID19 will be erased, as was H1N1, and markets will end much higher.

Messieurs Obrycki And Resendes are Co-Founders of Applied Finance Capital Management. Applied Finance Capital Management is an asset management firm dedicated to applying its 25-year history of valuation research to construct equity portfolios that outperform their benchmarks.