FOUNTAINHEAD INSIGHTS

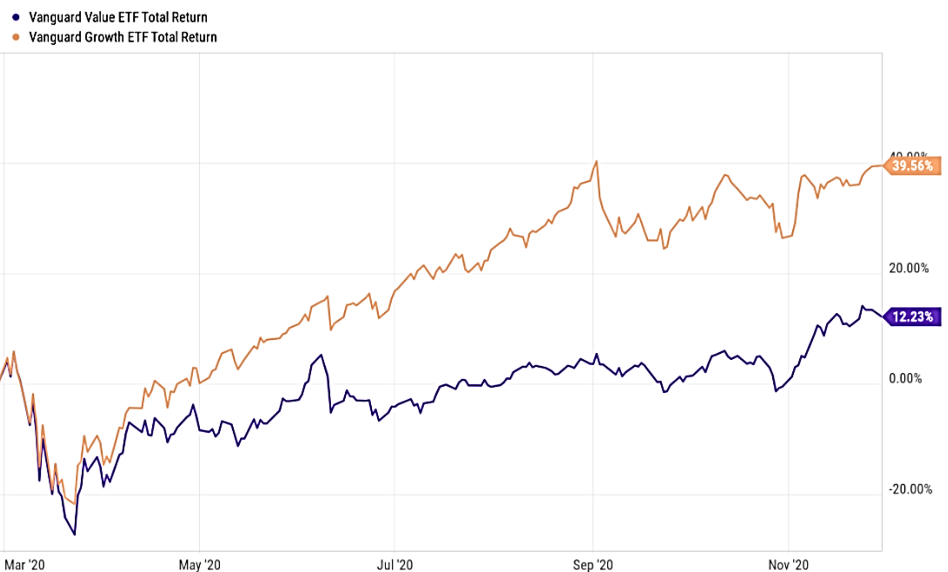
Market Commentary: Social Changes, Low Yields & the Effects on Growth Stocks

November 2020

Thank God for technology. My children can attend school, socialize with friends, and waste away their days watching an infinite variety of video (or playing games), all from the safety of their room. My family receives various boxes delivered all day long to our doorstep that hold products from around the world. None of us ever needs to leave the safety of our apartment (yes, we are taking vitamin D and eating citrus).

Hopefully one day my children will return to a physical school, go to actual non-screen enabled events, travel anywhere, and participate in other real-world activities. Adults will socialize more, embark on business trips, vacations and the like.

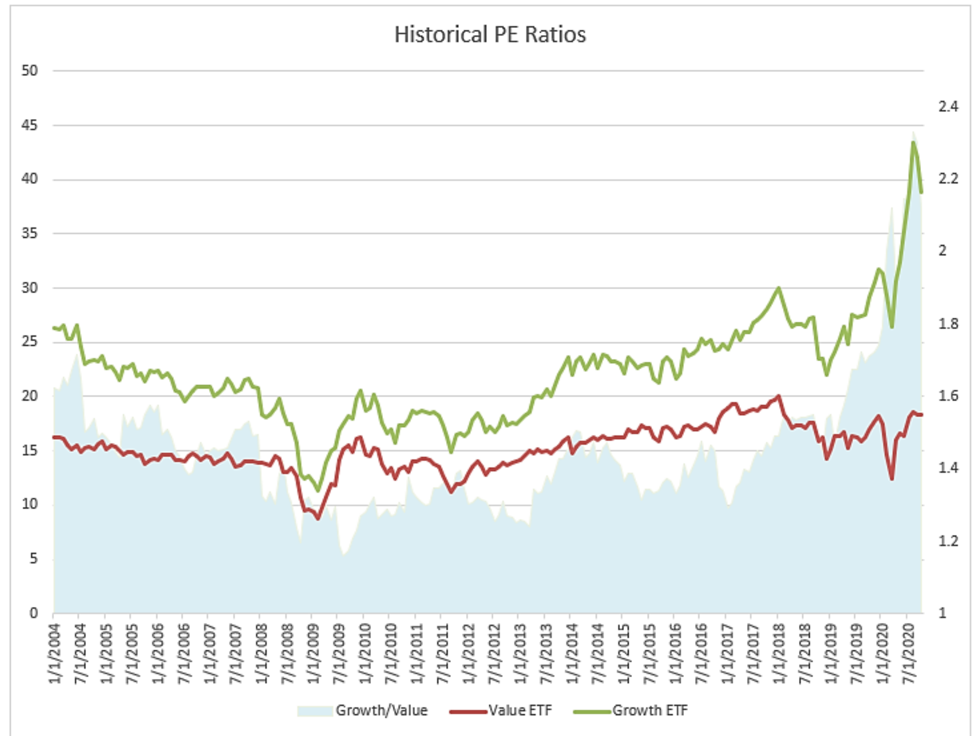
The big question for society (and therefore the markets) is which shifts are permanent, which shifts simply sped up a secular trend, and which will revert once we are past Covid (and we will one day be past Covid). The shorter-term effects from Covid on society have generally favored growth-oriented stocks relative to value-oriented ones. The chart below shows performance of growth stocks, using the Vanguard Growth ETF (VUG) as proxy, compared to value stocks, using the Vanguard Value ETF (VTV) as proxy. It is worth noting that technology comprises 46% of VUG, compared to 6% for VTV.



Some of these big questions about permanent vs temporary shifts in secular trends are starting to play through in the market. For example, on the day that Pfizer announced the efficacy of their vaccine and expected timeline, equity markets began the day with a material increase. The high for the S&P 500 that day was initially up 4.1%, before closing up 1.3% (meaning the market gave up most of its gains on that very same day). Some of the reason that the market closed only up 1.3% is due to a large rotation out of growth and into value. VUG (representing growth) declined 1.5% that day and has only returned 1.3% from the point of Pfizer's announcement through the end of November. Meanwhile, VTV (representing value) increased 4% that day and 7.1% for the month.

One way to compare performance of value vs growth is by the P/E assessed to each group. P/E stands for Price Over Earnings. If a company generates $20 in earnings per share and it trades at a price of $400 per share, then its P/E is 20

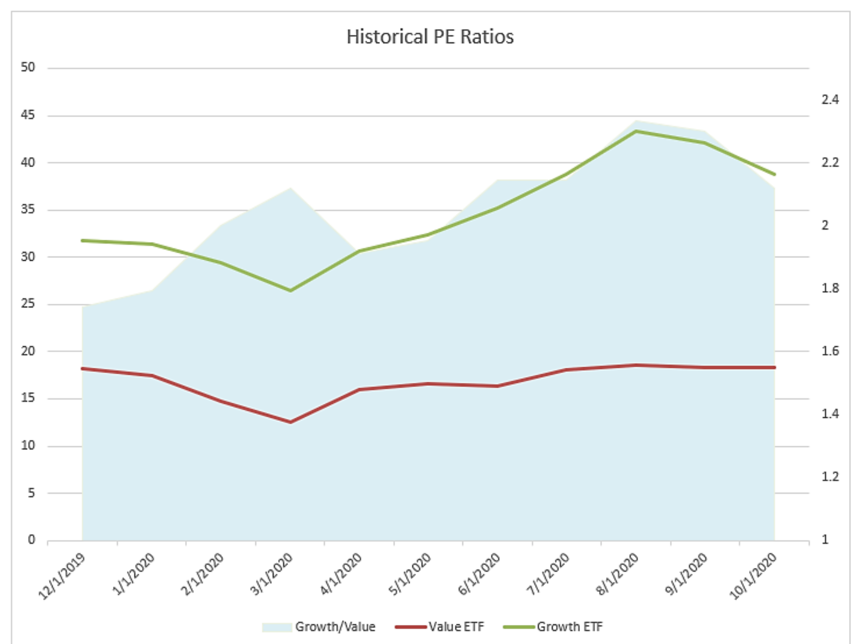
(400 / 20). As can be seen in the chart below, the P/E of growth stocks is typically higher than value stocks and, in recent years, the ratio between the two has continued to expand in favor of growth. Growth stocks typically have higher relative valuations due to the fact that they are faster growing. Recent expansion can be at least partially attributed to the aforementioned tail wind provided to technology due to Covid.



The second chart on right highlights the recent reversal of the longer-term trend (1st chart) of growth outperforming value.

Are Price to Earnings Ratios Highlighting Too Rich a Market?

It is worth noting that P/E levels as a whole have increased. Simply looking at the first P/E chart, one may come to the conclusion that the market is expensive, at least relative to history. As is typically the case, there is nothing quite black and white about the markets. For example, in assessing P/E levels relative to history, one must take interest rates into account. On a very basic level, when making an investment in a company, investors should assess how much they would make if they lent the company money (i.e., fixed income) versus if they invested in the company (i.e., equity). Lending to the company (fixed income) provides more safeguards in exchange for a fixed rate. A lender can make money even if a company is not too successful. Investing in a company (equity) has fewer safeguards, more risk, but better potential upside. That means an investor will prefer lending to or investing in a company based on the company's yield offer vs equity return expectations.



For example, a very low yield on a loan would most likely push an investor towards equity. Investors will always assess a premium to equity given its increased risk and

volatility, but that premium should be relatively constant. This means that as yields decline, so do equity return demands (and therefore return expectations) and vice versa!

Interest rates on government bonds dropped to historical lows earlier this year as the Fed looked to flood the economy with easy money. The 10-year Treasury is now yielding a touch below 1%. The same math highlighted above obviously applies to the market. Investors need to choose between fixed income and equities. If one is vastly out of line with the other, then they should move their investments accordingly.

Distributions (think dividends for listed companies) come out of earnings. With yields in the market low, distributions demanded by investors should also be low. Therefore, Earnings Over Price (E/P) can be lower than they were prior. For example, adding a 2% premium to distributions/earnings over the 10-year Treasury yield (~1%) would result in ~3%. If a company had earnings of $3 per share, then the market would assess a price value of $100 ($3 / $100 = 3%). Flipping this equation around creates a P/E level of 33.3! Prior to Covid, the yield on 10-year was 2%. Using that same math, the market would expect a 4% earnings ratio (so $4 per $100 in earnings) which would result in a P/E of 25 - and hence some justification for a material increase in P/E over at least this past year.

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