Runaway Markets

Show articles

Equities

Wall St split as more companies hit sky-high valuations

Calls to jettison traditional price to earnings metrics echo dotcom boom era

© FT montage

Laurence Fletcher in London 7 HOURS AGO

This article is part of the FT's Runaway Markets series.

A growing number of companies are joining Tesla in the sky-high valuation club, dividing Wall Street between those warning of a "bubble" and those questioning traditional assumptions about how best to value a business.

Tesla was a red-hot stock even before the coronavirus crisis, boasting a forward price/earnings ratio — a common measure of the value the market puts on a business's future profits — of 75 times at the start of 2020. That was the highest of any company worth more than $50bn, according to Bloomberg data.

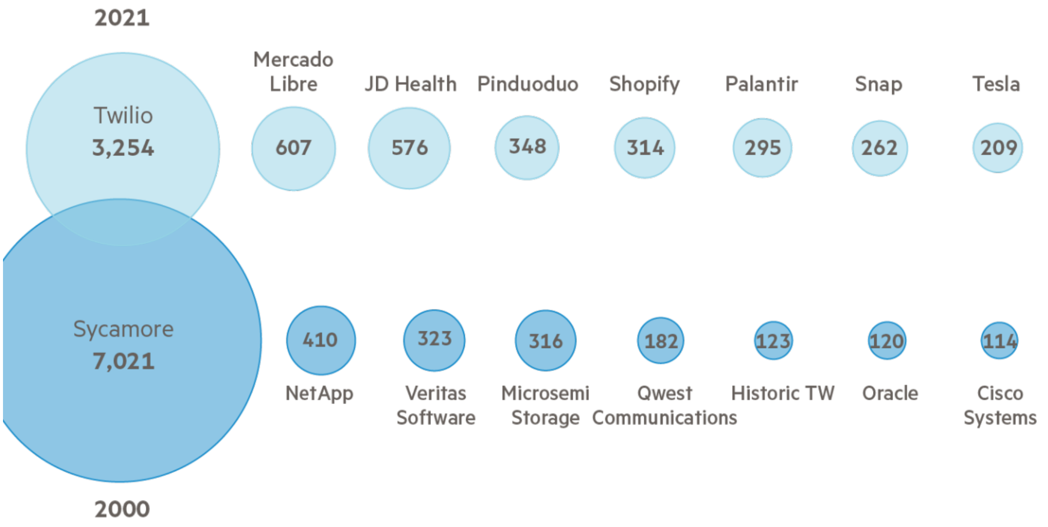
But now that stocks have hit new record highs, and share prices and profits become increasingly detached, 29 big companies trade on even higher earnings multiples. Tesla itself has moved to 209 times expected earnings.

"Nobody cares if you're profitable these days," said the European-based head of one large hedge fund, adding: "Who are you, Graham and Dodd?" Benjamin Graham and David Dodd were pioneers in using P/E ratios to find stocks undervalued by the wider market.

Other analysts argue that the run-up in valuations is yet another unsettling parallel to the dotcom boom and bust two decades ago. Once again, retail investors are stoking the gains for much-hyped "new economy" stocks. And alternative metrics such as price/sales, revenue growth or even operating expenses are being brought to the fore as better indicators of a company's prospects.

How the 2021 class of high-flyers compares with their dotcom-era peers

Forward price-to-earnings ratio



Source: Bloomberg
© FT

Global companies with market values of $50bn or above in 2021 dollars
For Mar 10 2000 and Jan 26 2021

“The best companies right now are investing in human capital,” said Michael Frazis, founder of Sydney-based Frazis Capital Partners, whose fund made 108 per cent last year, fuelled by stocks such as Tesla and Chinese ecommerce platform Pinduoduo.

“This investment is conventionally treated as cost, but in reality, they are getting exceptional returns on these investments,” he added. “Price/earnings and free cash flow metrics penalise companies for doing exactly what they should be doing”.

Such arguments are reminiscent of those put forward during the height of the dotcom mania. Some investors used new indicators such as eyeballs — the number of page views websites attracted — to justify prices. Many recommendations based on these alternative metrics proved ill-fated, with a number of tech stocks joining the so-called “99 per cent” club, measuring how far they eventually fell from their peak.

Today, valuations have been driven up across the tech sector, partly reflecting the benefits of Covid-19 lockdowns for companies serving those working and consuming from home. Stocks such as Tesla, up 964 per cent since the start of 2020, Twilio, up 277 per cent, and ecommerce firm Pinduoduo, up 363 per cent, have helped funds such as Boston-based Whale Rock Capital, Coatue Management and Baillie Gifford post huge gains.

The lagging P/E multiple, which compares stock prices to earnings over the past 12 months, for the tech-heavy Nasdaq 100 index has reached almost 40 times, a level not touched since the aftermath of the dotcom boom, according to FactSet data.

“Some companies have now moved to infinite valuations, by any mathematical expression,” said Daniel Kozlowski, chief investment officer at Denver-based Plaisance Capital and former manager of Janus’s $4bn Contrarian fund, underscoring how prices on some stocks have become massively inflated compared with earnings expectations.

Tech bulls argue that things are different to the dotcom days. The digital shifts under way in areas such as retail, healthcare, transportation and cyber security — and accelerated by the pandemic — justify the valuations, they say.

Runaway Markets

In a series of articles, the FT examines the exuberant start to 2021 across global financial markets

- Investor anxiety mounts over prospect of stock market 'bubble'
- US stock rally drives 'ludicrous index' towards dotcom era heights
- Companies raise $400bn over three weeks in blistering start to 2021
- Retail investors rush to find the next stock market unicorn
- Reddit traders wage battle against Wall Street
- Learning from market bubbles past

Robin Brown, managing director at US investment bank Stephens, who focuses on tech and worked at Cable & Wireless and WorldCom during the dotcom boom, points to greater investor understanding of the companies and industries they are betting on.

Tech valuations surge to highest since dotcom aftermath

Lagging 12-month P/E ratio for Nasdaq 100

Source: Factset
© FT

A big support for the latest tech-led rally, and one that analysts do not think is going anywhere, comes from ultra-low interest rates. In a discounted cash flow model, a traditional way of valuing a company based on expected future income, a lower rate of interest gives a higher value to future cash flows, supporting current high valuations.

The main US policy rate, which was 5.75 per cent when the Nasdaq hit its then-peak in March 2000, is near zero and set to stay there for some time.

James Paulsen, chief investment strategist at The Leuthold Group, cuts to the heart of this dichotomy: P/E multiples on stocks “advise extreme caution”, but when adjusted for historically low bond yields they demonstrate an “extraordinary opportunity!”

Warning Signal

When Elon Musk tweeted “Use Signal” on January 7, the Tesla founder was probably directing his followers to the smartphone messaging app. Many investors took it as an endorsement of a little-known penny stock.

Mr Musk’s message, retweeted more than 50,000 times, sparked a rise of as much as 11,700 per cent over the following days in the share price of Signal Advance, an unrelated Houston-based technology company whose share price had barely moved for years, and which last year told investors it may not generate enough revenue to meet its operating cash requirements.

Even following a statement from Signal Advance clarifying it had no relation to the messaging tool, its share price is still up more than 700 per cent on the pre-tweet price. Some investors point to the episode as an example of the irrational exuberance stoking prices.

“Every ladder is leaning against the same wall — interest rates and quantitative easing,” said Plaisance’s Mr Kozlowski. “If interest rates rise, there will be a real reckoning.”

For many, the growing dominance of Big Tech, and the “fear of missing out” on the wider sector rally, is enough to press on.

Those who have avoided the sector have passed up the chance of “the best investment opportunities in history” over the past 20 years, according to Mr Frazis. “The real lesson of the dotcom bubble was to stay invested in tech,” he said.

Additional reporting by Alice Kantor and Eric Platt