Global Matters Weekly

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What Were You Thinking?

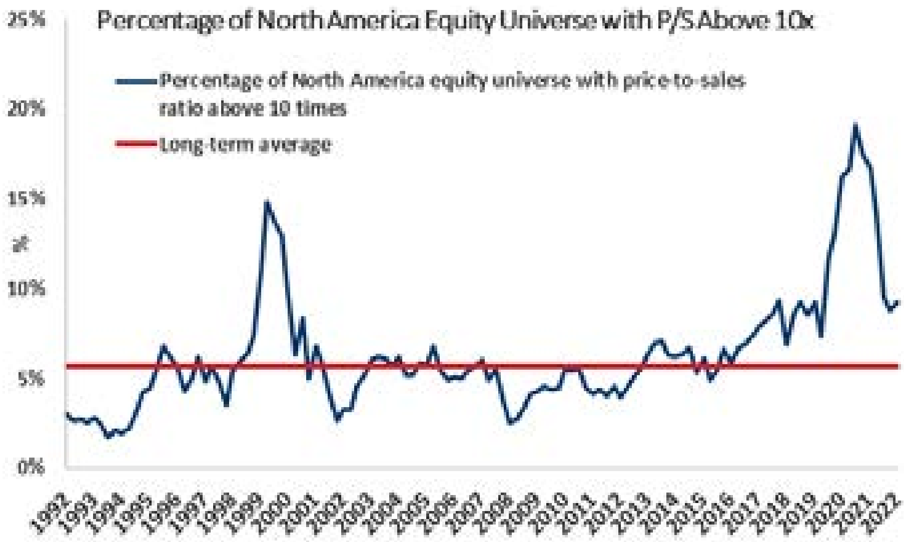
by Tom Delic, Portfolio Manager

2022 has been an eventful year across financial markets, and while anything could happen during the last few weeks of December, I thought it would be worth reflecting on the extraordinary market behaviour we have seen over the past few years.

It feels as though there are numerous examples from the final throws of this cycle that could be placed under the microscope of the financial historian, decades from now. Could it be Austria's 100-year bond that yielded 0.375% in December 2020, down over 60% since? Or perhaps US CCC rated corporate debt yielding 7.5% in the summer of 2021, a credit rating that has a long-term average annual default rate of 25%?[1]

Echoes of Scott McNealy's well-known "What were you thinking?"[1] post-DotCom crash interview from 20 years ago rings in the ears, as investors have once again collectively failed to learn the lessons of history. At the time, McNealy was CEO of Sun Microsystems, a poster child of the technology bubble at the turn of the century. Valued at a price-to-sales ratio of 10 times, McNealy walked through the illogic of making an investment in his business at that price.

As the chart below demonstrates, the speculation in the US equity market has not only matched the bubble at the turn of the century, but has exceeded it in an impressive fashion. 15% of the North American equity universe we track at Momentum Global Investment Management was trading at a price-to-sales ratio of ten times or more than in 2000. During the summer of 2021, as speculation raged in the 'junkiest' of junk bonds, the growth stock party was reaching its hedonistic highs as 19% of the universe traded above McNealy's "What Were You Thinking?" high watermark. While correction since then has put an end to the festivities, if you believe the below chart will revisit the long-term average the hangover may have not yet reached its head-splitting worst.



Source: Momentum Global Investment Management, Bloomberg Finance L.P. as at 06 December 2022.

What can we learn from the latest cycle of speculative excess? It's satisfyingly easy to blame investment losses on an external factor and when the finger is pointed at central bank behaviour, there is understandable merit to this approach. The problem, however, is those kinds of external factors are never in your control, but your own actions and behaviour are.* A conservative, valuation, absolute return focus cannot necessarily shield an investor from volatility, but it can protect from the peril of permanent loss of capital.

A valuation discipline is designed to place the odds in your favour. Paying less than you think for something is a concept that appears to come naturally to most of the population - just watch the crowds of shoppers at the upcoming Boxing Day sales! Bargain hunting often gets lost for investors as the daily price movements in financial markets shifts the focus away from fundamental investing to one of speculation.

Further, the era of TINA (There Is No Alternative) is coming to an end. The philosophy has its roots in a relative return investment approach, but comparing less rotten apples to very rotten apples doesn't mean you need to take a bite out of the former.

With global interest rates starting at sub-atomic levels, the normalisation of interest rates has drastic effects in a relative investing world. Like an accidental nudge of the James Webb Telescope, a two to three percent increase in interest rates has put you in a different galaxy. A reset to an absolute return world is long overdue, assessing an asset on its own risk-return profile, instead of relying on the over-valuation of one asset class to justify the other.

* Or at the very least, they are more likely to be in your control, depending on your view of free will, but that is beyond the scope of this blog and my own intelligence!

Sources:[1] Bloomberg Businessweek – A Talk with Scott McNealy, April 1 2002. Unless stated all figures sourced from Bloomberg Finance, L.P

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Important notes

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