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Irrational Markets Don't Last Forever

DECEMBER 2020

Snapshot

- Equity markets have become narrowly focused on a few mega-cap growth stocks.
- Meanwhile, stocks with attractive valuations have largely been left behind.
- SEI's research indicates that good values are often indicative of strong long-term performance, while the performance of growth may be more fleeting.

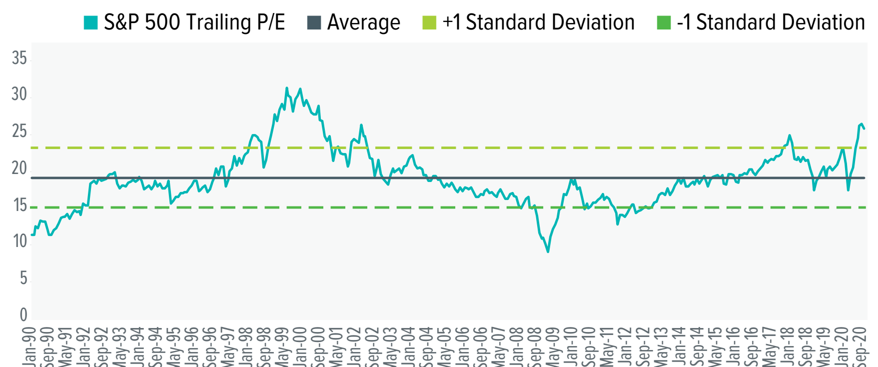
In SEI's view, U.S. equity markets have been behaving irrationally for some time now. Valuations are some of the most expensive we've seen, both compared to history and foreign markets. Concentration is also at an all-time high with the top five stocks in the S&P dominating the index. This has led to a prolonged and exaggerated period of growth outperforming value. SEI believes these are market anomalies that can't persist forever and are bound to revert.

The founders of value investing, Benjamin Graham and David Dodd, noted that 'the margin of safety is always dependent on the price paid'[1]. In other words, paying a low price generally increases an individual's odds of making a profitable investment. Even though value investing may be out of favor right now, we still prefer to buy low and sell high.

Historically Expensive U.S. Equities...

The trailing Price-to-Earnings (P/E) ratio of the S&P 500 Index is well above its historical average as can be seen in Exhibit 1. In fact with the exception of the "Tech Bubble" in the late 1990s, the S&P 500 Index's P/E is higher than any point in the past 30 years. History is littered with anomalies where equity valuations have exceeded their long-term averages, but history also shows that while these periods of stretched valuations may persist for years, they are also unlikely to be maintained forever.

Exhibit 1: Trailing P/E Multiple of the S&P 500 (January 1990–October 2020)



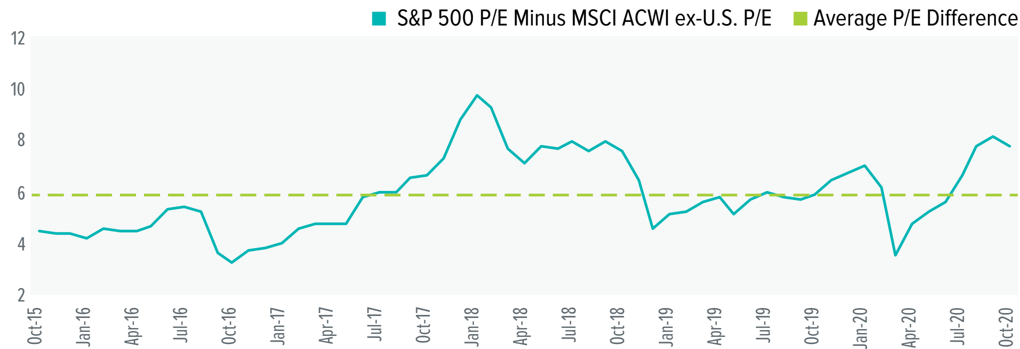
Source: FactSet as of 10/31/20

[1] The Intelligent Investor, Benjamin Graham

...And Versus the Rest of the World

It's not uncommon for U.S. equities to trade at richer valuations than the rest of the world, but we believe the current valuation spread is larger than what is justified and certainly above the recent spread.

Exhibit 2: U.S. Equities are More Expensive than Non-U.S. Equities



Source: FactSet as of 10/31/20

But we also know that not every stock is trading at rich valuations. There are plenty of currently unloved "value" stocks out there trading at attractive valuations. It's a question of identifying those stocks and then having the wherewithal to stick with them even while growth-oriented stocks outperform. We believe this is a formula for long-term outperformance.

It's a Narrow Market

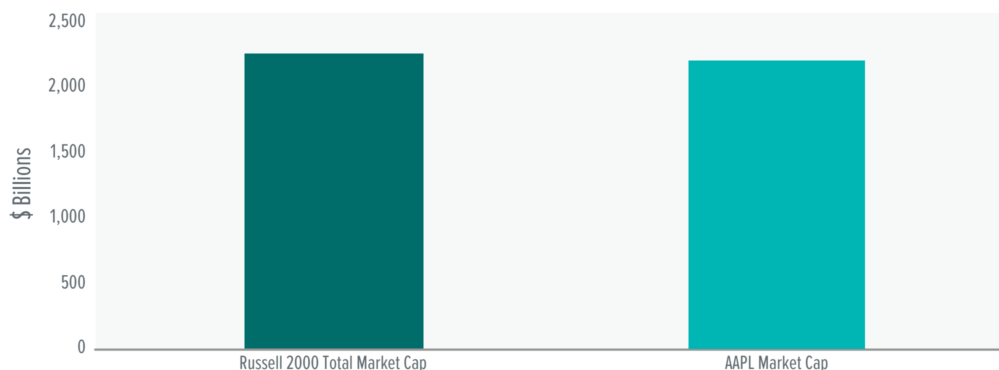
It's not just that index valuations are in our view much higher than can be sustained long term, it's also the level of concentration in equity indexes. The top five stocks by market capitalization are Apple, Microsoft, Amazon, Alphabet (parent company of Google) and Facebook. In terms of market capitalization weight, this is the most concentrated that the S&P 500 Index has ever been.

Exhibit 3: Weight of Top 5 Companies in the S&P 500

Source: FactSet as of 8/31/20

Of course we aren't challenging the idea that these market leaders are great companies, but we question whether they are good investments. An investor with a spare $2 trillion or so could essentially buy the entire market capitalization of Apple, or for about the same price they could buy the entire market capitalization of the Russell 2000 Index. Greatness alone is not enough to justify investing in a company, the price paid also has to be attractive.

Exhibit 4: Market Cap Comparison of the Russell 2000 vs. Apple Inc. Stock

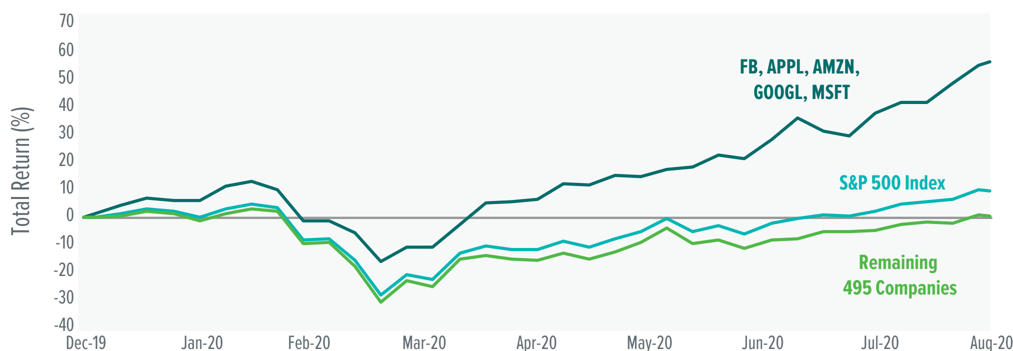


Source: FactSet as of 8/31/20

Greatness can and usually is fleeting too, especially in terms of market capitalization. How many of the largest companies by market capitalization during the late 1990's "Tech Bubble" are still dominating the top ten holdings of major indexes? Or how about all the leading Japanese companies from the late 1980s and early 1990s? The "Peak Oil" companies from the early 1980s? The "Nifty Fifty" companies from the late 1960s? Many of the companies that led these periods of market exuberance are still around and doing quite well, but many are also long ago bankrupted or merged with stronger competitors. The point being though is that sentiment often changes and buying the largest companies has not been the best investment strategy over the years.

That said, there can be times where buying the largest stocks works—we're in one of those times right now. Because many popular indexes, such as the S&P 500, are capitalization weighted outperformance can be a bit of a self fulfilling prophecy in terms of concentration—the more a stock outperforms, the larger its index weight becomes. As Exhibit 5 shows, some of that concentration is related to the extreme outperformance of the five largest companies.

Exhibit 5: Five Have Led the 500



Source: SEI, FactSet. Data as of 8/31/2020. Index returns are for illustrative purposes only and do not represent actual investment performance. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

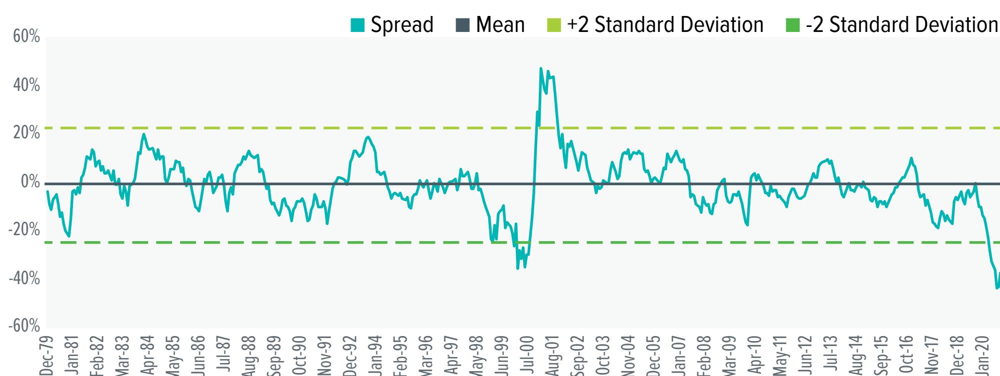
While the Big Five have been responsible for massive long-term gains, their earlier years of outperformance were substantially supported by high growth rates but the growth rates of the Big Five have declined even as their valuation multiples have risen. There are newer mega-caps such as Netflix or Tesla (which is being added to the S&P 500) that have had even bigger recent gains but have lofty valuations and spotty profitability. We prefer some other stocks that you've probably heard of: Target, Lowes, Johnson & Johnson and Morgan Stanley for example.[2] These are business that are less dependent on massive capital spending (as compared to Amazon and Tesla), less dependent on product cycles (Apple and Tesla), less vulnerable to regulatory and antitrust issues (Facebook and Alphabet), and have not struggled to maintain profitability (Tesla and Netflix). In addition, these companies have lower valuations and have the cash flow to pay dividends, meanwhile, as a short-term positive, their businesses have been robust even during the pandemic.

All of this has Been Hard on Value

This market environment has led to challenged performance for SEI portfolios versus standard benchmarks. We encourage investors to remember why they chose a diversified portfolio in the first place—because it's impossible to know with any regularity which asset classes will have short-term outperformance and for how long. Diversified portfolios are never top performing asset over short time periods, however, SEI believes they provide investors with the best opportunity for long-term gains and meeting one's goals. We also remind investors that active management is not just about the quest for alpha, but also is a critical component of risk reduction within the portfolio.

Those are reasons why you hold a diversified portfolio, but there are also reasons to believe now may be one of the best opportunities to invest in value that we've seen. The performance dispersion between growth and value is a wide as we've ever seen. We believe this dispersion will revert, and it may be in dramatic fashion.

Exhibit 6: 12-Month Returns (Russell 1000 Value–Russell 1000 Growth)



Performance prior to 1/1/87 is backtested. Back-tested performance, which is hypothetical and not actual performance, is subject to inherent limitations because it reflects application of an Index methodology in hindsight. No theoretical approach can take into account all of the factors in the markets in general and the impact of decisions that might have been made during the actual operation of an index. Actual returns may differ from, and be lower than, back-tested returns. Index returns are for illustrative purposes only and do not represent actual investment performance. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

We understand it's hard to overcome the recency bias—where investors project short-term trends will last indefinitely—of the performance of a select group of U.S. equities. Yet when investors ask themselves if they believe 2021 will be like 2020, or better yet if the next decade or three will be like 2020, we believe the answer is a resounding no. Therefore, as always, we believe investors should remain diversified and if necessary review goals and risk tolerances.

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[2]No mention of particular securities should be construed as a recommendation or considered an offer to sell or a solicitation to buy any securities.

Glossary

Market Capitaliztion Weighted Index: A company's market capitalization is calculated by multiplying the total shares outstanding by the share price. A market capitalization weighted index will include the entire market capitalization of all the index constituents, hence companies with larger market capitalizations will comprise a larger portion of the index.

Index Definitions

MSCI ACWI ex-USA Index: includes both emerging-market countries and developed markets, excluding the United States.

Russell 1000 Growth Index: measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000 Value Index: measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values.

Russell 2000 Index: includes 2,000 small-cap U.S. equity names and is used to measure the activity of the U.S. small-cap equity market.

S&P 500 Index: an unmanaged, market-weighted index that consists of 500 of the largest publicly-traded U.S. companies and is considered representative of the broad U.S. stock market.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice.

There are risks involved with investing, including loss of principal. Diversification may not protect against market risk. There is no guarantee any strategies discussed will be successful.

No mention of particular securities should be construed as a recommendation or considered an offer to sell or a solicitation to buy any securities.

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201033.01 IMU (12/20)