SOMERSTON
ASSET MANAGEMENT

SOMERSTON INSIGHTS

Navigating High Valuations and Market Risks: 21st May 2024

When we find a company's **fundamental** merit attractive, the **macro** environment supportive, and the **valuation** reasonable, we often say that the "stars are aligned."

If the **fundamental** merit of an investment or **macro** environment diminishes, negatively surprising expectations, the investment will likely fall in value almost immediately. However, **valuation** can stay high and remain unattractive for a long period, certainly long enough for investors to lose sight of its importance! Yet, studies show that valuation contraction is the main culprit of the major equity bear markets throughout history.

For example, the equity market peaked in March 2000 and fell 48% over the next two years. Only 4.7% of the fall came from a decline in aggregate revenues; 14.3% came from margin compression, forcing earnings 18% lower. However, 30% of the drop came from valuation compression. While just one example, all multiyear bear markets in history involve significant valuation compression. In other words, high valuations don't cause a bear market, but they are a prerequisite to a bear market.

Another more recent example of a much shorter bear market is the 35% fall in the Nasdaq between 2021 and 2023. In this instance, aggregate sales of technology companies *increased* by 10%, margins *fell* by 5%, causing earnings to *grow* by 5% throughout the 12 months of this bear market. It was the 40% **compression in valuation multiples** from 36x earnings to 22x earnings that caused all the damage.

We are confident in the fundamental merit of our holdings across all strategies, and while the macro environment is unspectacular, it is not presently cautioning trouble. However, valuations across many asset classes are increasingly hard to brush aside.

1. **Investment Grade Credit**: Eighteen months ago, we could earn 1.87% above equivalent government bond securities; now they yield just 0.97% above treasuries. These low levels are extremely rare, and we would argue, entirely insufficient to compensate for the extra risk.
2. **High Yield Credit**: Yields are just 3.2% over equivalent government securities, lower only in 2007, on the eve of the Great Financial Crisis, when they were just 2.7% above government bond securities.
3. **MSCI World Technology Index**: Trading at 28.8x forward earnings estimates. That is appreciably lower than 55.5x in 2000 but it is the same as we saw at the end of 2021, just prior to the 12-month bear market in 2022.
4. **Quality Companies**: Representative of our Core Equity investments are trading with a forward P/E ratio of 23.5 times, nearly as high as we saw in 2021.
5. **Defensive Sectors**: Utilities, healthcare, and staples are significantly more attractively valued compared to traditional cyclical sectors such as financials and industrials. This may be more a sign of investor complacency than anything else.

In the Technology portfolio, we are compelled by the artificial intelligence opportunity and excited that we are already seeing incremental growth from AI applications from Microsoft, Adobe, and Amazon. Similarly, we believe security spending will command an ever-increasing share of the technology wallet, and companies like Crowdstrike and Zscaler will benefit enormously. In our Core Equity fund, we have no doubt that luxury will endure and LVMH will continue to benefit, that Mastercard and Visa have an unassailable moat, and that Novo and Eli Lilly are dramatically changing standards of living with innovative obesity treatments.

We are not sounding the proverbial 'alarm' or calling an immediate 'time out'. However, should fundamentals deteriorate, or the macro trend become more unfavourable, valuations are once again at levels where meaningful declines are possible.

Within the Core Equity fund we have been mitigating valuation risk by trimming stocks that appear excessively valued. Intuitive Surgical, which, while undeniably compelling as the leader in robotic hospital procedures, at 60x earnings is just too expensive. Similarly, European-listed ASML, despite its enviable monopolistic position in semiconductor equipment design and manufacturing, is very hard to justify at 44x earnings. We have also been allocating to companies with far less valuation risk, such as our recently 're-acquired' position in Reckitt Benckiser.

Further to these actions, in recent days, we have increased the cash levels within the Technology and Core Equity funds. However, these are long only, fully invested funds, and they are only permitted to have a maximum weighting of 10% in cash.

Within the **Somerston Multi Asset Fund**, after the recent 10% reduction in equities, our net equity exposure is a modest 55%. This weight to equities reflects several considerations:

1. The combination of satisfactory economic growth and moderating inflation is a 'reasonable' macro environment for equities (the consequence of high valuations may not have its day just yet!).

2. There are very compelling investment opportunities in 'risk off' strategies that would mitigate equity losses:
    a. Utility, healthcare, and consumer staple companies are substantially cheaper than industrials and financials and have a very high chance of outperformance in bear markets. We have a 14% allocation to this long/short strategy.
    b. Long-dated implied volatility has also substantially reduced, making buying 'insurance' in the options markets far more attractive. We have another 14% allocated to such strategies.
    c. Within bonds, the fund's largest exposure is to the US 2-year bond with a yield of 4.8%, but we have shorted a duration-matched proportion in the 30-year bond that yields 4.5%. Normally, 30-year bonds yield 1.5% more than 2-year bonds to compensate for the extra risk. Instead, the spread to 'normal' is 1.8%.
    d. We also favour US inflation-linked bonds with a 3-5 year maturity. These bonds offer a real yield of 2.1% plus inflation.
    e. Gold and silver represent 9% of the allocation and a further 6% is in industrial commodities.

In summary, we're confident in our holdings and excited about opportunities in technology and AI, but high valuations across many areas make us cautious. While the stars are not perfectly aligned right now, our strategy is designed to navigate these conditions. The Somerston Multi Asset Fund, with its diversified and risk-mitigating approach, is better insulated from potential market declines. This strategy reflects our best investment view in the current environment.

LINKS:

- Wall Street Oasis: Bull vs Bear - Overview, Market Phases, and Factors
- Oliver Wyman Forum: Overhauling the Science of Valuations
- Barclays Private Bank: Anatomy of a Recession and Financial Markets

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