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Entry Points | Valuation Discipline, Risk and Pricing

Video Transcript

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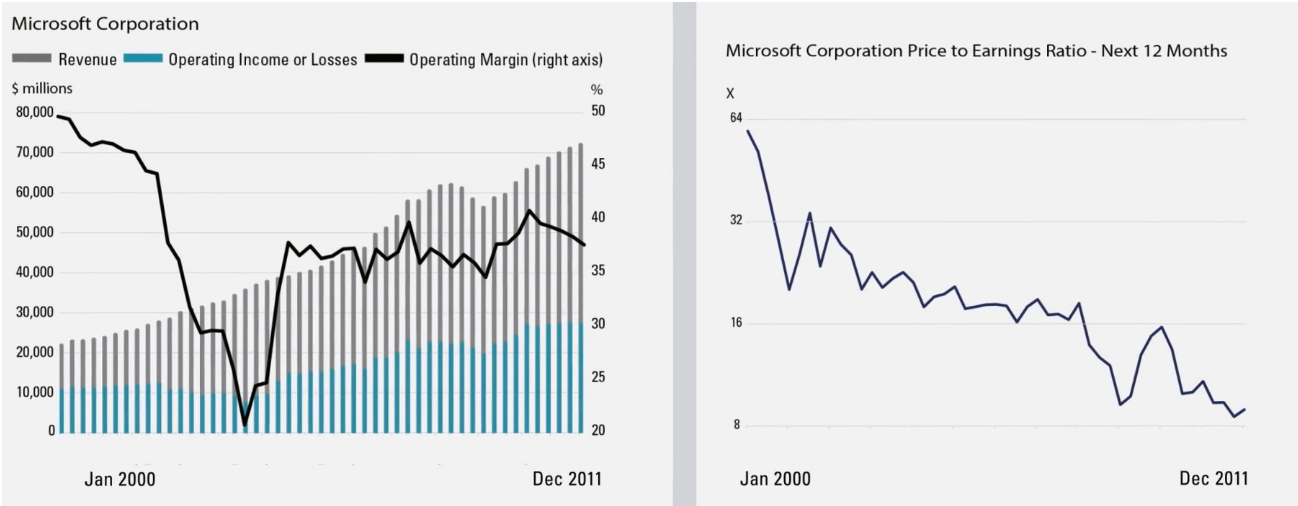
Portfolio Analyst Brandon Smith, CFA, CAIA, highlights the importance of adhering to a valuation discipline and the risks associated with investing in statistically expensive companies.

Are today's highly valued growth stocks vulnerable? I'm Brandon Smith, Portfolio Analyst at Boston Partners, and on this edition of Entry Points, I'm going to highlight the importance of adhering to a valuation discipline and the risks associated with investing in statistically expensive companies. We have just emerged from a decade in which investors enjoyed historically high rates of return with low inflation. We believe these returns were primarily driven by multiple expansion as central banks experimented with zero-interest rate policies. Growth equities in particular saw multiples rise to valuation levels not seen since the dotcom era of the early 2000s.

Today, we are in a dramatically different market environment. Inflation, though it may have peaked, remains uncomfortably high, central banks have rapidly tightened their monetary policies and risk is seemingly being priced once again by the open market instead of the U.S. Federal Reserve. We believe we are in the early innings of multiple compression across a wide swath of equities, and we believe it's an important time to remind investors that a great company does not necessarily equal a great investment. Let's look at an example of such a great company, Microsoft, during a period that we believe has many similarities to today's market environment, the dotcom era of the early 2000s. This illustration covers the 12-year period from January 2000 through December 2011, with the chart on the left showing Microsoft's revenues in gray and operating income, or EBIT, in blue, with the black line showing operating margins which remained healthy.

Now, this chart is Microsoft's PE [price-to-earnings] multiple over this time period. Microsoft sales more than tripled over the 12-year period. Operating income, or EBIT, more than doubled, yet the market cap of the stock was reduced by more than half, going from $476 billion to $218 billion. The PE multiple went from 53 times earnings to nine times earnings over the 12-year period. And the cumulative stock price return was negative 55.5%. Why did the stock perform so poorly? Because investors paid way too much for it in 2000. Again, this was a great company that continued to grow, but investors experienced a poor return because they overpaid for it. We believe today's market indices are populated with many similarly expensive stocks and we remain optimistic on the prospects for continued outperformance of low-valuation stocks in the coming years.

Are Today's Yighly Value Growth Stocks Vulnerable?
Microsoft — From Growth to Value, it has happened before.



Data as of December 2011.

Source: Bloomberg, Company Filings.

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Sales	$23B – $72B	Market Cap	$476B – $218B
EBIT	$11B – $27B	P/E	53x – 9x

Data as of December 2011.

Source: Bloomberg, Company Filings.

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Brandon Smith, CFA, CAIA
Portfolio Analyst

Brandon Smith is a portfolio analyst for Boston Partners and has extensive experience with all of the firm's strategies. Prior to this, Mr. Smith was a Vice President and senior investment analyst at Envestnet Asset Management. Before that, Mr. Smith held investment analyst roles within the fund of hedge funds groups at Gottex Fund Management and Columbia Partners Investment Management. Mr. Smith holds a B.A. degree in government from Dartmouth College. He holds the Chartered Financial Analyst® and Chartered Alternative Investment Analyst designations. Mr. Smith has sixteen years of industry experience.

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