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What's On Cary's Mind: "Valuation Risk"

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Nearly every client we speak to expresses their relief that 2020 is behind us. For many reasons – health, political, economic, global, etc. – 2020 was an extraordinary year. No need to dwell on the past, or re-hash. However, we are where we find ourselves.

The S&P 500 just notched another record high (intraday), and valuations in many parts of the market are stretched at best. GameStop has gone from $17.25 on January 4th, to $199.90 as of January 25th at 10:30AM. What is driving the fundamental underpinnings of such exponential growth?

I will not attempt to answer this question, but a piece we recently read that provides a historical perspective that was illustrative of how quickly things can change. Maybe 'this time is different….' However Valuation Risk when considering making an investment is very real and always matters...

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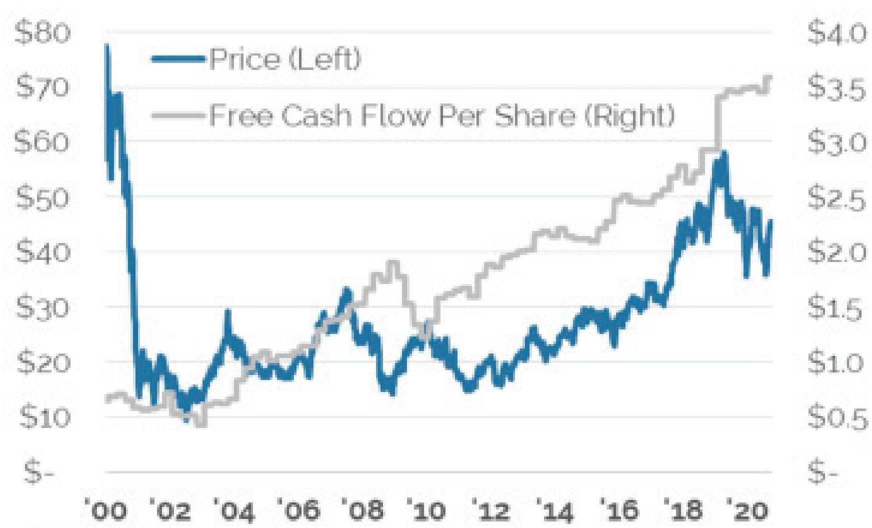
Tesla in 2021 vs. Cisco in 2000

The stratospheric performance and extreme valuation of Tesla brings to mind the example of Cisco two decades ago. In March of 2000, after a 1,300% price increase over the prior three years, Cisco's weight in the S&P 500 hit 4%. Its stock price of $77 then was around 120x trailing twelve-month free cash flows and reflected enormous optimism about future growth prospects.

This optimism was not unfounded as free cash flows increased 450% over the ensuing 20 years. But despite this growth, the stock remains more than 40% below its price in 2000 (See Figure 9.) The explanation for this disconnect between the stock price and its fundamentals is simple—the multiple paid for free cash flow contracted by 90%, providing a stunning example of the risk over overpaying for the shares of a good business.

Cisco's stock price is over 40% below its March 2000 level even though free cash flows have increased 450% since then.

Figure 9: Cisco Stock Price vs. Free Cash Flow



Source: FactSet

Tesla today looks remarkably similar to Cisco in 2000. Tesla is up around 1,300% over the prior three years and is valued at roughly 300x forecast next-twelve-month free cash flows of $2.7B. Similar to Cisco in 2000, this valuation does not leave any cushion or downside protection and the risk of valuation compression over time will be a substantial obstacle for growth to overcome. While it is not unusual for certain stocks to periodically achieve rich valuations, Tesla is somewhat unique in that it was added to the S&P 500 Index after its extraordinary rise and then moved substantial higher again on only the news of its inclusion. We doubt that many investors would be happy with a manager who announced to the world their intention to buy a substantial amount of a stock in several months' time and then after the stock went up significantly on the news, bought that much more of it, yet this is the path of the S&P 500 and all those who are simply invested in a passive vehicle mimicking it.

Source: Distillate Capital

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