SPECIAL TOPICS

When Fundamentals don't Matter Any Longer: It´s the Story, Stupid!

Since the mid-1920s, the average P/E ratio of the S&P 500 index fluctuated around between 10 and 20. Notable exceptions were disruptions around WWII, during both oil crises, the internet bubble and the financial crisis of 2008. Right now, this ratio stands at 40, having risen by more than 50% over the last 12 months. - Of course, this rise is also due to Covid19 battering companies´ core performance parameters. However and noteworthy, over the same period S&P 500 growth stocks have outperformed all value stocks of the same index by more than three times, even prior to including Tesla, a car manufacturer. That growth firm, now worth more than all its major competitors combined, trades at a P/E exceeding 1,600 at this very moment in time.

Have traditional valuation approaches been set aside? – Yes, it seems!

The Discounted Cash Flow Approach (DCF), for example, requires a well-thought through business case, if not a comprehensive list of possible scenarios and their respective outcomes (with well-defined numerical probabilities attached to each of them). – But, what if those are hardly or not at all predictable?

Next to Covid19, a combination of challenges ranging from global warming to unsustainable income gaps to technology-driven disruptions have made predictions about the future even more difficult: We seemingly face not only an incomplete knowledge of the world, but also about the connections between our present actions and their subsequent impact. – We simply do not know.

In this context, John Kay and Mervin King have shaped the term "radical uncertainty": It comprises the vast range of possibilities that lie in between the world of unlikely events - which can nevertheless be described with the aid of probability distributions -, as well as the world of the unimaginable.

Meanwhile, however, shares are traded and valuations attached. The preferred – and apparently more solid - DCF becomes de-facto irrelevant in times when valuations merely rely on (stratospheric) Terminal Values. This is not to say that multiples-based valuation approaches would make a Tesla stock – for example - any more "sound" or "reasonable".

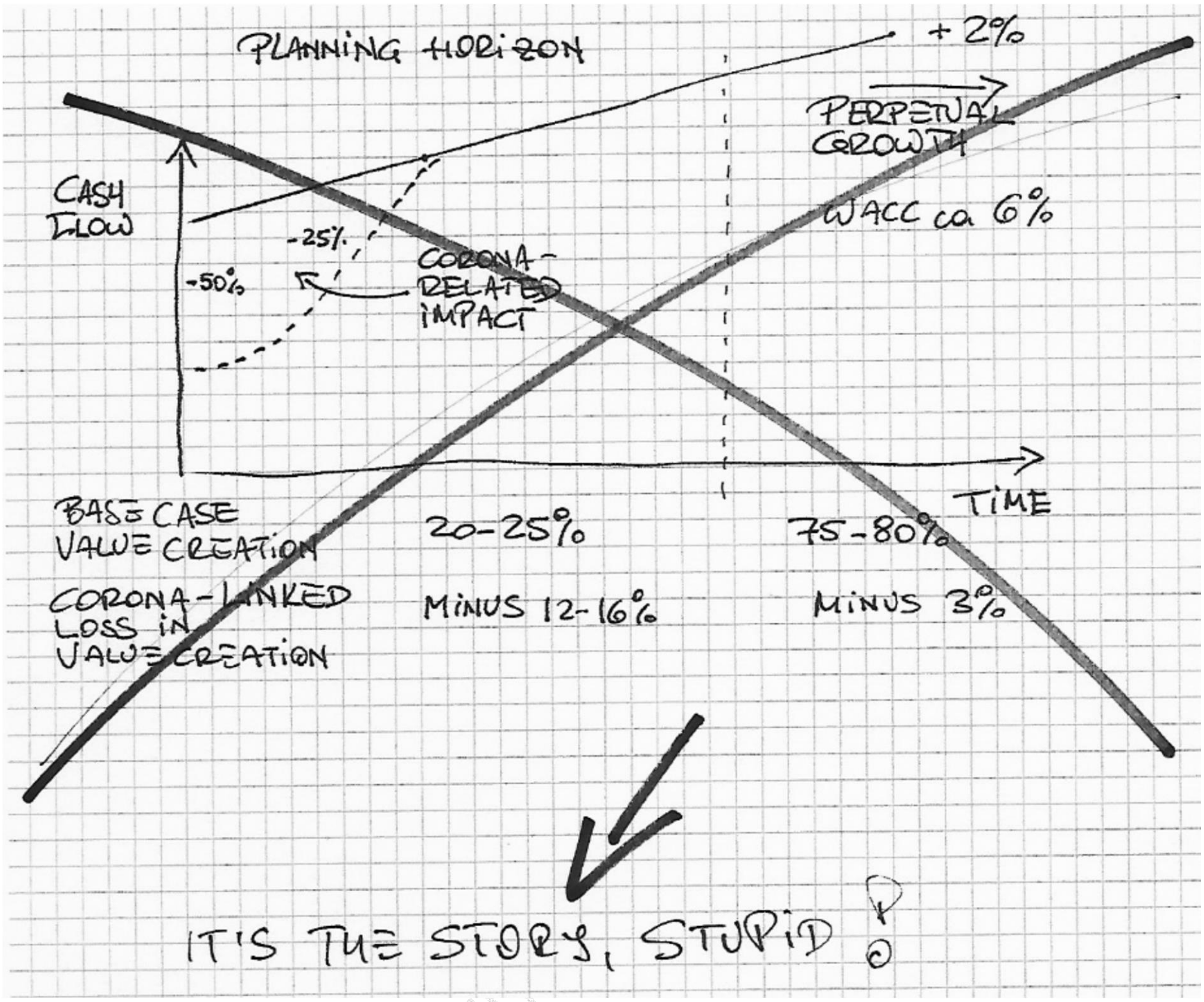
Hence, it is apparently the hype stirred by a corporate story, its unique narrative, which increasingly must "justify" valuations levels. (This concept isn't new: When bidding millions for a Picasso, a collector certainly doesn't have the painting´s "fundamental" substance value in mind, comprising of a piece of a few dollar-worth canvas with pigments on it and the wooden frame it is attached to).

A good corporate story highlights differentiation: First of all, investors aim to understand how a business fits with existing business models, today as well as over time. Picking appropriate public-market peers will guide investors and analysts to targeted valuation levels but also set more general standards. – Needless to say, disclosures are important, as investors don't like surprises (and such may / will happen, regardless whether caused by externalities or not).

However, even more relevant is investors´ trust in a corporate´s management and its ability to deliver and execute a clear, concise and consistent story: Be it claims substantiated through M&A activities (to strengthen product offerings or address operational challenges) or through cost-cutting programs (meant to boost margins). – Commitment is underlined by explaining how a firm´s strategic priorities (top-line growth, margin expansion, cash generation) translates into shareholder value. Hence, financial disclosure will focus on key performance indicators and ensure that numbers are consistent with information provided in previous announcements.

Creating as well as delivering a coherent, compelling story is not easy at all: The way some companies think about themselves doesn't necessarily align with what capital markets care about. Many firms claim to be market leader, innovation champion, unique, …: If not backed up by substance, markets will dismiss them.

If however – and as recently can be observed -, corporate stories confirm people´s own opinions and views over time, valuations can literally go through the roof!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PERPETUAL GROWTH
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CORONA-RELATED IMPACT
TIME
BASE CASE VALUE CREATION
20-25%
75-80%
CORONA-LINKED LOSS IN VALUE CREATION
MINUS 12-16%
MINUS 3%
IT'S THE STORY, STUPID !