

# INSIGHTS

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## Are Growth Stock Valuations Underpinned by Reality?

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Since the credit crisis in 2008, annual returns for value stocks, which are stocks trading at low multiples of earnings, cash flow, or book value, have badly trailed returns for the broader market, particularly those for growth stocks. Our analysis shows that through May 24, 2019 the ten-year annualized return for the Russell 1000 value index was 13.05% badly lagging the Russell 1000 Growth Index's return of 16.24%.



According to Rick Friedman at Grantham Mayo Van Otterloo and Company, a leading value investing firm, the Russell 3000 Value Index has underperformed the broader market as measured by the Russell 3000 Index by 2.0% per year since the last cycle began in 2007. This is quite a reversal from the 1.1% outperformance by value stocks since the index's inception in 1978 through 2006.

Our view is that when markets get exuberant valuation guidelines which can underpin asset values in more rational markets are disregarded and that protection for investors is lost. For example, useful guidelines for residential real estate values are cash flow yields in the form of rent versus market value or prices relative to replacement cost which both tend to put a floor under real estate prices.

These guidelines which can limit your downside risk if factored in to the prices you pay were thrown out the window during the real estate bubble when prices rose well above what those benchmarks would indicate were fair values due to speculation that housing prices could only go up regardless of housing affordability, your ability to rent out your house and generate positive cash flow or

price relative to replacement cost. This speculation turned out badly. While we certainly didn't see the credit crisis coming, we were advising any client who asked that their real estate holdings were overvalued based on paltry, historically low income or cash flow yields relative to what you could get on a ten year government bond at the time of 5%.

It's worth considering whether something similar (although probably not as drastic) is occurring today in the wide disparity between price levels for growth stocks relative to value stocks. What would a rational buyer pay for the entire company? That is a valuation benchmark that can guide you on a reasonable price to pay for shares representing ownership in that company. Does that guideline provide a floor close to what you're paying for a growth company today?

We were glad to have two large holdings increase in price substantially after offers to buy the companies were made well above our cost. Does that same protection exist for an investment in Netflix which as of June 24, 2019 has a market value of \$163 billion and negative cash flow? Years ago, when Netflix had a much lower valuation, Bob Iger the CEO of Disney approached Netflix about a transaction which never came to fruition. Today, Disney has decided its smarter to start their own streaming service rather than buy Netflix. So has Apple, Amazon, and AT&T/ Time Warner. Companies that all had the scale to buy Netflix. Do investors in Tesla have that protection? Apparently not as many major car companies are spending large sums to start their own electric car production as opposed to trying to buy Tesla. When investors started paying prices for real estate well above replacement cost and with anemic or negative free cash flow yields they were moving out of the realm of investors and into the realm of speculators in our view and we would say the same about many of the growth companies whose outsized returns have driven so much of the market returns recently.

*Mr. Nowell has over thirty years of experience in the finance business. Prior to founding South Atlantic Capital he worked in the leveraged lending department of Bankers Trust Company, New York as an Assistant Vice President. His primary responsibility was arranging bank financing for leveraged buyouts led by Kohlberg, Kravis, Roberts & Company. During graduate school he interned with Merrill Lynch's Capital Markets Group in New York. Later he served as an institutional fixed income salesman for Carolina Securities/Prudential Bache Securities and worked with Fox, Graham, and Mintz Securities. Mr. Nowell graduated from the University of North Carolina with a B. S. in Economics and received his MBA from the University of Virginia.*

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