GLOBAL CIO PERSPECTIVES

Beware of the Bubbles
Twenty Years After The Dot-Com Bubble, Some Sector Valuations Have Become Frothy

BY DAVID P. HARRIS, CFA
The Father of Value Investing
Upon the publication of Security Analysis in 1934, co-authored by David Dodd, Benjamin Graham earned his reputation as the “father of value investing.” Graham, however, may be better known for the star pupil he taught at Columbia Business School, the now famous Warren Buffett. A little known story about Graham best illustrates his concept of value investing (buying assets for less than they are intrinsically worth). In 1927, Graham invested in Northern Pipe Line, one of eight transport companies spun out of Standard Oil. Northern’s stock was selling for $65 per share, but Graham’s research uncovered an investment portfolio with at least $90 per share worth of net liquid assets. At a shareholder meeting, Graham lobbied for a large dividend payout, but to no avail. Undeterred, he reportedly wrote a letter to John D. Rockefeller, Jr. and the finance committee members of the Rockefeller Foundation to enlist support for a large dividend to distribute the excess cash. His persistence paid off when Northern Pipe Line agreed to pay shareholders a special dividend of $70 per share.

The dot-com bubble of the late 1990s is an excellent example of a sector’s valuation becoming significantly disconnected from its fundamentals. Consider the frenzy that developed around the time that Amazon.com went public in May 1997 when it raised $54 million (valuing the company at roughly $400 million). Amazon used “.com” in its corporate name to emphasize its business model of selling books online, a novel concept back in 1997. By 1999, Amazon’s success helped spawn a tech frenzy that became so overheated that 95 companies added “.com” or “.net” to their names. According to a study done by Purdue University, shares of these dot-coms gained an average of 74% simply from changing their names. Amazon’s success proved to be the exception during this era as the tech-heavy Nasdaq index peaked in March of 2000 and did not fully recover for 14 years.

Whether it is the dot-com era of 1999 to 2000, the Japanese market bubble of the late 1980s, or even the roaring ’20s, periods of bubble valuations have typically been associated with investor euphoria surrounding optimistic economic or sector growth prospects. What is far rarer is when investors place lofty valuations on markets or sectors during periods of decelerating growth or economic uncertainty.

Valuation Concerns
The key lesson from Graham is that most valuation anomalies get recognized and corrected, even if requiring some external intervention. More than 90 years later, we still see periods when sectors and markets become disconnected from their fair underlying value despite investors now having far more data.

Investors have reacted to increasingly accommodating central banks’ policies by concentrating investments in a select few sectors, resulting in a distortion of valuations. As a result, we see overvaluation centered largely in two groups of stocks: those within steady dividend paying sectors such as staples and utilities, and those in certain sub-sectors of technology perceived as having revenue growth immune to an economic slowdown, primarily software and cloud stocks.

The silver lining for investors is that fear of economic weakness has created some attractive valuations across a wide range of companies offering an opportunity to acquire shares of quality businesses at depressed prices. In this issue of Global Foresight, we assess which sectors look most interesting and those which warrant caution.
Several high-profile initial public offerings (IPOs), including UBER, Lyft, Chewy, and Beyond Meat have raised investor caution on valuation excesses. Our concerns about valuation are more broad-based as a handful of mostly successful IPOs should not set off alarm bells. Instead, what should give pause is that established software companies are now selling for the highest valuations since the tech bubble, although they are not nearly as expensive as they were in 2000.

**Chasing Yield: Utilities, Consumer Staples**

Software companies at least hold the promise of growing into their multiples. More troubling is that many U.S. utilities are selling for 20 to 30 times earnings, a level that is hard to reconcile with their respective growth prospects. Even though shares of U.S. utilities have benefitted from lower yields on bonds, we believe there is a limit to how low a yield an investor should accept. As a group, U.S. utilities are yielding only 3.25%. Remarkably, Japanese utilities have higher yields and lower multiples despite interest rates that are roughly 2.2% lower than those in the U.S.

U.S. utilities are not the only sector that has been bid-up on lower yields. Virtually any steady dividend-paying group, including REITs, telcos and consumer staples has soared on lower rates. A closer look at the three largest companies in the staples sector illustrates the disconnect between growth prospects and current valuations. The three largest companies in the staples universe, Walmart, Coca-Cola and Procter & Gamble, have seen their valuations steadily move higher over the last 10 years. These may be iconic “blue-chip” companies, but an objective look at their historic growth suggests they are already very mature. For the last 10 years, Walmart has generated earnings per share (EPS) growth at an annualized rate of 2.8%, Coke at 3.2%, and P&G at 0.9%. Net income growth for each has been even lower than their EPS growth, which has been boosted by share buybacks. The respective current price-to-earnings (P/E) ratios for Walmart, Coke, and P&G are 22.8, 24.7, and 24.1- lofty multiples for companies with anemic growth, and typical of what we see in the consumer staples sector.

**Valuation Opportunities**

Europe has become a collateral victim of the global trade wars due to its heavy dependence on trade with China. Chinese economic weakness impacts European economies roughly twice as much as it does the U.S. The U.S. exports $120 billion per year to China, representing 0.6% of its annual economic output, while the European Union exports roughly $230 billion of goods, or 1.2% of its economic output. However, some of Europe’s issues are also clearly self-inflicted. It has now been three years since the U.K. passed its Brexit referendum, yet no resolution has been reached. While we still do not expect the U.K. to leave the European Union without a trade pact, the risks of a disorderly Brexit are rising given that the U.K. will have a new Prime Minister and faces a deal deadline of October 31st.

In addition to political uncertainties, economic data have been softening around Europe. However, it is important to place this weakness into context as Europe’s median GDP growth has been a meager 1.9% for the past 20 years. Current data are trending just below that level with forecasts suggesting just a bit over 1% growth for the next few years. Given Europe’s aging populations and the inherent structural flaws of the European Union, we believe 1% to 2% growth is about all we should expect over the next several years. However, many stocks seem to be priced for...
an even more dire economic outlook, which we do not foresee. Some of the best opportunities in global equities have been generated by concerns surrounding Europe’s economic outlook.

**Opportunities in Financials**

Economic jitters have weighed on European banks, now arguably the cheapest sector in the world. During periods of economic uncertainty, we look closely at how the debt of companies is trading as an important marker of distress. One key measure is the cost of insuring against a credit default swap (CDS). In Exhibit 3, we plotted the CDS of ING Bank, which has a pan-European footprint and is thus a reasonable representative example of a European bank. Many banks in Europe have CDS trading in a similar range to that of ING. The cost of insuring ING’s debt against a default peaked at close to 300 basis points near the height of the Greek debt crisis in 2012.

Today, ING’s CDS is selling for less than 25 basis points, barely higher than it was in 2004-2006 when Europe was posting economic growth of generally 2% or higher. Yet ING’s equity valuation (and those of most banks in Europe) suggests a far more dire economic outlook than we expect. European banks now trade at 9.0 times 2019 earnings and 0.8 times book value. Notably, European banks as a group offer 6% yields, providing the potential for an attractive return while waiting for investor sentiment to improve.

While U.S. financials are not as inexpensive as those in Europe, they are arguably the cheapest sector within the U.S. market as recession fears have hurt their standing among investors. We think these concerns are misplaced for three reasons. Firstly, although recent growth has been trending lower in the U.S., it is hovering around 2% which we consider to be the long-term norm given the weight of aging demographics. Secondly, investors may be over-extrapolating the likelihood of another financial crisis since the memories of 2008-2009 remain vivid. Thirdly, fears of net interest margin compression are overdone as banks have effectively re-priced deposit rates and managed expenses in an effort to offset the impact of lower short-

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**EXHIBIT 2: WESTERN EUROPE REAL GDP GROWTH**

![Western Europe Real GDP YoY](chart)

Source: Bloomberg Western Europe GDP YoY (EHGDEUR) Index and Rockefeller Capital Management. Data provided is shown as of 6/25/2019.

**EXHIBIT 3: ING BANK 5YR. SENIOR CDS SPREAD**

![ING Bank 5Yr. Senior CDS Spread](chart)

Credit conditions also look stable to us, additionally suggesting bank weakness is overdone. High-yield spreads above the risk-free rate typically widen during periods of economic weakness, reflecting concerns about underlying credit quality. Exhibit 4 illustrates that high-yield bonds have continued to show few signs of stress. While banks may struggle to grow earnings in a lower-rate environment, they are selling for less than half the multiple of the growth-challenged staples sector.

Finally, U.S. banks are in a much better financial condition than they were heading into 2008. None of the 18 banks in the recently released 2019 Dodd-Frank stress test came close to failing a punishing simulation testing their balance sheets’ resilience to a severe recession. The mere fact that these stress tests exist as part of the post-financial crisis regulatory framework should help ease some investors’ concern of a repeat of 2008-2009. More importantly, capital buffers are now far stronger than they have been in decades, as seen in Exhibit 5.

While we see potential opportunities in financials both in the U.S. and Europe, their risk/return profile differ slightly. U.S. banks are generally inexpensive, unloved, well-capitalized and pay shareholders attractive dividends. European banks are even less expensive and have higher dividend yields. As a group, even though European banks are not as well capitalized as those in the U.S., there are still many to choose from that have strong capital buffers.

Much like banks, shares of industrial and consumer discretionary companies have been punished due to fears of global economic weakness. We see potential opportunities in these sectors with the caveat that industrials and consumer discretionary sectors are not very homogenous. There are now stocks in these sectors selling for low-double digit multiples that appear to have stronger growth characteristics than those of staples and utilities.
Technology Valuations

The communications sector perhaps provides the starkest contrast of valuation disparities across sectors. To illustrate this, we compared fundamentals of the two largest constituents by market capitalization in the communications sector versus consumer staples and utilities. The results are shown in Exhibit 6 where we list four key metrics: 1) earnings per share growth for the last ten years (eight years for Facebook since it was not publicly traded in 2009), 2) the price-to-earnings ratio for the current fiscal year, 3) the expected three year revenue growth and 4) the expected three year earnings growth.

Facebook and Alphabet (the parent company of Google) have generated the strongest earnings and revenue growth, which is expected to continue for the next few years, yet they sell for valuations at or below staples and utilities. One explanation for this valuation disparity is that investors are fearful of the threat of new regulations being imposed on these platforms. We expect more rules governing privacy in the U.S. much as we have seen in the European Union (EU). However, EU privacy rules have not had a material impact on their profitability and further regulation in the U.S. will likely only have a modest impact on growth prospects.

One of the principles that Benjamin Graham espoused was buying stocks with a “margin of safety.” The earnings of most utilities and staples tend to be viewed as safe and relatively predictable, but there is no margin of safety in the current valuation of their shares. When Graham invested in Northern Pipe Line, he clearly saw this margin of safety. Northern was overlooked when it was spun out of Standard Oil and broken up into many companies. While we do not view a breakup of Alphabet to be likely, we believe it would unlock much of its hidden value.

Conclusion

Economic momentum is slowing down around the world. From Brexit to trade wars, much is self-inflicted and can be resolved. The bigger challenge is aging demographics and high levels of debt that suggest long-term global growth will continue to be slower than it has been for prior generations. We believe that investors have indiscriminately piled into perceived defensive sectors and have not been mindful of their valuations. Specifically, staples and utilities in both the U.S. and Europe look expensive to us as do parts of the technology sector. At the same time, we are encouraged by the attractive valuations we see in the stocks of companies in other sectors outside of staples and utilities, which seem to be pricing in a rather dire economic outlook. We believe there are many attractive sectors in which to invest, even in a world with slower economic growth.

### Exhibit 6: Comparison of Two Largest Constituents in the Communications Services, Consumer Staples and Utilities Sectors

<table>
<thead>
<tr>
<th>Name</th>
<th>Market Cap. (USD Bln.)</th>
<th>Past 10 Y EPS Compound Annual Growth</th>
<th>Price to Next Year Earnings</th>
<th>Forward 3Y Revenue Compound Annual Growth</th>
<th>Forward 3Y EPS Compound Annual Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Communications Services</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Alphabet Inc.</td>
<td>755.68</td>
<td>20.70%</td>
<td>19.7</td>
<td>17.20%</td>
<td>11.70%</td>
</tr>
<tr>
<td>Facebook Inc.</td>
<td>539.12</td>
<td>56.30%</td>
<td>22.1</td>
<td>21.70%</td>
<td>13.50%</td>
</tr>
<tr>
<td><strong>Consumer Staples</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Walmart Inc.</td>
<td>314.54</td>
<td>3.50%</td>
<td>22.6</td>
<td>2.70%</td>
<td>2.80%</td>
</tr>
<tr>
<td>Procter &amp; Gamble Co.</td>
<td>276.22</td>
<td>1.50%</td>
<td>24.6</td>
<td>2.50%</td>
<td>7.00%</td>
</tr>
<tr>
<td><strong>Utilities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NextEra Energy Inc.</td>
<td>98.13</td>
<td>6.80%</td>
<td>24.4</td>
<td>6.40%</td>
<td>10.10%</td>
</tr>
<tr>
<td>Duke Energy Corp.</td>
<td>64.91</td>
<td>2.60%</td>
<td>18.1</td>
<td>2.80%</td>
<td>4.90%</td>
</tr>
</tbody>
</table>

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