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Revisiting the Wisdom of Buying Absurdly Expensive Stocks

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Time to read: 4 minutes

In December 2020, we published a piece titled *'The Wisdom of Buying Absurdly Expensive Stocks'*. At the time, our motivation for writing the article was driven by the furious multiple expansion in hyper-growth tech and related industries in the wake of the first waves of Covid-19, which had pushed the number of stocks with an EV/Sales ratio above 10x in the Russell 1000 to the highest since the peak of the dotcom mania, and those in the MSCI World to their highest ever. Fourteen months on, what has happened to the universe of exorbitantly expensive companies?

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Introduction

In December 2020, we published a piece titled '**The Wisdom of Buying Absurdly Expensive Stocks**'. At the time, our motivation for writing the article was driven by the furious multiple expansion in hyper-growth tech and related industries in the wake of the first waves of Covid-19, which had pushed the number of stocks with an EV/Sales ratio above 10x in the Russell 1000 to the highest since the peak of the dotcom mania, and those in the MSCI World to their highest ever.

Our conclusion at the time was that history suggested forward returns after crossing this threshold were not great: the median Russell 1000 and MSCI World stocks underperformed cumulatively by 65% and 33%, respectively, after five years; and the mean performance was a bit better at 28% and 7% underperformance, respectively, reflecting the impact that a few extraordinary successes can have on the sample.

Raising the bar to an EV/Sales ratio of more than 20x resulted in future prospects that were even dimmer: cumulative median underperformance for Russell 1000 and MSCI World was 73% and 50%, respectively, after five years; and cumulative mean underperformance was 42% and 22%, respectively.

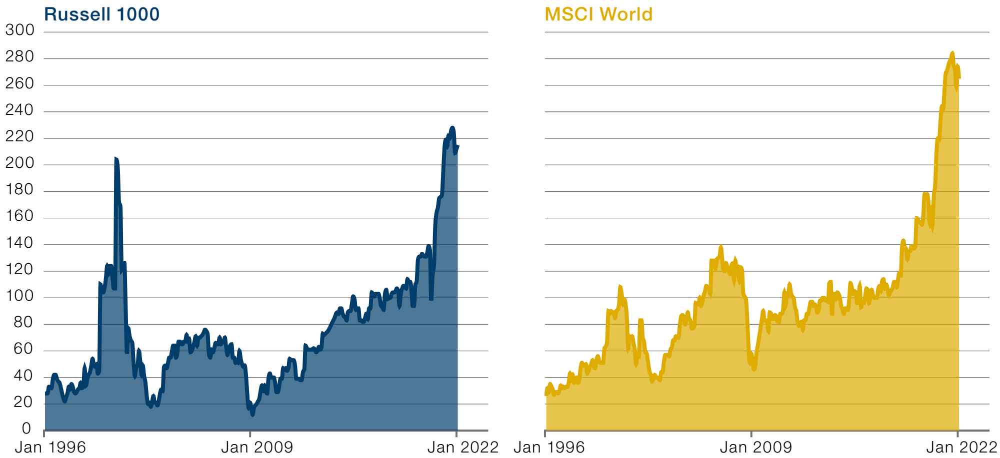
These findings were a timely reminder of the power of mean reversion. Market participants have a tendency to focus on errors of omission during bull markets, whereas in the long-run, errors of commission are powerful determinants of long-run performance. For all the endless searching for 'the next Amazon', scant attention is paid to the risks of being the bagholder in 'the next Webvan', a USD3-billion market cap online grocery delivery company that peaked at c. 40x sales, and subsequently went to zero.

Fourteen Months On...

Fourteen months on, what has happened to the universe of exorbitantly expensive companies?

Well, perhaps to the surprise of no one, the number of these companies has continued to increase. This is most evident in the number of Russell 1000 stocks with an EV/Sales ratio of more than 10x comfortably exceeding the 2000 peak, and the number of MSCI World stocks above this threshold peaking about 40% above the levels in our original analysis (Figure 1).

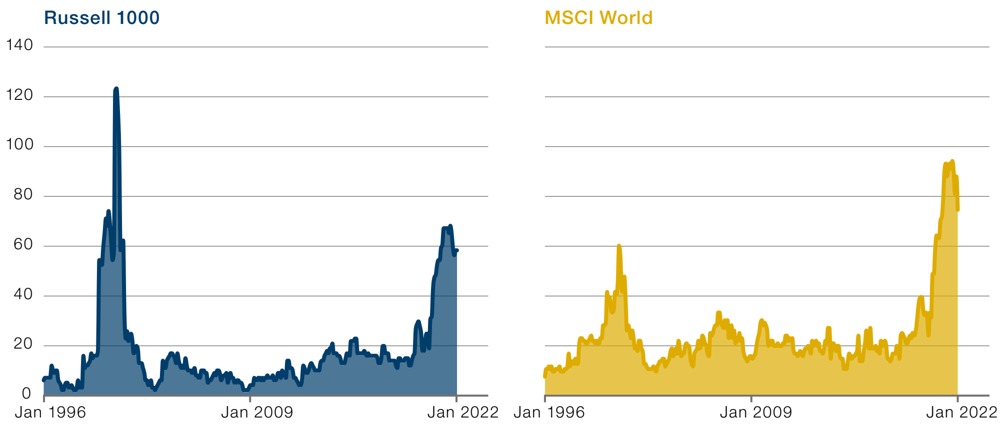
Figure 1. Number of Stocks With an EV/Sales Ratio of More Than 10x



Source: Man Numeric; as of 31 January 2022.

For all the headlines grabbed by Rivian and Lucid Motors[1] (pre-revenue companies capitalised at tens of billions of dollars at IPO), the reality is that the total number of Russell 1000 stocks in the more extreme 20x EV/Sales cohort has undershot the 2000 peak. In essence, we can observe that while expensive valuation has become more commonplace, eye wateringly expensive valuation has occurred with less frequency than in the past (Figure 2). However, at an MSCI World level, the end of 2021 was uncharted territory.

Figure 2. Number of Stocks With an EV/Sales Ratio of More Than 20x



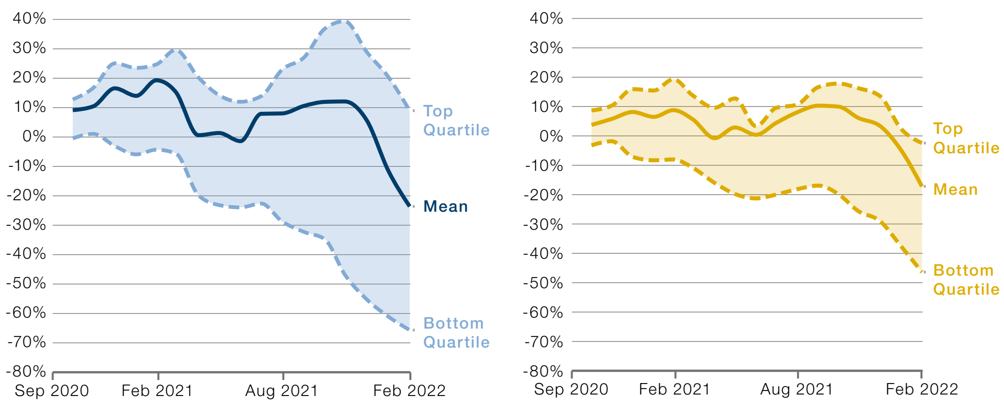
Source: Man Numeric; as of 31 January 2022.

> All but the top quartile of Russell 1000 stocks has underperformed the market (in terms of excess returns) in the months subsequent to crossing the 20x EV/Sales threshold.

Our original analysis went up to the end of August 2020. In the 17 months since then (until the end of January 2022), the performance of the cohort with an EV/Sales ratio of more than 20x gives a pretty clear picture of egregiously expensive stocks coming back to earth.

Figure 3 shows how all but the top quartile of Russell 1000 stocks has underperformed the market (in terms of excess returns) in the months subsequent to crossing the 20x EV/Sales threshold. Indeed, the worst quartile has underperformed by more than 60% since August 2020. And it's a similar story in the MSCI World.

Figure 3. Excess Returns of Stocks With an EV/Sales Ratio of More Than 20x (Since September 2020)



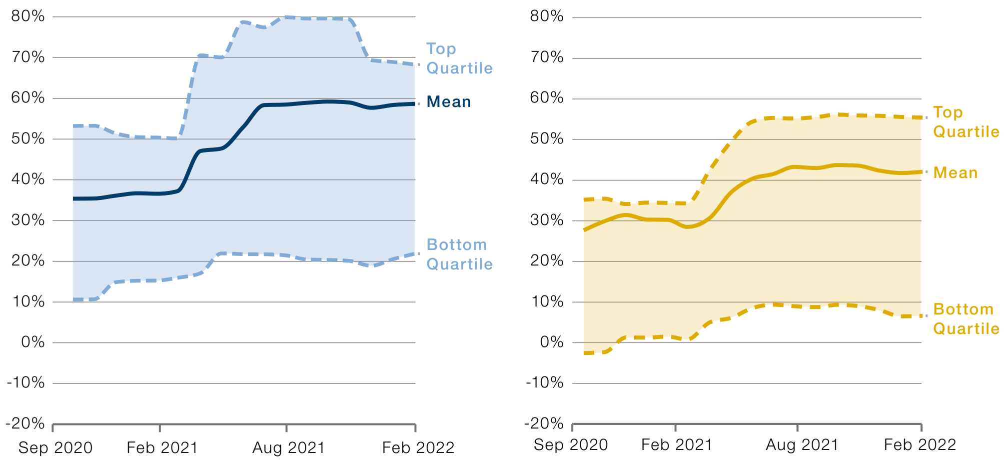
Source: Man Numeric; Between 1 September 2020 and as of 31 January 2022.

1. See, for example, www.bloomberg.com/news/articles/2022-02-02/ev-startups-are-wilting-under-harsh-light-as-public-companies?sref=Arnx08gV

Of course, there are those who argue that the collapse in the returns is due to disappointments in the stocks' fundamentals. Our data suggest the exact opposite: those expensive stocks, in fact, far outgrew the overall market, just not far enough to cope with the absurd multiples.

Figure 4 shows how the expensive cohorts in the Russell 1000 and MSCI World Indexes have delivered average excess top-line growth rates of about 60% and 40%, respectively. Indeed, all of them seemed to have reported a considerable increase in sales around the beginning of 2021.

Figure 4. Excess Sales Growth of Stocks With an EV/Sales Ratio of More Than 20x (Since September 2020)



Source: Man Numeric; Between 1 September 2020 and as of 31 January 2022.

> The reality is, when it is absurdly expensive, it is … absurdly expensive.

So, yes – if we don't look at the returns, one may say that their fundamentals look rather dreamier. Yet, the reality is, when it is absurdly expensive, it is … absurdly expensive.

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Ben Zhao is a quantitative researcher at Man Numeric. Prior to joining Man Numeric in 2017, Ben worked as a quantitative trading strategist at Grantham Mayo Van Otterloo in Boston. Ben graduated from Duke University with a doctorate degree in economics with a concentration in financial econometrics. In addition, he received a master's degree in economics from Duke University and a bachelor's degree in mathematics and economics from University of Wisconsin-Madison.

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Daniel ('Dan') Taylor is CIO of Man Numeric. He also serves on the Man Group Executive Committee and the Man Numeric Investment Committee. Dan has had multiple roles at Man Numeric since joining as an intern in 1998, including director of small cap strategies, head of hedge fund strategies, and senior member of Man Numeric's strategic alpha research team. During his tenure at Man Numeric, Dan has conducted a wide range of research, including areas such as momentum, earnings quality, valuation, investor behavior, and market timing. Dan holds a Bachelor of Arts degree in economics with honors from Harvard University. He is also a CFA charterholder.

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Edward Cole is Managing Director of Discretionary Investments at Man GLG. He is responsible for the development of investable strategies, and provides market strategy insight for the portfolio managers and the firm's clients. He joined Man Group in 2015, co-managing emerging-market equity strategies until the end of 2018. He started his career in 2001 working for specialist Eastern European-focused investment banks as an equity strategist during the period of EU accession for former communist-bloc countries, and moved to JPMorgan in 2005 as a global emerging market equity strategist. He has worked in investment management since 2007, managing long-only, long/short and multi-strategy emerging market funds. Edward graduated from the University of Bristol with a BSc in Politics and from the London School of Economics with an MSc in International Development.