Newsletter

September 2020

INDEX House View

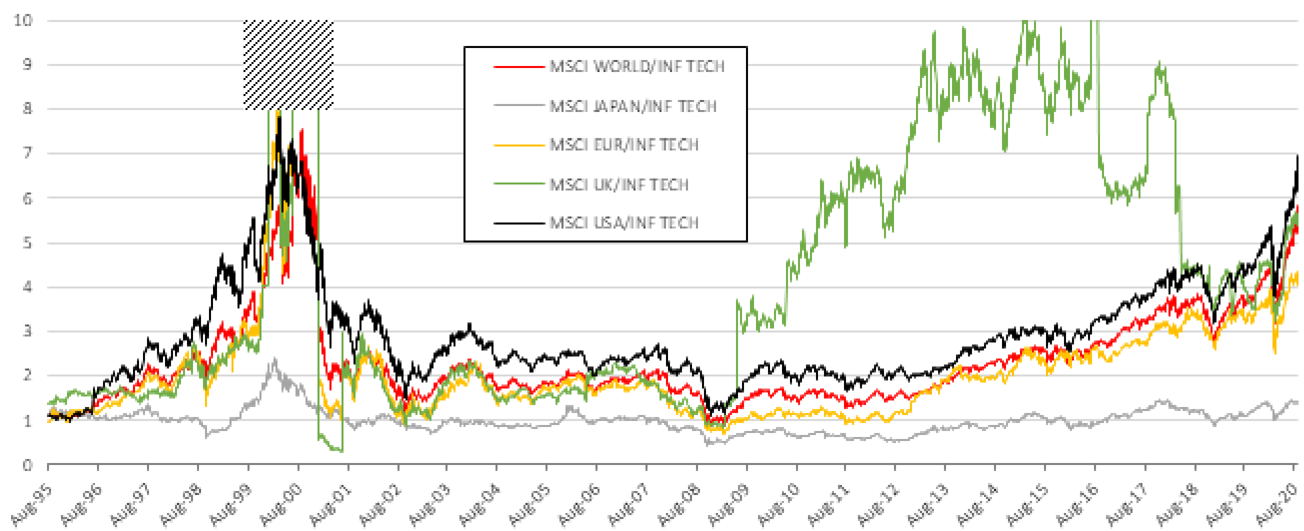
Three contemporary questions on Tech

First question – Is the US tech sector in a bubble?

Yes, and we believe that the COVID-19 trade is unwinding at a rapid pace.

Among the myriad metrics we could use to depict the current state of affairs in the world tech sector – which is anyway dominated by US companies – the enterprise value over the revenues of the last 12 months provides us with an interesting historical comparison.

EV/Sales multiple of MSCI information technology sectors, by country or region



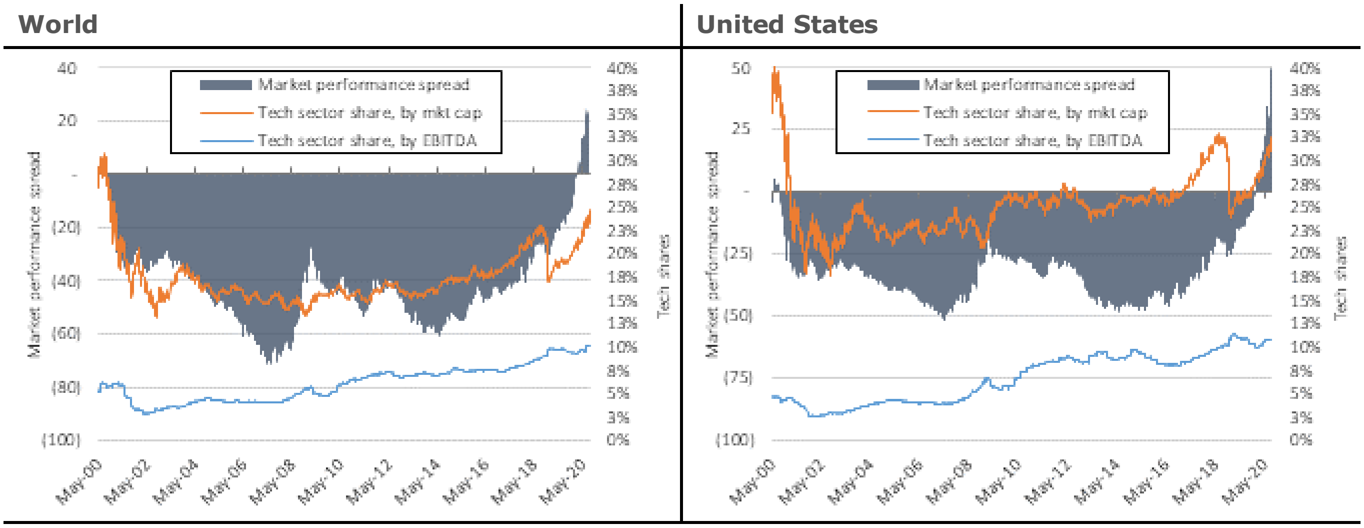
Source: Bloomberg

It is rather evident that the current situation resembles the last dotcom bubble of 2000-2001, when the almost totality of US tech stocks had zero fundamentals – and in most cases no business model whatsoever – and yet reached astronomical market valuations based on expectations. More precisely, a valuation of about 7 times revenues seemed to be the limit. Today, both the US and the aggregate world multiples are exactly at that level. Might this be a good time to exit a bet on a very expensive sector?

It is rather easy to make the connection between this technical level and the correction of the past three days. A large part of investors – retail, Masayoshi Son and institutional alike – might be now unwinding a trade based on stocks that were supposed to take the highest advantage of an at-home-economy. This is now changing, with some hiccups along the way, as major developed countries have largely reverted stringent country-wide lockdowns. With people going back to work, economies have already begun to show the first signs of normalization – decreasing unemployment, better new employment figures, trade balance improving, industrial production picking up. While we are definitely not out of the proverbial woods, market participants have indeed chosen to take some money off the betting table, in anticipation of US tech companies not being able to sustain the revenue numbers seen during the worst months of lockdown.

Second question – What if COVID-19 only accelerated the advent of the 4th industrial revolution? In other words, could we be looking only at a temporary valuation correction, in a sector that is destined to dominate the global economy from now onward without interruption, hence deserving an absurdly high market valuation anyway?

To answer this long-term question, we might want to look at how the global and US tech sectors developed in the last 20 years in economic and valuation terms.



Source: Bloomberg

The pictures compare economics with market valuations. Tech sector share by EBITDA refers to what percentage of profits does the tech sector contributes to global profits, whereas the Tech sector share by market cap refers to how much is this sector valued at against the market valuation of the global economy. A caveat: we excluded profits generated by financials and energy companies from global profits to have a cleaner representation of the weight of tech in the real economy. Globally, the tech sector contributes 10% and 11% of global profits and US profits, respectively. In market valuation terms, the tech sector counts for 25% and 31% of the global economy's and US market capitalizations, respectively. In other words, a sector that contributes 10% of global profits is valued at a quarter of the global market capitalization. This should be enough to close the chapter on whether or not a bubble exists in the tech sector.

From a price point of view, the graphs above give us an idea of what's the divergence in market performance over the past 20 years. Since 2000, tech stocks never outperformed the rest of the economy. Only since March 2020 did we see a neck-breaking rise in valuations, to the point that in 2020 the tech sector outperformed the global and US equity markets by 25% and 39% respectively. While we do not dispute that a shift in developed economies towards a more tech-heavy infrastructure will only intensify, we believe this year's events are just a spike in volatility due to opportunistic market forces, to put it simply. If we are right, there is a strong chance of a 25-40% correction when valuations normalize, according to their upward looking historical trend.

Third question – Will volatility and a correction pass on to other industries?

We do not think so. We believe this shock will be limited to the tech sector and to those participants that are concentrated in it. In general, we like and own selected securities within this realm, and are not willing to stay fully away by timing the market. While it is highly likely the sector will feel more pressure going towards year end, it is also true that tech is the new ground where empires are built, defended and conquered. The Sino-American struggle is only one of the many manifestations of this reality.

Should volatility pass on to other industries and widely ravage valuations, perhaps due to the polarized US elections later in November, we stand ready to accumulate on stocks with solid business models, clear competitive advantages and a long runway for earnings growth. Since 2019 we have been building our positions in neglected but excellent companies with exactly this characteristics, in line with our Value Investing, long-term approach. We believe these stocks will receive the deserved attention from markets when earnings start normalizing later next year. As markets usually act on expectations, positive corrections are not too far away from now.

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