ALGER

COMMENTARY

Market Insight

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THERE ARE NO SHORTCUTS

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In the media and the investment marketplace, we often hear about "valuations." The statistics quoted are invariably multiples of earnings, sales or a similar measure. These figures are often invoked to support a bullish or bearish thesis. But are these metrics meaningful? They may be insightful for the market in aggregate, but for growth companies and particularly for small growth companies, they can be misleading. We argue that returns for these kinds of companies are driven much more by fundamentals than shorthand valuation metrics.

Lazy Valuations

What passes for "valuation" on factsheets and investor commentaries is nothing more than an abbreviated version of real analysis. The intrinsic value of a stock is the net present value of all its future cash flows. Shorthand valuation metrics like price-to-earnings (P/E) have major drawbacks. First and foremost, they are static and only look at a snapshot in time. For mature companies that don't grow, that may be just fine, but for small and medium-sized high-growth companies, P/E multiples are often inflated as companies grow in step-functions. Concur, which provides expense management, travel and invoice software, is an example. In the decade before it was bought by SAP, its average P/E was over 50x, but that turned out to be justified as its earnings per share quadrupled, driving a 30% annualized return in its stock price.

Second, valuation metrics should and do vary widely based on the quality of the businesses. We define quality as the level and sustainability of the return on invested capital that businesses may generate. The former is impacted by a company's value proposition to its customers and its business model while the latter is driven by competitive advantage.

Lastly, the amount of debt a company has may dramatically impact a metric like P/E as investors pay less for more highly leveraged companies because of heightened risk, all else being equal.

In addition to being impacted by growth, quality and risk, P/E multiples are also impacted by accounting. Growth companies recognize a much greater proportion of their investment for the future in the income statement than old-economy companies. This is because investment in intangible assets like research and development on software algorithms or new drugs are expensed, serving to depress earnings. By contrast, investments in tangible assets like property or plant and equipment are capitalized and hit income slowly over time. Many growth

Inspired by Change, Driven by Growth.

stocks like software as a service (SaaS) companies also recognize revenue and earnings proportionately over time as they provide the service, despite often getting paid upfront. These accounting issues increase the proportion of net income that growth stocks turn into free cash flow relative to value stocks (see Figure 1). Investors should and do pay more for higher free cash flow conversion.

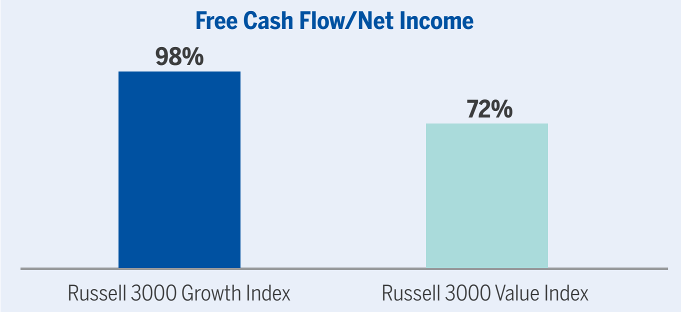
The Real Driver of Returns

Long-term returns are driven by fundamentals more than fluctuations in shorthand valuation metrics, in our view. The level of P/E may meaningfully impact returns if fundamental growth rates are low or holding periods are short, but the faster the growth and the longer the holding period, the more it comes down to fundamental growth of the business. For example, the S&P Small Cap 600 Growth Index has increased in price 8% annually over the past 20 years, driven by a very similar 8% compound annual growth rate in earnings per share. Even in the unlikely event that P/E changed dramatically despite strong growth, one could still achieve robust returns over the long term with a high growth stock. To illustrate, if a hypothetical small growth stock that traded at $50 per share and had $1 in earnings per share (EPS) grew its EPS at a 20% annual rate over a decade, it would be earning over $6 per share. Even if the stock's P/E were cut in half from its beginning level of 50x to 25x by the end of the period, its stock price would still have appreciated 12% annually or 210% to $155 (see Figure 2).

We believe that historical data shows that investing in lower valuation multiples alone does not work. The Russell 3000 Growth Index has produced more than double the return of the Russell 3000 Value Index over the decade ended May 2020. While much of that performance gap may be due to one particularly flawed valuation multiple, price-to-book value, other measures such as P/E have not performed well either. Over the past decade, high P/E stocks have outperformed low P/E stocks by nearly 200 basis points (bps) annually (see Figure 3). Interestingly, loftier P/E stocks also had a lower standard deviation than the "cheaper" stocks.

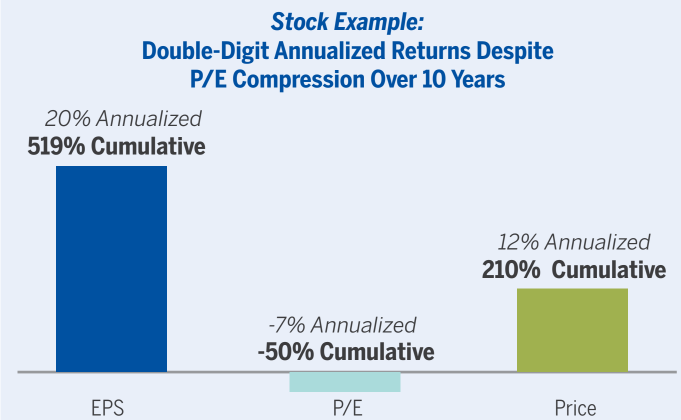
The fact that stocks that had lower shorthand valuation metrics underperformed over time further reinforces that these statistics are flawed and can be easily overcome by dynamic fundamentals. We see this clearly when

Figure 1: **Growth Stocks Convert More of Net Income into Cash**



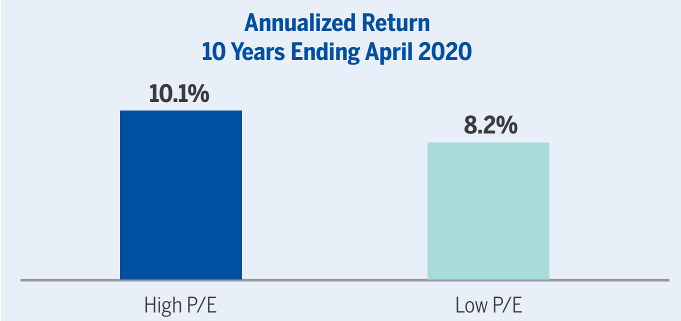
Source: FactSet and Alger. Data aggregates 2015–2019.
We believe that 5 years is enough time to smooth out any cyclical or idiosyncratic issues in the data but short enough to reflect the changing nature of the business models in the two indices.

Figure 2: **Fundamentals Drive Results**



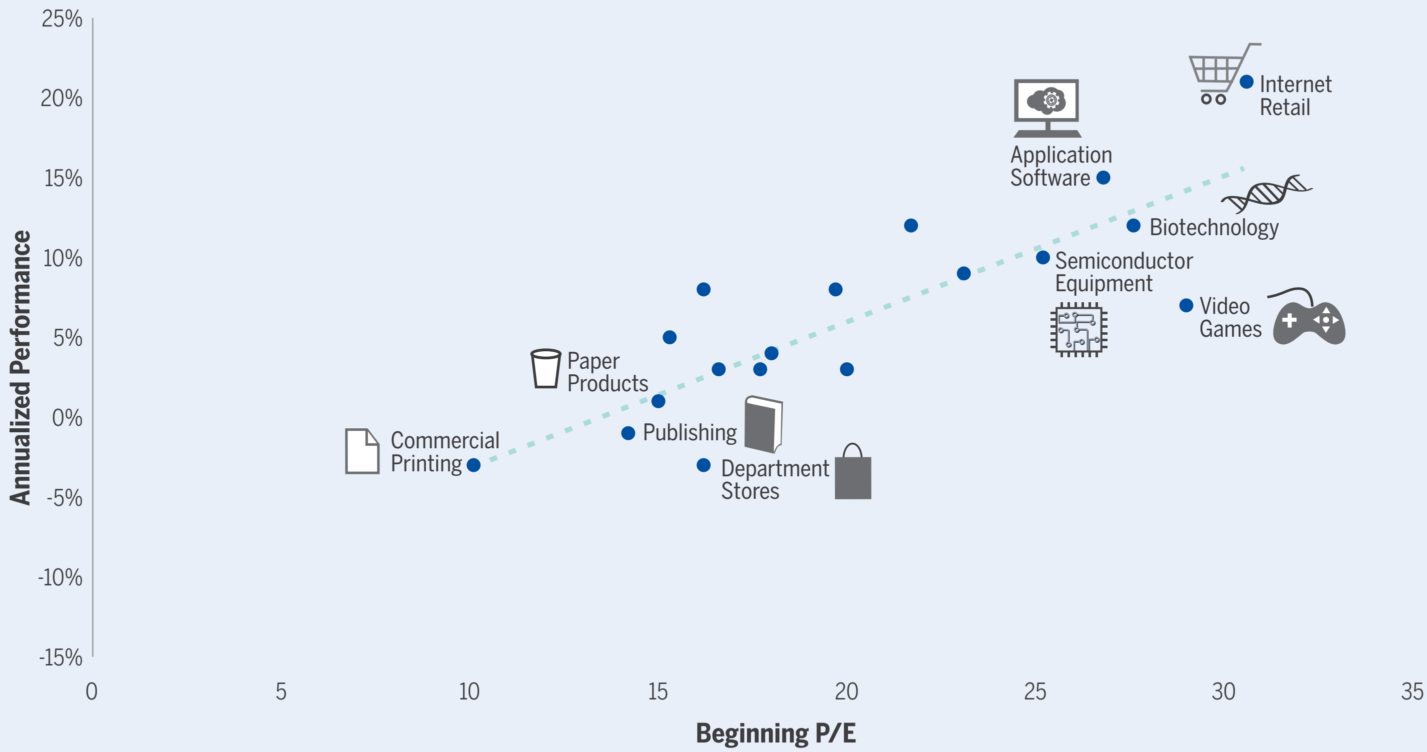
Source: Alger.
Note: A 15% annualized EPS growth rate and a 25% decline in P/E would also yield 12% annualized stock price appreciation.

Figure 3: **No Advantage to Lower P/Es**



Source: FactSet Alpha Testing. High P/Es are highest quintile of Russell 3000 and low P/Es are lowest quintile. Data calculated monthly.

Figure 4: **Sectors with High P/Es Have Historically Outperformed**



Source: FactSet. S&P 1500 industries graphed: Advertising, Apparel Retail, Application Software, Asset Management & Custody, Biotechnology, Commercial Printing, Computer & Electronics Retailing, Department Stores, Food Retail, General Merchandise Stores, Interactive Home Entertainment, Internet Retail, Paper Products, Publishing & Printing, Semiconductor Equipment, Semiconductors, Specialty Stores, and Systems Software for the 15 years ended 12/31/19. The performance data quoted represents past performance, which is not an indication or a guarantee of future results.

looking at industry performance over the long term. Industries that were on the right side of innovation dramatically outperformed other industries that were being disrupted, irrespective of valuation multiples. So-called “cheap” industries underperformed much more “expensive” industries (see Figure 4).

The Art of Investing

While it would be nice to be able to invest successfully based on valuation multiples alone, we believe it doesn’t work. Mechanical valuation frameworks can be misleading because companies grow in step-functions, making snapshots of P/E multiples at any given time often flawed.

In our view, being able to divide using a simple calculator isn’t an edge in this competitive market. We believe that generating long-term excess returns is driven by having a differentiated view of long-term fundamentals. This is achieved by understanding businesses and industries as a result of in-depth research, including speaking with suppliers, competitors and customers. An important part of this process is evaluating managements’ long-term strategy and the likelihood of successfully achieving it. In short, it is driven by hard work, not shorthand valuations. There are no shortcuts.

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Price-to-earnings is the ratio of a stock's trading price and earnings per share. Earnings per share (EPS) is the portion of a company's earnings or profit allocated to each share of common stock. Price-to-book value compares a firm's market value to its book value by dividing the price per share of a stock by the book value per share. The Russell 3000® Index measures the performance of the largest 3,000 US companies representing approximately 98% of the investable US equity market. The Russell 3000® Index is constructed to provide a comprehensive, unbiased and stable barometer of the broad market and is completely reconstituted annually to ensure new and growing equities are included. The Russell 3000® Growth Index combines the large-cap Russell 1000® Growth, the small-cap Russell 2000® Growth and the Russell Microcap® Growth Index. It includes companies that are considered more growth oriented relative to the overall market as defined by Russell's leading style methodology. The Russell 3000 Value Index is an index that measures Russell 3000 companies with lower price/book ratios and lower forecasted growth values. The S&P Small-Cap 600 Growth Index is an index composed of small-capitalization U.S. equities that exhibit growth characteristics. The S&P Composite 1500 is an unmanaged index that covers approximately 90% of the U.S. market capitalization.

Investors cannot invest directly in an index. Index performance does include deductions for fees.

SAP and Concur represented the equivalent of -0.06% of Alger assets under management as of June 30, 2020.

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