ClearBridge Investments

Cash Flows the Best Antidote to Speculation

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Key Takeaways

- Small cap multiples across the growth and value spectrum are topping those achieved at the height of the dot-com boom.
- Given the extremely low cost of equity and debt capital, the opportunities for investor speculation have increased.
- While speculative bets in meme stocks like AMC, cryptocurrencies and non-fungible tokens run the risk of permanently destroying capital, there are still some stocks with asset values and/or recurring cash flows that offer attractive returns.

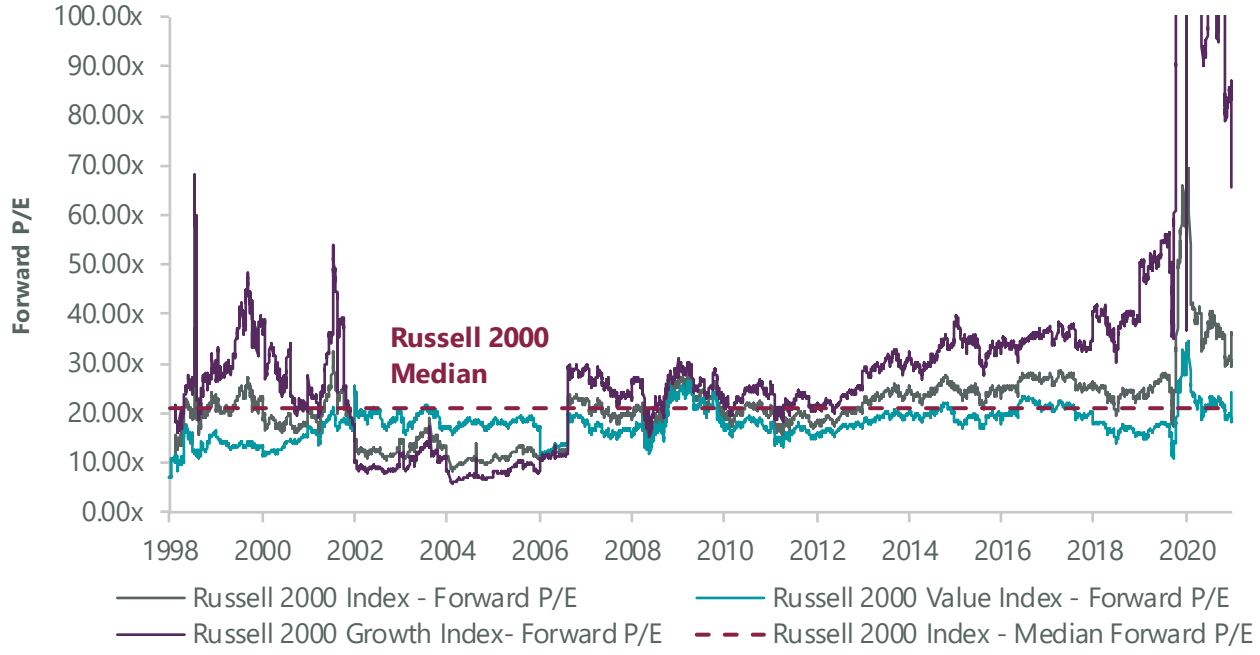
High Multiples, Low Costs of Capital Make for Pitfalls

The end of June marked the fifth consecutive quarter of gains for the Russell 2000 Index, which has doubled since March 2020 and is up more than 40% since the end of 2019, prior to the COVID-19 selloff. The 40% increase for small cap stocks since 2019 came not just despite the pandemic, but also despite the market's roaring performance leading up to 2020.

We noted at the time that growth stocks had driven a 12% compounded annual growth rate in the Russell 2000 since 2011, inflating the benchmark's valuation while putting the Russell 2000 Growth Index near its highest forward P/E multiples since the dot-com bubble and the Russell 2000 Value Index near its 20-year average.

Well, not surprisingly, everything is higher now. The Russell 2000 is over 36x forward earnings, while the value index is over 24x and growth more than 65x. All of those multiples top those achieved at the height of the dot-com boom.

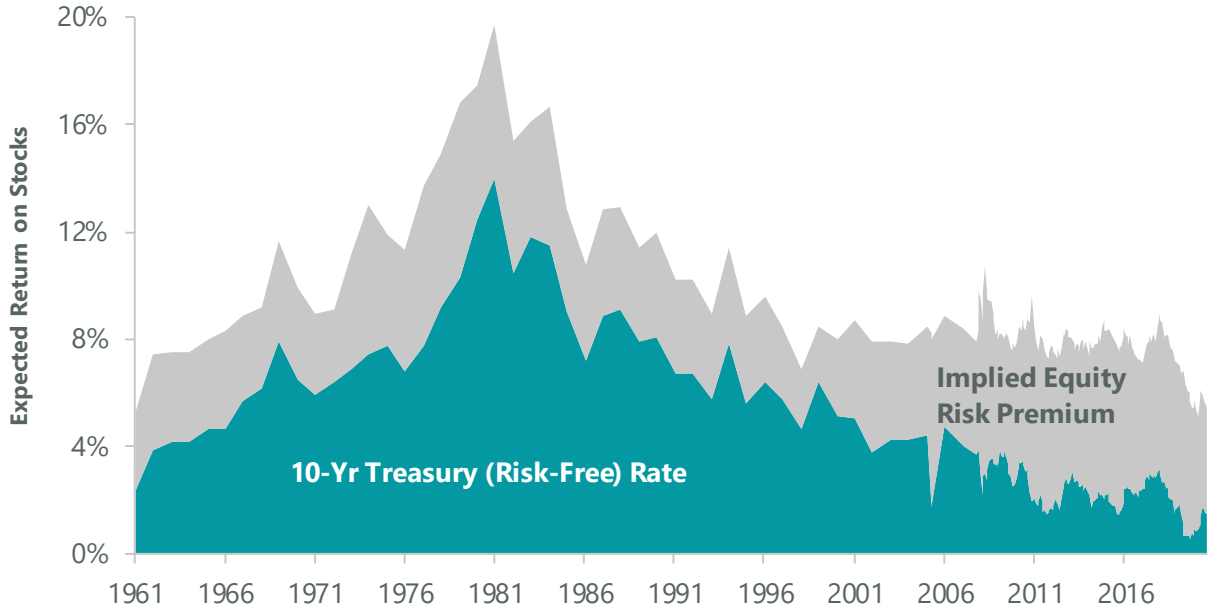
Exhibit 1: Historically High Small Cap Multiples



Source: S&P, ClearBridge Investments.

What's more remarkable about now relative to 2000 is that the federal-funds rate is near zero and 10-year Treasury notes yield only about 1.3%. Not only is the equity risk premium low; so is the risk-free rate, meaning that the cost of equity is the lowest it's been since the 1960s (Exhibit 2).

Exhibit 2: Equity Risk Premium



Source: Aswath Damodaran, Bloomberg.

Given the extremely low cost of equity and debt capital, it's not surprising that speculating has replaced investing for many people. A true investment vehicle produces income — a bond coupon or a stock dividend or buyback — that justifies the opportunity cost of employing capital and provides a basis for valuing the investment. Speculative instruments don't generate any return on investment per se, except by selling them to someone else at a higher price. Jewelry, baseball cards, art and currency are all examples of speculative instruments. They may have emotional value or be worth more or less than in the past, but their economic value depends solely on what other people will give you in return for them. Putting real money into something speculative, like bitcoin, means missing out on the cash flow available from a stock or bond. But when the expected return on those investments is low, the opportunity cost is minimal. So sure, why not throw some dollars at dogecoin, or non-fungible tokens (NFTs), or even some long-shot stock like AMC or GameStop, on the off chance that the mania continues, and one can make a quick buck?

Here's why one shouldn't participate in these schemes: permanent loss of capital. Yes, if some software company is trading at 30x sales with no profits in sight, maybe it will go to 40 times or 50 times, or perhaps it will grow and become profitable enough to create further long-term value. But if the future resembles every other speculative mania in the past, it's likely to be much lower eventually and never fully recover. There are many people who would say that it's different this time, that stocks are at a permanently high plateau, that cryptocurrencies will replace fiat money, that their particular NFT is the next Mona Lisa, and they may be right. But if they're wrong, much of the capital put in those vehicles will be permanently destroyed. It's not just about low opportunity costs, but permanent capital destruction.

Another pitfall in this undisciplined market are the sharks looking to profit off it. MKM Partners reports that more than 350 special purpose acquisition companies (SPACs) launched in the first half of 2021, raising $110 billion, following the $84 billion SPACs raised in 2020. These are "blank-check" vehicles that hold investor money until they find a company to buy, generating no return in the meantime and returning the money in two years if they can't find a deal. SPACs are not created equal — some sponsors are more credible than others — but the amount of money going to this speculative channel, prior to finding a company to buy (whose price is unknown), is noteworthy. Many other companies are going public much earlier in their lifecycles than they have in the past because the window for capital is wide open. Some are helping themselves to a bunch of free or low-cost equity, like AMC and Plug Power, who used irrational share appreciation to lard the balance sheet with cash. Finally, companies are handing out ever more generous gifts, like equity grants and loan forgiveness, to insiders, while investors show they don't care by overlooking these grants as "non-cash" or "non-recurring."

Fortunately, there are still good investments out there. Although their number is shrinking, some stocks are priced attractively now, with asset values or recurring cash flows that limit their downsides. Coming out of the dot-com bubble, unexciting value stocks did much better than hyper-growth Internet stocks. Many stocks with high near-term cash flow potential are being ignored in this market because they're not flashy and don't seem to have multi-bagger potential. But what they will do is hold their value and provide investment dollars over the coming years that hopefully can be put to work in a better risk-return environment.

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