THE WORLD HAS A PROBLEM. IT IS STARVED OF GROWTH.

We are in the middle of earnings season in the US right now, and the pattern of the last couple of years looks on course to repeat itself. Collectively, the S&P 500 index companies have delivered less than 4% growth in revenues and a bit over 4% growth in earnings. From a top down perspective, this makes a lot of sense: the economy is growing at about that rate in nominal terms.

The trouble is that a lot of money is invested with fund managers who like companies which are growing. But with fundamental corporate growth rates falling and valuation multiples expanding, it becomes increasingly hard to justify why there is still substantial potential left in a big section of the stock market. The result has been investors crowding into a number of high growth names which, although eye-wateringly expensive on many measures, have the potential to grow into and beyond their stock prices. Simply put, with growth in short supply, the market is attaching a higher price to the growth that it can see. This is doing what a market is supposed to do, finding a price where there is a balance between supply and demand.

We have seen this before, and I for one am feeling a big sense of déjà vu. Although the current market is nowhere near as extreme as 1999 amid the dot.com mania, it has some of the same characteristics. These include the use of unconventional valuation measures (multiples of eyeballs being my personal favourite) and big first day IPO pile ins for companies that have done little more than use the right buzzwords like social media, 3D printing, or “the cloud”. Still, it is different this time - taxi drivers are not giving me stock tips. This is a professional mania not an amateur one.

You can probably tell by now that I have a bias against high growth investment styles. However, the problem with being a sceptic is that even when the valuation becomes bonkers, the stock can still double or triple from there. When stocks move well past the anchor of understandable valuation metrics they are in a world of their own. That world is called momentum.

In the world of momentum there will be some long-term winners, just as there were plenty of long-term winners hidden in the 1999 bubble. Yet once you have entered that momentum phase it works both ways. There are stocks out there already down 30% to 50% from their peak, but that dip is hard to buy because in many cases they are just back to trading at fourth quarter 2013 prices. The high growth names may have a lot further to fall. On the other hand, this might be one of those healthy “refresh and renew” market corrections which bull charges go through. Time will tell, but for the moment I am in capital preservation mode.

Have I scared the life out of you? I hope not, because there is good news. It has been a mini-mania, and has really only affected a narrow part of the market by definition, because if it was easy to find growth potential then it might not have happened at all. As a result, the market as a whole has not become anything like as expensive as it was 15 years ago. Back then, many parts were cheap and value strategies did phenomenally well for the following decade but the major indices were expensive. This time, the majority of the developed market universe is still reasonably priced.

For me, the best managers for this environment will be disciplined and experienced. If you have seen “it” before, like I have, then you are better able to manage through it even if there is no certainty as to how it will end. Meanwhile, the best asset class in this environment looks to be emerging markets, where you can now buy decent growth prospects at discounted valuations.
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