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GLOBAL EQUITIES AND IT— WHERE'S THE BUBBLE?

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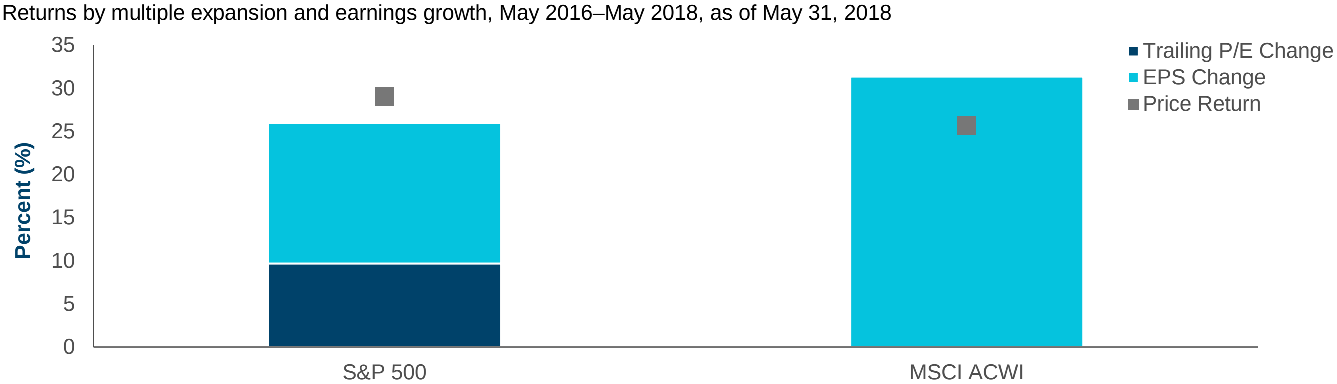
Q. How much has the price-to-earnings ratio (P/E) of global equities risen over the past two years?

A. Valuations on a P/E basis for global equities haven't risen over the past two years (Figure 1), because returns have been driven entirely by earnings growth (the S&P 500 has, however, seen its valuation rise by a modest 9%).

Figure 1: **Earnings Growth Mutes Rise in P/E Levels**

Returns by multiple expansion and earnings growth, May 2016–May 2018, as of May 31, 2018



Source: FactSet Research.

Q. How much has Facebook's P/E risen over the past two years?

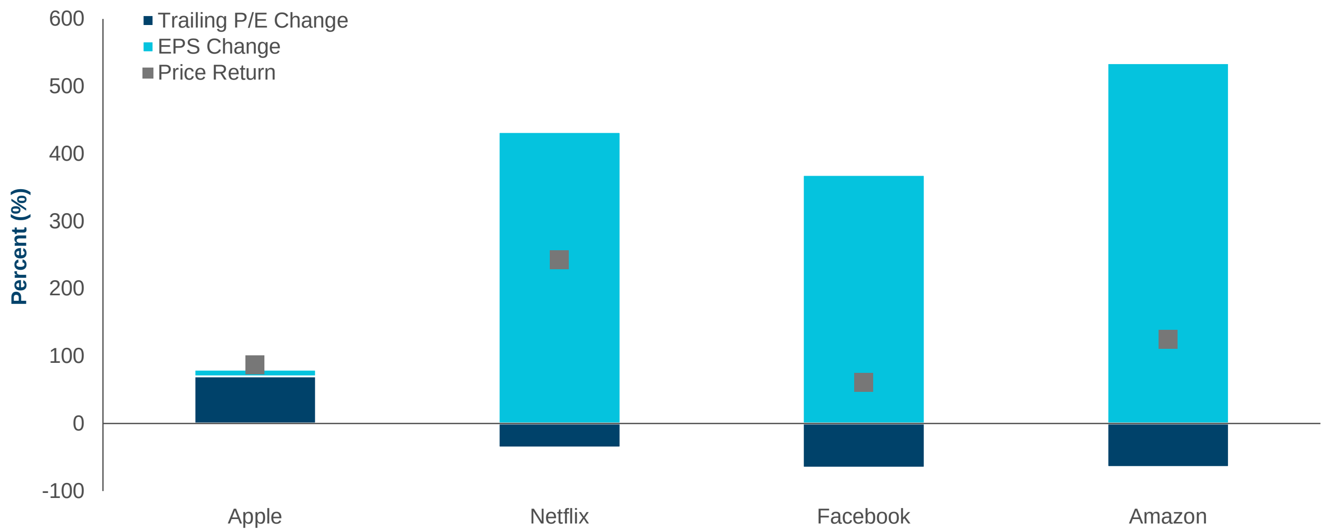
A. Facebook's P/E has not risen; it has actually fallen by about 50% (Figure 2) because Facebook's earnings have risen faster than the stock price (this is the case with many other technology leaders with unique and monetizable products and service offerings).

This is not just a U.S. phenomenon either. Alibaba's stock price has risen around 70% in a year,[1] but then so has its earnings, leaving its valuation about the same at 31-times 2019 earnings (and 21-times the following year's earnings). That's okay for a company compounding earnings growth at about 30% p.a. and in itself shows the power of earnings growth in keeping the valuation down or making the valuation fall in the face of fears that high valuation = bubble.

[1]Alibaba Group Holding Depositary Receipts share price has risen 70.09% from May 31, 2017, to June 6, 2018. Source: Thomson Reuters DataStream (Code: BABA.K).

Figure 2: **This May Surprise You**

Returns by multiple expansion and earnings growth, May 2016–May 2018, as of May 31, 2018



Source: FactSet Research.

A BUBBLE VERSUS A CHANGE

Herein lies the difference between a strong price chart (which equities, Facebook, and IT certainly have) and a bubble. If a strong price chart is backed by speculation and hope (go back to the year 2000), then it's hard to fight the bear case that a bubble might be forming. When a strong price chart is backed by improving earnings and cash flow growth, then the mosaic of valuation, fundamentals, and earnings durability needs more forensic analysis to make a conclusion on whether a chart implies a bubble or some inherent positive change from the start point.

OUR VIEW ON GLOBAL EQUITY VALUATIONS

Our conclusion on global equities remains that valuations sit at a modest premium for an asset class that has premium fundamentals, in both an absolute and a relative sense. That premium can hold for some time in a solid economic growth environment, something that bears and bearish sell-side strategists rarely want to talk about as they quote Shiller ratios and tail risks.

OUR VIEW ON TECHNOLOGY SHARE VALUATIONS

Our conclusion on many technology stocks is that this time it is indeed different. Why is current IT strength not implying the same valuation and earnings risks as the IT bubble that peaked in 2000? Because the foundations and infrastructure of the Internet, and the ability to monetize that infrastructure by successful and innovative companies, have changed—they really have. I had a Nokia 8310 in the year 2000. "Snake" was the cutting-edge game on that phone at the time. While the Nokia 8310 had awesome backlights, device technology, penetration and connectivity have changed dramatically since 2000. Importantly, the ability to create profits from those changes has dramatically changed as well.

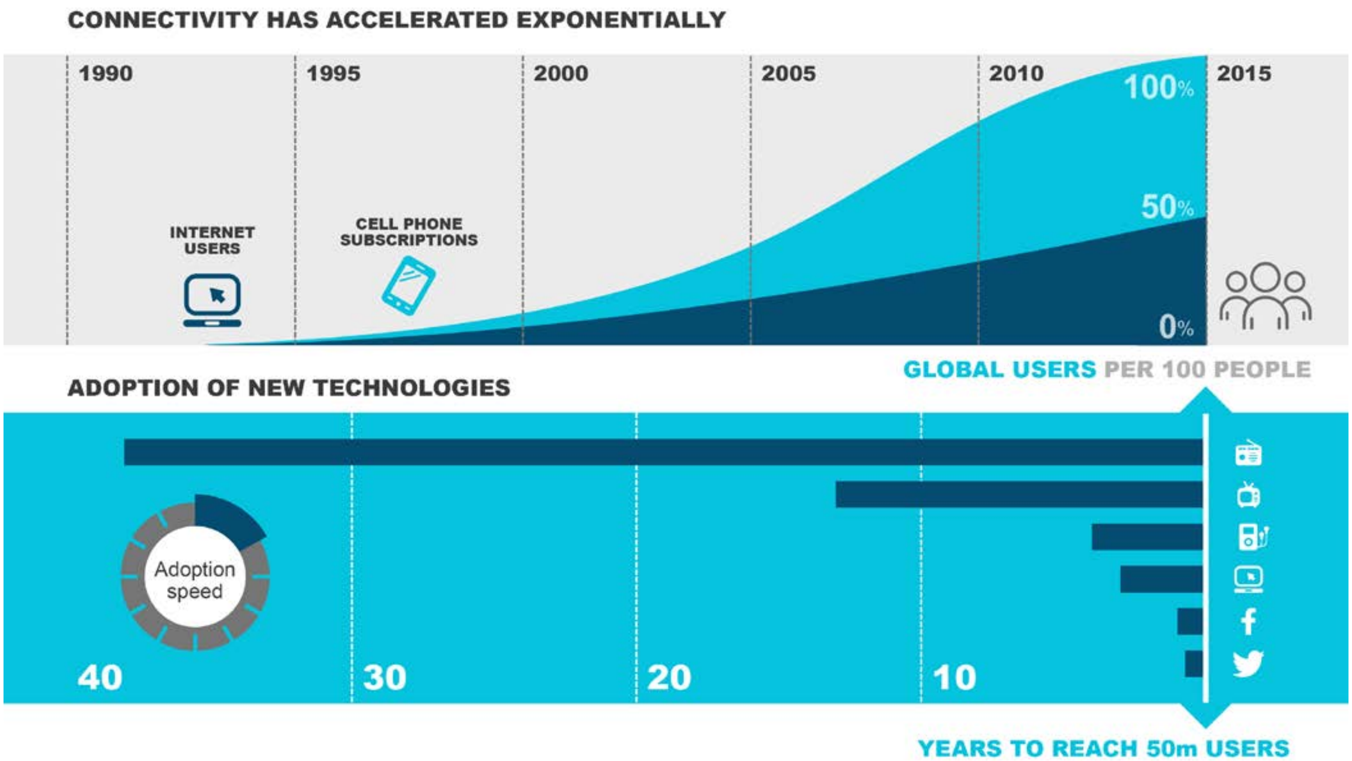
The result is that the application of technology is changing, especially for the consumer and certain companies that have innovated to create real market share, from real profitable industries. Some companies have even created whole new industries at the expense of older industries and their market incumbents. That has created a really fertile environment for some stock pickers who have the imagination to see what is changing and look beyond initial valuation levels out toward what valuation and market share might become with time and patience.

WILL TECHNOLOGY BECOME A BUBBLE?

Maybe, even possibly. But there is still plenty of stock-specific opportunity out there today for us to capture as alpha as we study the mosaic of valuation, fundamentals, and earnings durability. We continue to seek and find underappreciated earnings growth, and we will take the counterview to those who desperately want to call a bubble. A bubble that we will always seek evidence of, but cannot yet see any sign of today.

Figure 3: **Adoption and Connectivity Have Accelerated Disruption**

As of December 31, 2015



Sources: World Bank, McKinsey.

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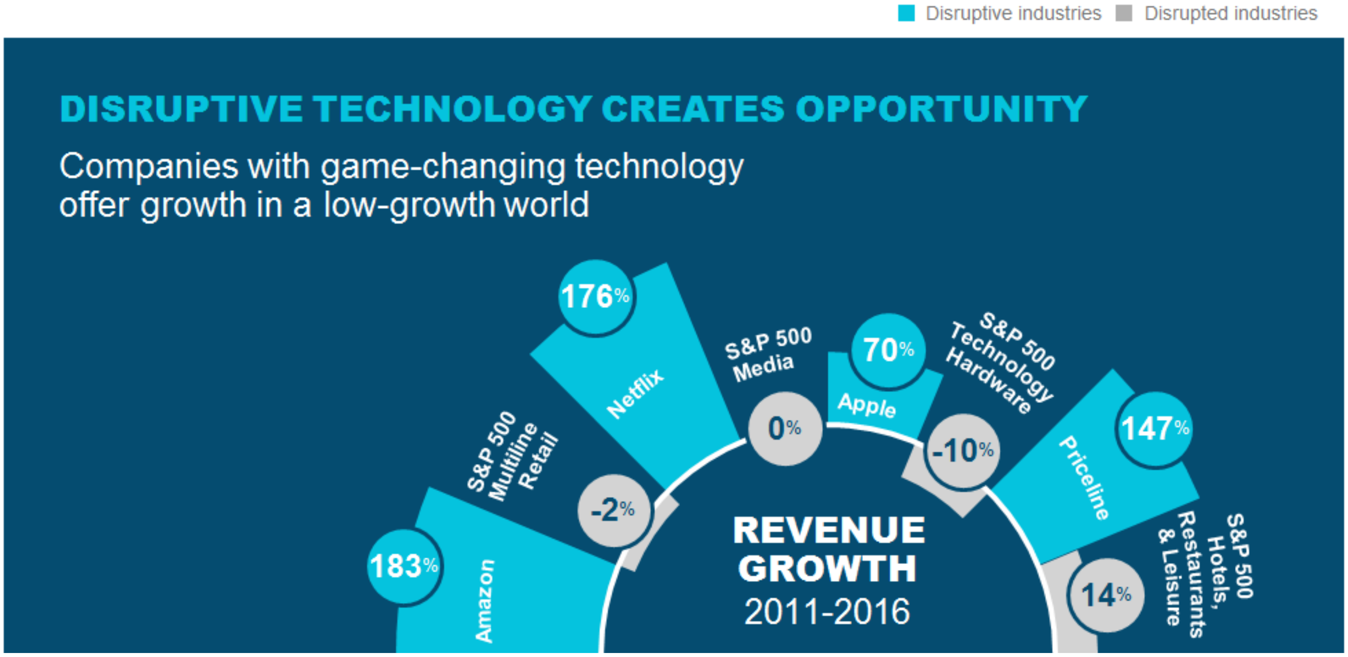
RISK AND OPPORTUNITY

We are not blind to the risks embedded within markets today. Like all good investors, we are paid to take prudent risks in our global equity strategies to generate attractive risk-adjusted alpha. With markets flat year-to-date, and beta not helping out clients as they did last year, our Global Growth and Global Focused Growth strategies are both circa 600bps above the MSCI ACWI Index for the year to May 31, 2018. This has helped to consolidate some very strong 1-, 3-, 5-, and near 10-year track records, evidencing hundreds of basis points of alpha and outperformance of passive indices over time.

Figure 4: **Disruption, Deflation, and the Right Side of Change**
As of December 31, 2016



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Source: FactSet.

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