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Do high margins justify high valuations?

From the Field
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Key Insights

- The profit margins of growth stocks have remained elevated for years, partly due to the technology "moats" guarding the largest of them from competitors.
- Conversely, value stocks' margins are linked to bank profits, commodities prices, and other cyclical factors that tend to revert to the mean.
- The market's valuations are elevated overall, but they appear sustainable given accelerating earnings growth and a return equity near all-time highs.

Sébastien Page
Head of Global Multi-Asset and CIO

The narrative that high profit margins justify the S&P 500 Index's frothy valuation is only marginally correct. Our Asset Allocation Committee maintains a slight overweight to stocks, looking for better entry points to increase the position.

As I write this in mid-November, the S&P 500 is up 54% over the last two years. Its forward 12-month price/earnings (P/E) ratio is 22.[1] It's hard to argue that stocks aren't expensive.

Yet the bears have been quiet. The U.S. election outcome could favor pro-growth policies. The economy looks fine, the Fed is easing, and earnings growth is accelerating.

And, of course, artificial intelligence (AI) is awesome. I asked ChatGPT what it "artificially" thinks (see box at right):

[1] Source for cumulative total return and P/E ratio: Bloomberg Finance L.P., as of 11/12/2024. **Past performance is not a reliable indicator of future performance.**

Is AI awesome?
"Absolutely! AI is transforming industries, sparking innovation, and making everyday tasks easier and faster. It enhances problem-solving, opens up new creative possibilities, and helps us make more informed decisions. While it comes with challenges, its potential is vast and incredibly exciting."

Give me a shorter, snarky answer.
"Yep, it's like magic—minus the wand and with a few more bugs."

Please make it actually funny.
"Absolutely! It's like having a wizard on call...if that wizard was fueled by caffeine, code, and a mild existential crisis."

That wasn't funny. I give up.
"Fair enough! I'll stick to straightforward answers for now."

Some strategists argue that high profit margins justify the S&P's high valuation. Here are some recent examples of this narrative:

> "Profit margins for the S&P 500 are at all-time highs and considering ROEs [returns on equity] as well it is not at all surprising that the market is trading at historically rich valuations."
> —Jason Trennert, Strategas, Oct. 24, 2024.[1]
>
> "The U.S. equity market is going to trade at higher multiples for a long time because margins are going to be higher in the future than in the past."
> —Adam Parker, Trivariate Research, June 6, 2024.[2]
>
> "As a business owner, higher profit margins, all other things being equal, are more valuable....The profit margins for the technology sector are close to double the market as a whole, which helps explain the premium valuation."
> —Bill Stone, Forbes, Sept. 29, 2024.[3]

[1] Jason Trenet, Strategas, quoted in the *Financial Times*, Oct. 24, 2024, "Bond yields rise, stocks don't care."
[2] Adam Parker, quoted in the *Financial Times*, June 6, 2024, "Higher margins are a mixed blessing."
[3] Bill Stone, *Forbes*, Sept. 29, 2024, "Are Stocks Overvalued? S&P 500 At All-Time Highs."

High profit margins justify high valuations only if they are sustainable and generate high profit growth. Sustainable margins come from benefits of scale, barriers to entry, and reinvestments in profitable projects. In other words, they come from what Warren Buffet calls "economic moats."

This has been true for growth stocks in the era following the global financial crisis (GFC), but not necessarily for value stocks.

Also, the pre-GFC data are less conclusive for growth stocks. Margins don't grow to the sky, and we've had periods like the internet bubble when valuations divorced from fundamentals.

Hence, the recent 15-year expansion in growth stock margins has been unusual by historical standards. As our head of Integrated Equity, Peter Stournaras, recently wrote:

> "Contrary to what we learned in business school and studying for the CFA [Chartered Financial Analyst exam], returns on capital and growth have not been mean reverting. Unlike anything we have seen since utilities 90 years ago or the railroads more than 130 years ago, fundamentals are proving doggedly persistent. Consequently, traditional rules of thumb predicated on reversion to the mean have disappointed investors.
>
> Skilled investors have adapted by developing a disciplined way to identify stocks with persistent and durable abnormal growth and profitability."

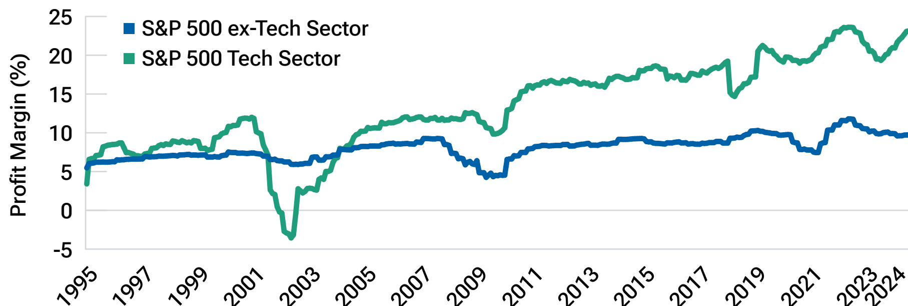
Digital business models are scalable. You can add a user to an online social platform at no cost. Plus, once a platform reaches critical mass, the network effect becomes a barrier to entry. More users attract more users, and the big get bigger.

And it's not just about the network effect. Technology has been the key to building competitive advantages in software, phones, web searches, online shopping, and

computer chips. And it's been a significant factor in the U.S. stock market historically outperforming the rest of the world. **Technology is steroids for margins.**

The chart below compares the upward movement in margins for the technology sector after the global financial crisis with the rest of the S&P 500, for which margins have only slightly increased.

(Fig. 1) Profit Margins for S&P 500 Tech Sector vs. S&P 500 ex-Tech Sector



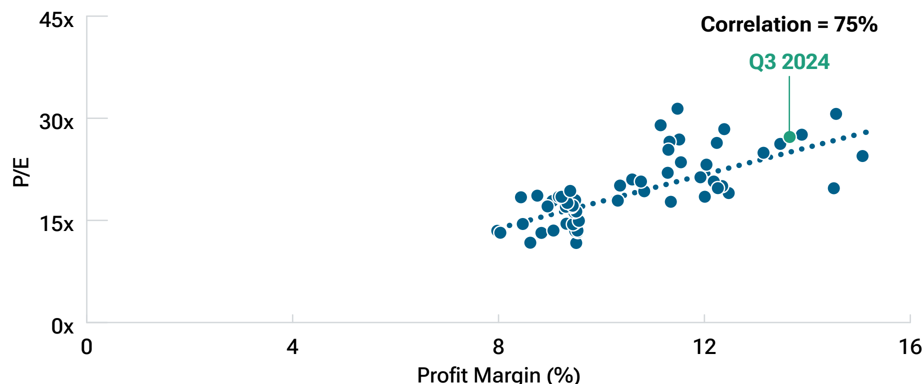
Past performance is not a reliable indicator of future results.
Source: FactSet. Quarterly data from Q1 1995 to Q3 2024. Profit margins are the ratio of net income/revenues.

Using that lens, high margins justify high valuations. Below is a scatterplot of the P/E ratio and profit margins for growth stocks from Q1 2010 to Q3 2024. There's a 75% correlation between margins and P/E ratios. High margins indicated strong future profit growth potential—and perhaps they still do if we think AI investments will be profitable.

The green dot shows the latest data point as of September 2024. It's close to the regression line, which means that the current P/E for growth stocks—if we believe this relationship will persist—is neither cheap nor expensive. It's high, but so are margins.

But there are caveats. First, high margins did not command high P/E ratios for value stocks over this same period. There was no relationship, as shown below.

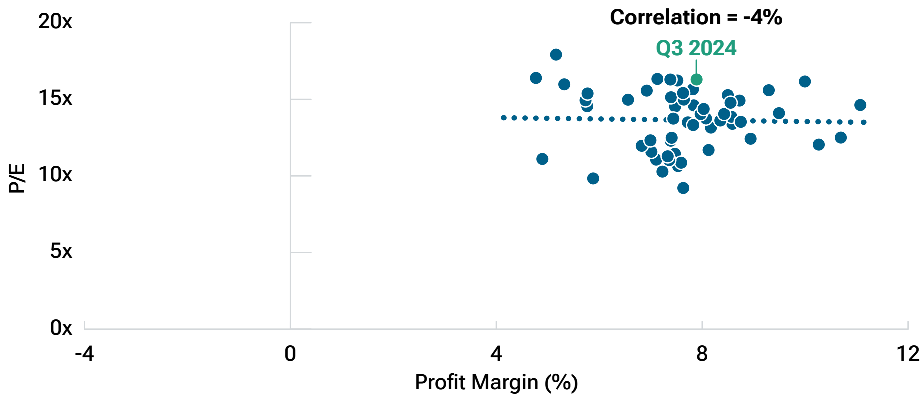
(Fig. 2) P/E Ratio vs. Profit Margin for Russell 1000 Growth After the Global Financial Crisis



Source: Bloomberg Finance L.P. Quarterly data from Q1 2010 to Q3 2024 for the Russell 1000 Growth Index. Profit margins are the ratio of net income/revenues. P/E ratios are based on forward 12M earnings.

Value stocks' margins are linked to bank profits, commodities prices, and other cyclical factors that tend to revert to the mean.

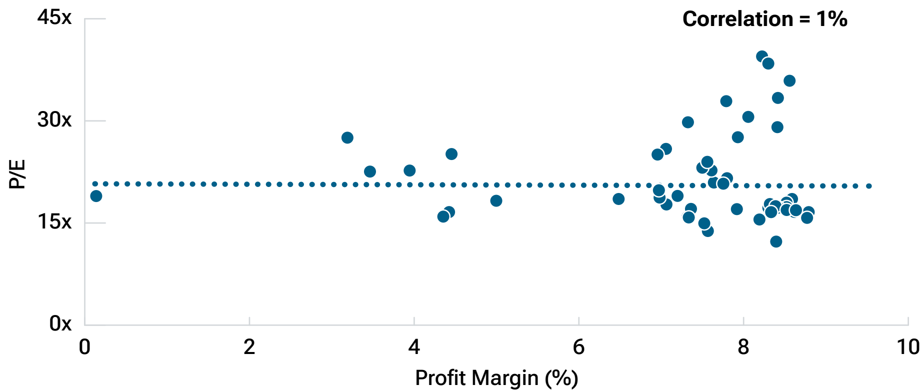
(Fig. 3) P/E Ratio vs. Profit Margin for Russell 1000 Value after the Global Financial Crisis



Source: Bloomberg Finance L.P. Quarterly data from Q1 2010 to Q3 2024 for the Russell 1000 Value Index. Profit margins are the ratio of net income/revenues. P/E ratios are based on forward 12M earnings.

There was no relationship for growth stocks before the global financial crisis either, as shown below. In particular, P/E ratios were divorced from fundamentals during the tech bubble. Internet companies commanded high valuations without generating revenues, let alone high margins.

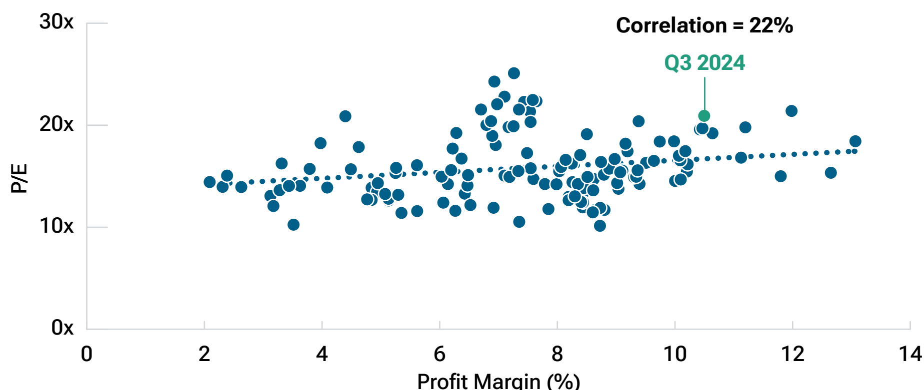
(Fig. 4) P/E Ratio vs. Profit Margin for Russell 1000 Growth before the Global Financial Crisis



Source: Bloomberg Finance L.P. Quarterly data from Q1 1995 to Q4 2007 for the Russell 1000 Growth Index. Profit margins are the ratio of net income/revenues. P/E ratios are based on forward 12M earnings.

Combining the data and examining the long-run relationship over more than 30 years, we find a 22% correlation and a relatively flat slope between P/E ratios and profit margins for the S&P 500, as shown below.

(Fig. 5) P/E Ratio vs. Profit Margin for S&P 500 Over the Long Run



Source: Bloomberg Finance L.P. Quarterly data from Q1 1991 to Q3 2024 for the S&P 500 Index. Profit margins are the ratio of net income/revenues. P/E ratios are based on forward 12M earnings.

Our analysis justifies our moderate risk-on position. Valuations are high, but...

- they aren't as high as during the tech bubble;
- margins are significantly higher and driven by the moats of mega-capitalization companies;
- the market's return on equity is also close to all-time highs (not shown here); and
- earnings growth is accelerating.

The bottom line is that high margins are a good thing, but they're only part of the story about market fundamentals.

One last thing...

I'm regularly asked to discuss our views on live national television or to print journalists. It's stressful. With one or two minutes per answer, nuance is out of the question. I often use facile talking points—like everyone else. So, I say this with empathy for anyone speaking in the media, including those I quoted at the beginning of this article: Beware of oversimplified narratives.

I'm grateful to William Liu for running this analysis and to Rob Panariello, Charles Shriver, Josh Yocum, and Dave Eiswert for their valuable contributions, as always.

Definitions:

Profit margin is used to identify a company's health and its potential for growth. As a percentage, it is the amount of profit a company has generated compared with its revenue.

Relative valuation is the concept of comparing the valuations (such as price-to-earnings ratios) of different securities or asset classes.

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