PZENA Investment Management

The new sure thing: A market running on sentiment

September 2020

Several years of significant political and economic uncertainty have investors grasping for a sense of certainty through the go-to growth stocks that have led markets higher during this late stage of the cycle.

Indeed, since the beginning of April, while we continue to suffer through a global pandemic and extreme economic contraction, the market has been on a tear, led by the big tech stocks and, more generally, the "big grower" universe. We believe the disconnect between the market and the economy has gotten too big. But what lies at the heart of it?

Perceptions of Interest Rates

- Deliberately suppressed interest rates have given rise to the notion of real rates being held negative indefinitely.
- This gives license to a new investment math: a growth rate of, say, 10%, an equity risk premium* of about 3%, and real rates at or near 0% justifies any multiple you want—until you realize you are just accepting a low single-digit rate of return.

At Pzena we target companies that our research indicates can achieve *double-digit* embedded cash-on-cash returns—and we believe our holdings offer that.

The Stay-at-Home Reality

- The pandemic has accelerated revenue growth for all things internet.
- Government stimulus and simplified lifestyles provided people with more money and time, driving an internet spending spree and a massive boost to cloud providers.
- Some increase in virtual services spending may be permanent, and it likely accelerated the drop off in physical retail. But the COVID-related halt in discretionary spending (visiting a favorite store, vacations, large purchases, etc.) should rebound, and some cloud and online services growth will likely slow once the world returns to a more normal path.

Permanent effects of the COVID lockdowns would not be all positive for "new economy" stocks or all negative for "old economy" stocks.

Momentum Takes on a Life of its Own

- Quant investors, indexing, and autonomous trading are significant factors reinforcing this momentum.
- Retail day trading is back to a level we haven't seen since the dot-com era. The trading platform Robinhood has picked up where Motley Fool left off.

If there's ever a time when a rally seems to have become untenably bifurcated, we believe it's now. Netflix aside, the FAANGs plus Microsoft have posted strong returns and now make up about 20% of the S&P 500 Index; the other 495 stocks have notched modestly lower gains this year. We've seen this movie before. The narrow rally off the March bottom has magnified the growth/ value dislocation, which has reached a level we view as unsustainable. When uncertainty (unprecedented events) hits, the trend is your friend until the fog lifts. And the fog will lift; the pandemic will end. We are vigilant in understanding permanent changes and investing where we believe the companies are well positioned relative to competition.

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FURTHER INFORMATION

*The equity risk premium refers to an excess return that investing in the stock market provides over a risk-free rate. It is a forward-looking figure and, therefore, theoretical.

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