TBC CAPITAL

VALUE INVESTING DURING PAST YEARS

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Rati Kalandarishvili
Associate, Capital Market Research

Aleksandre Gotsadze
Analyst, Capital Market Research

Nikoloz Chitadze
Junior Analyst, Capital Market Research

Tatia Dzaptashvili
Analyst, Capital Market Research, Brokerage

Nika Zakareishvili
Junior Analyst, Capital Market Research

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“Under Value Investing, for years, Amazon, Microsoft and most tech and online companies were never considered a value. To a growth investor, these things become their bread and butter.”

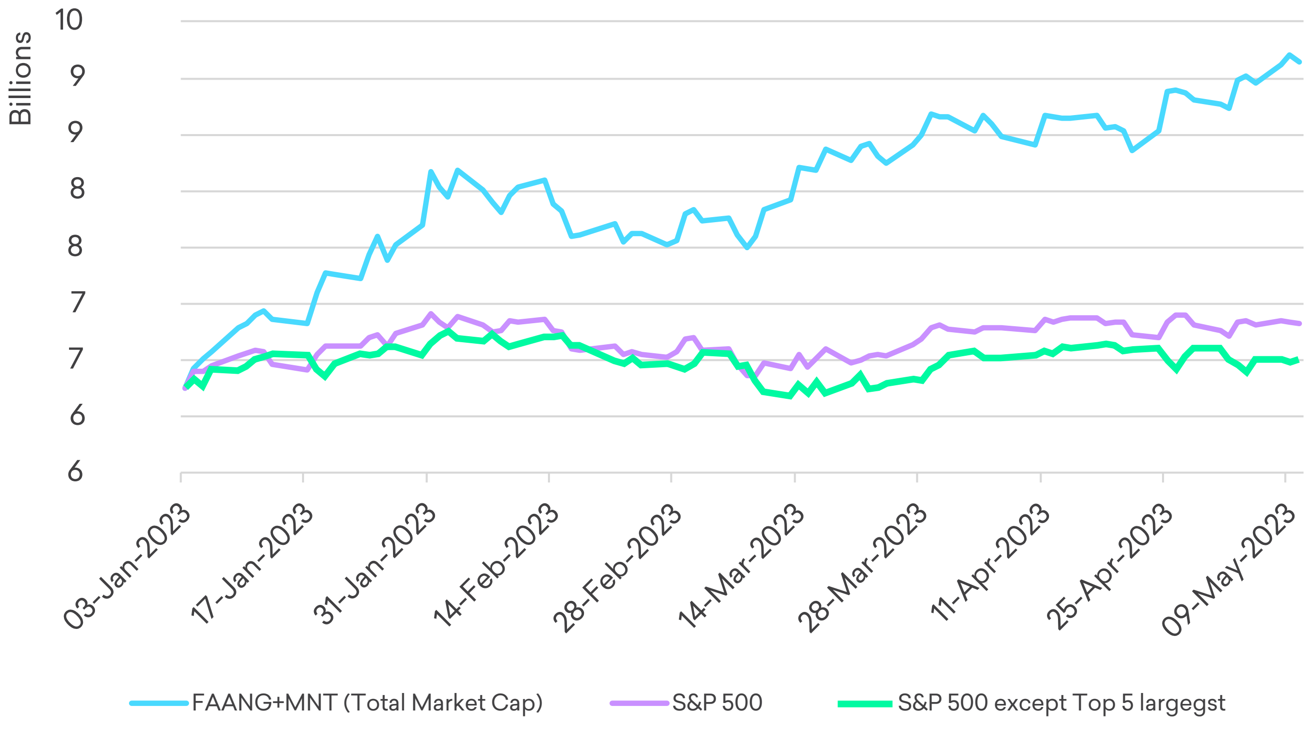
Mark Zone, Swing Trading ©

“Party like it’s 2020”

The start of 2023 was quite unexpected for many investors interested in the US equity markets, despite practically all large investment banks' research teams claiming that we would see a recession and the S&P 500 at the level of 3500 in Q1, the index gained more than 8% from January to May 2023. Even against the backdrop of some problems in the regional banking system, the stock market is not in a rush to go down.

The main driver that pulls the market up is so-called “Big Tech” sometimes mentioned as FAANG, sometimes as FAAMG (as Microsoft definitely should be there), but the most “comprehensive” way to refer to it is FAANG+MNT: Facebook (META), Apple (AAPL), Amazon (AMZN), Netflix (NFLX), Alphabet (GOOG) + Microsoft (MSFT), Nvidia (NVDA), Tesla (TSLA)). These 8 stocks have gained an incredible $2.9 trillion together in 2023, which translates to a YTD return of over 40%, while the S&P 500 has only increased by 8.5% and the Goldman Sachs index of 495 of S&P 500 companies minus the largest 5 (Apple, Microsoft, Alphabet, Amazon and Berkshire Hathaway) (Bloomberg ticker: GSCMSPY5 Index[1]) is relatively flat with about 3.5% return since the January beginning.

FAANG+MTN market cap VS S&P 500 (normalized, base = 6,500)



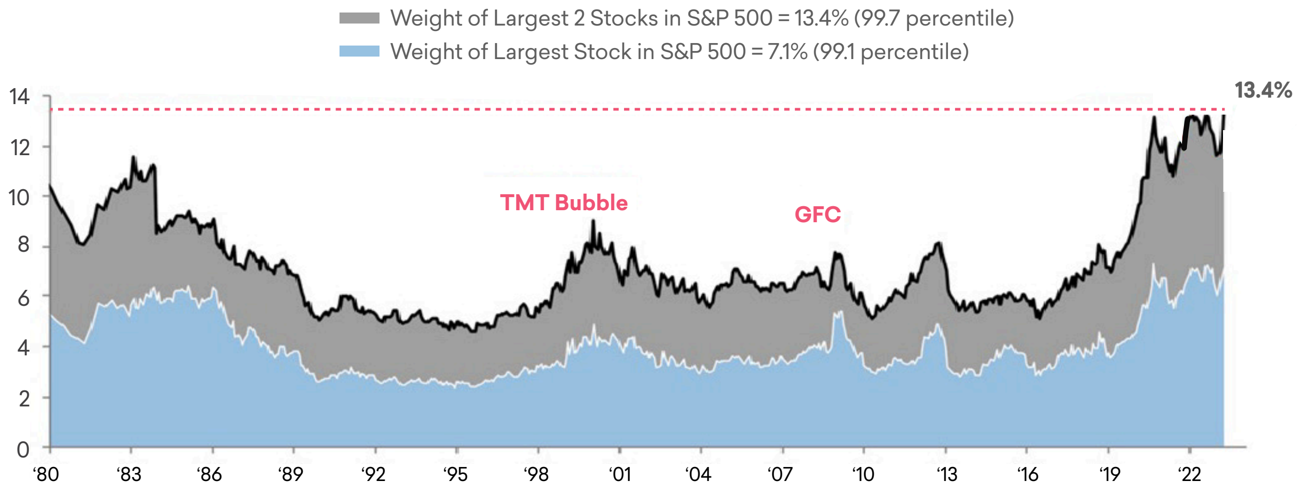
[1]The Goldman Sachs Top 500 ex-Top 5 is a GS enhanced index solution that eliminates concentration by taking out the largest 5 stocks from the top 500 by market cap. The basket is market cap weighted but diversified.

The market is heavily influenced by a small group of companies involved in advanced AI and language models. Investors are also favouring safer options like big, established companies. This has resulted in a narrow range of companies driving market growth, which is unusual during an upward trend. Although there was a brief period of success for riskier investments earlier this year, overall, the trend has been towards safer options.

Currently, investors are focusing a lot on large, established companies, with their market value being very high compared to the past. The two biggest companies in the S&P 500 index have a significant impact on the market, more than ever before. This means that the recent market growth is mostly driven by a small number of these large companies, rather than a wide range of companies as we usually see. Some people compare this concentration on big technology companies to what happened in 2020 when everyone was thinking about the digital world. Technology companies seemed like a safe investment because people relied on digital devices and the internet when they couldn't travel or do other things.

However, this situation may not last forever. Currently, the top 10 companies in the S&P 500 make up around 29% of the index, which is higher than in previous periods like the dot-com bubble and the Global Financial Crisis, but lower than during the peak of the COVID pandemic. When we consider the top 50 companies, the concentration is not as high. So, while the situation is significant, it's not extremely concentrated compared to past periods.

Largest 2 stocks at 13.4% weight in S&P 500



Source: J.P. Morgan Equity Macro Research

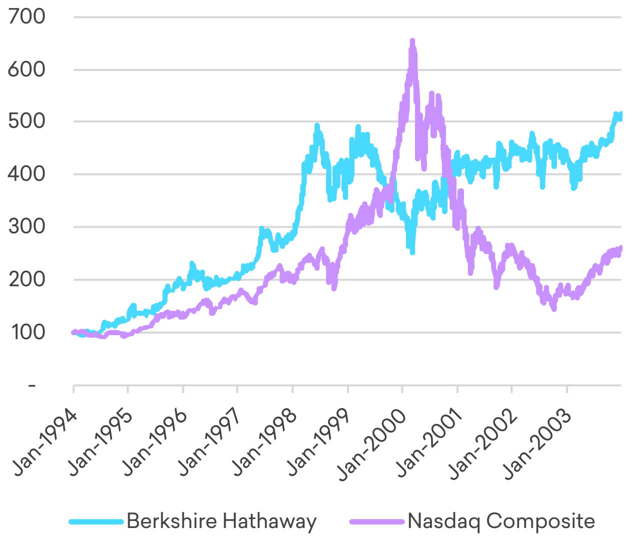
Investing like a Buffet

When it comes to investing in the stock market, there are different approaches that investors can take. One common opposition is between two styles: "value investing" and investing in growth stocks.

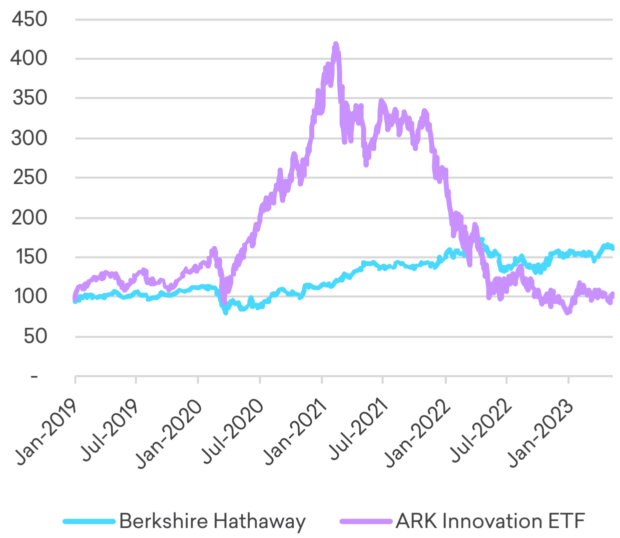
To simplify, the report mainly discusses "value investing" type strategies based on Buffett's portfolio and his past decisions – nothing personal, the Oracle of Omaha is simply the most well-known adept of this strategy nowadays.

Below are perhaps the two most famous "overperformance" examples of Warren Buffett vs. growth stocks: Berkshire's share price relative performance against the Nasdaq index (a proxy of tech stocks) during the dot-com bubble on the first chart and against Cathie Wood's ARKK ("ARKK is an actively managed ETF that seeks long-term growth of capital by investing in disruptive innovation companies").

Buffet VS "fancy internet stocks"



Buffet VS Cathie Wood



Source: Bloomberg Finance L.P.

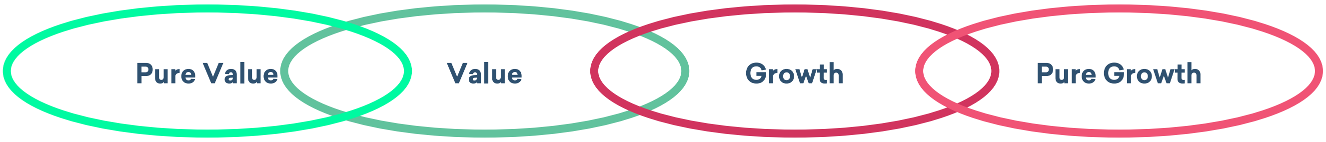
People often see "value investing" as a reliable approach because it involves investing in stable companies, like soft drink producers, that may not see explosive growth but also won't likely suffer major losses. This seems like a safe strategy compared to investing in companies that have been consistently unprofitable and whose stock prices have dropped significantly.

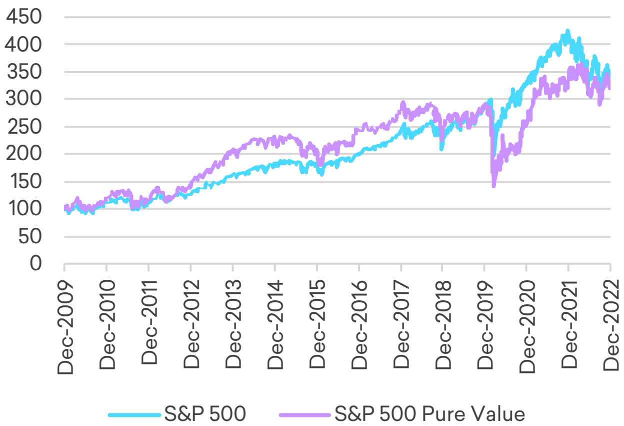
However, there are a couple of things to consider. First, what exactly qualifies as a "value stock"? It's not always clear. And second, is it wise to invest in a market bubble even if you're aware that it's a bubble?

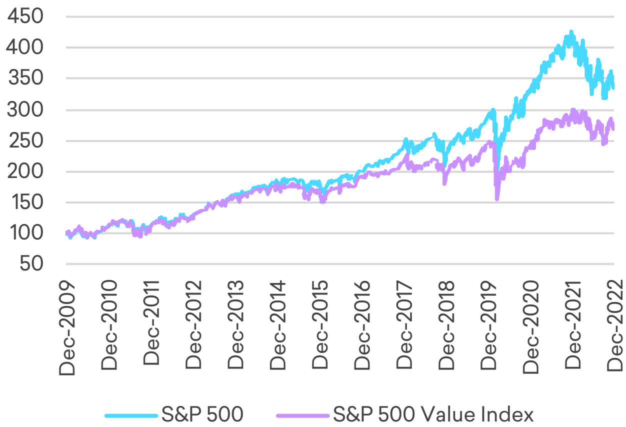
Value VS Growth – S&P Edition

Benjamin Graham, known as the "father of value investing," believed that investors could identify these undervalued stocks and achieve long-term performance by focusing on a company's underlying value and strong fundamentals. He looked for companies with a strong balance sheet, consistent earnings growth and a history of paying dividends, as these were all indicators of a company's underlying value – absolutely not about unprofitable most small-cap tech stocks.

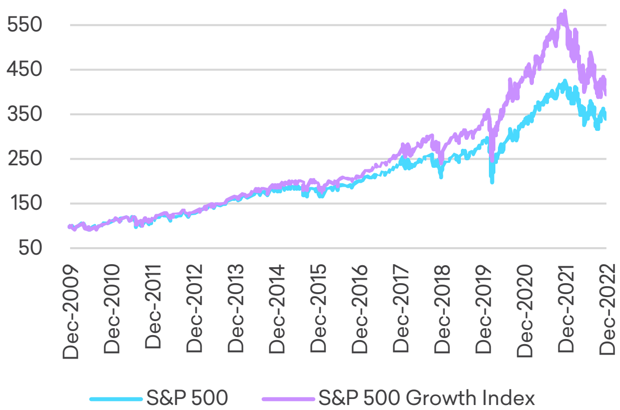
If we dive deeper, we can discover a few quite interesting points: aside well-known S&P 500 index, there are 4 thematic indices: S&P 500 Value, S&P 500 Growth, S&P 500 Pure Value and S&P 500 Pure Growth. If a stock is a member of the Value Index, it also can be a member of the Pure Value and Growth indices, but if the stock is a member of the Pure Value Index, it could not be in Growth Index or, of course, Pure Growth[2]. The same approach works for Growth and Pure Growth indices. To summarize possible membership:

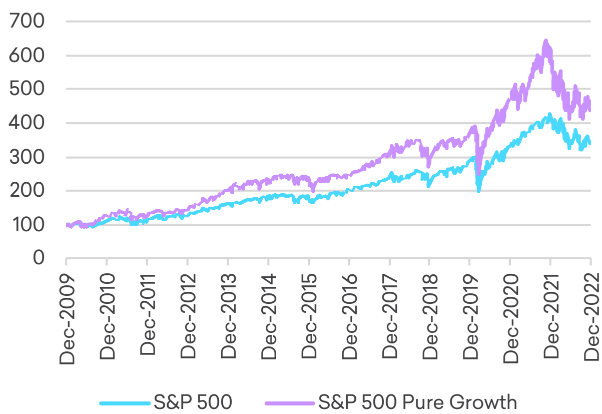






Source: Bloomberg Finance L.P.





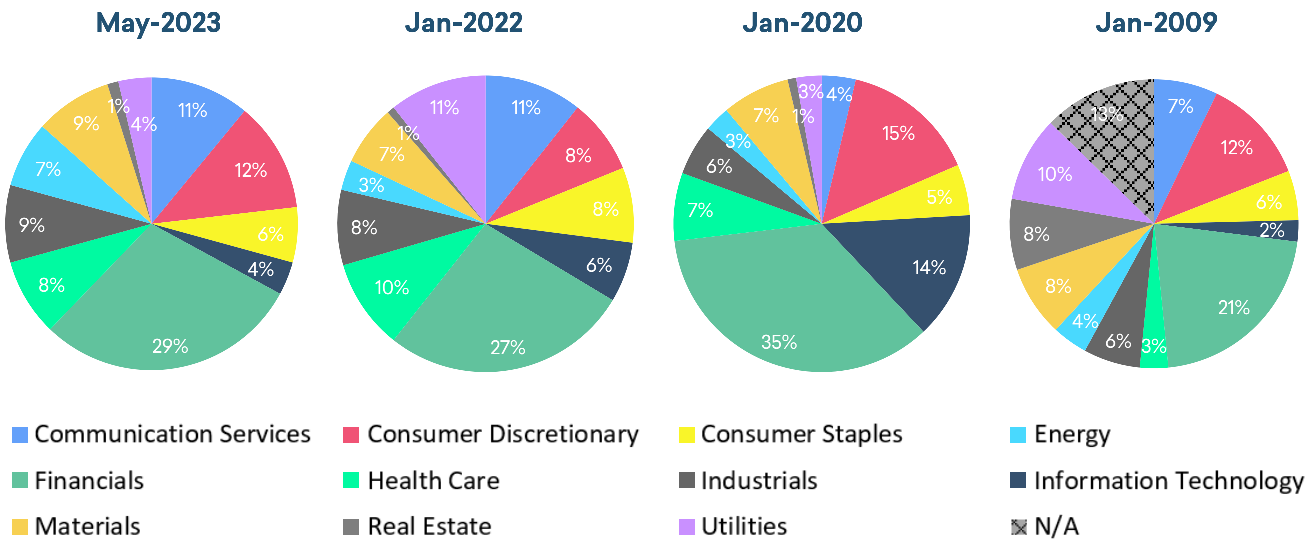
Source: Bloomberg Finance L.P.

[2] The S&P 500 Value (Growth) Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. The S&P 500® Pure Value (Growth) index is a style-concentrated index designed to track the performance of stocks that exhibit the strongest value (growth) characteristics by using a style-attractiveness-weighting scheme.

The Value Index has consistently underperformed the S&P 500 since the financial crisis, while the Growth Index and Pure Growth Index have shown strong performance. However, it's important to note that neither the Value nor Pure Value Index can guarantee protection during market downturns, including the March 2020 crash. Even though the Pure Value Index fared better than the Value Index during the selected period, it still experienced larger losses compared to the benchmark.

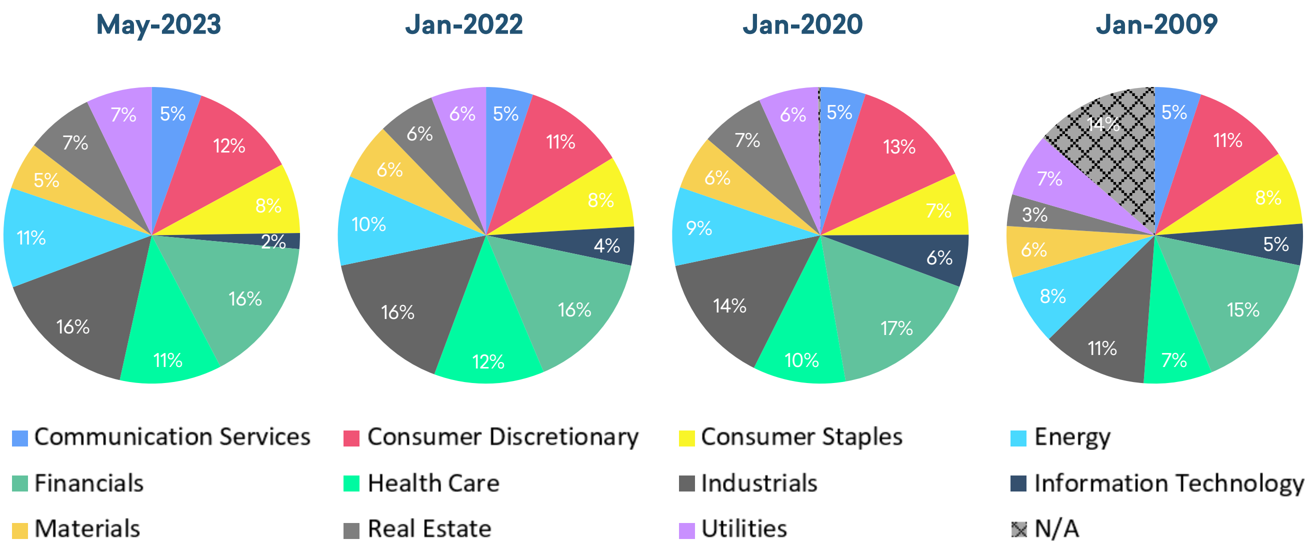
To understand why these trends are happening, it's important to take a closer look at the indices and see if the success of mega-cap tech companies is the main reason for the growth and whether these same tech companies continue to drive the growth in the US market. Below is a breakdown of each index by GISC Sectors:

Pure Value index



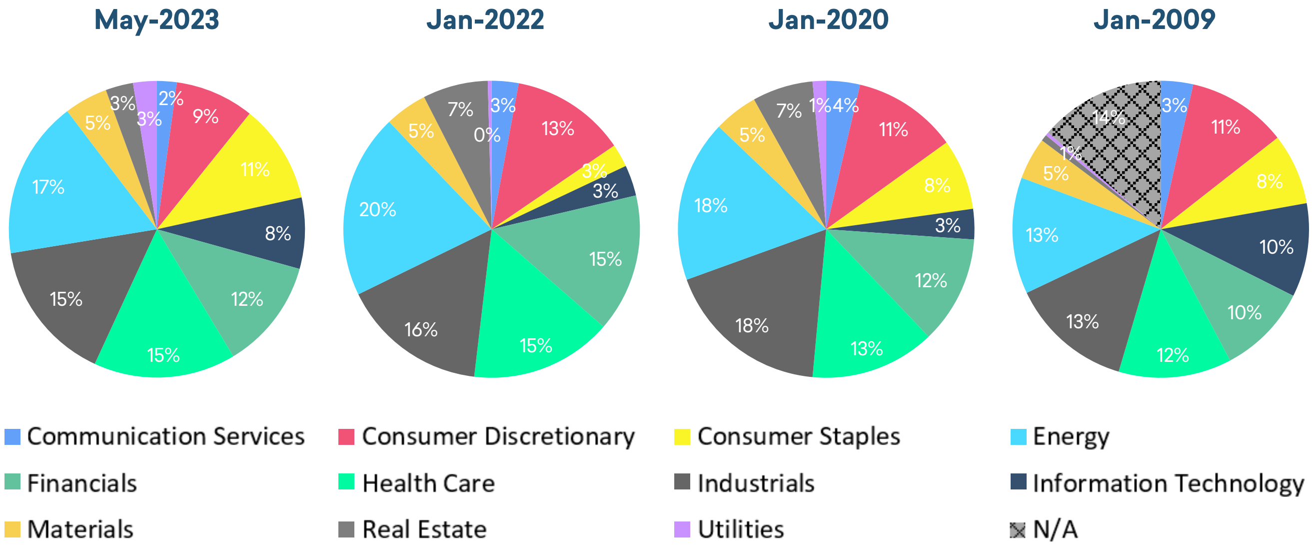
Source: Bloomberg Finance L.P.

Value index



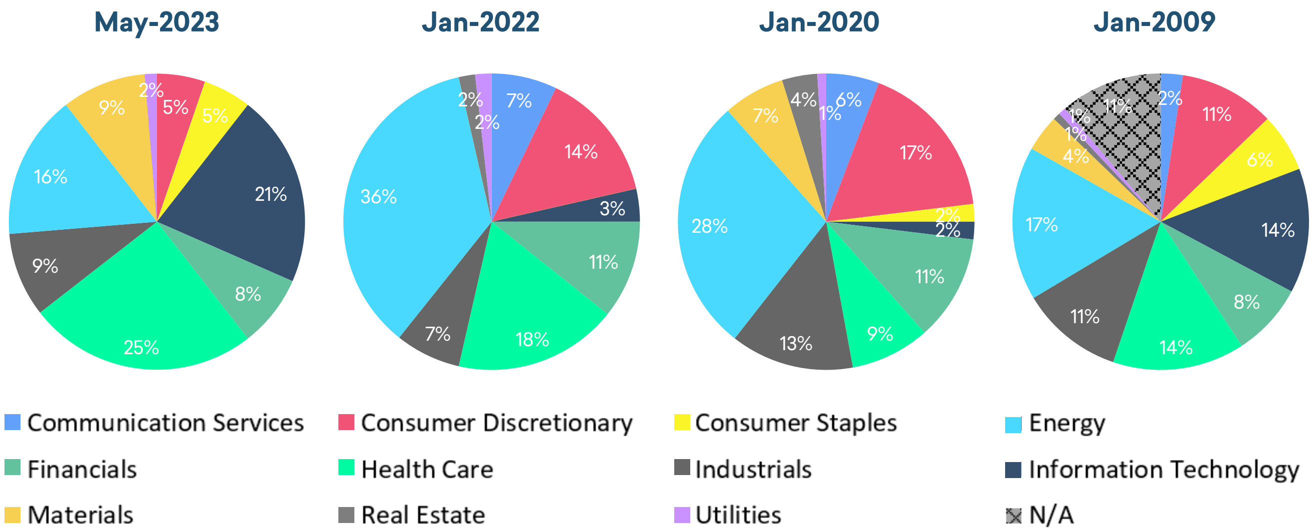
Source: Bloomberg Finance L.P.

Growth Index[3]



Source: Bloomberg Finance L.P.

Pure Growth Index



Source: Bloomberg Finance L.P.

There are several interesting points in the sectors distributions in the discussed indices:

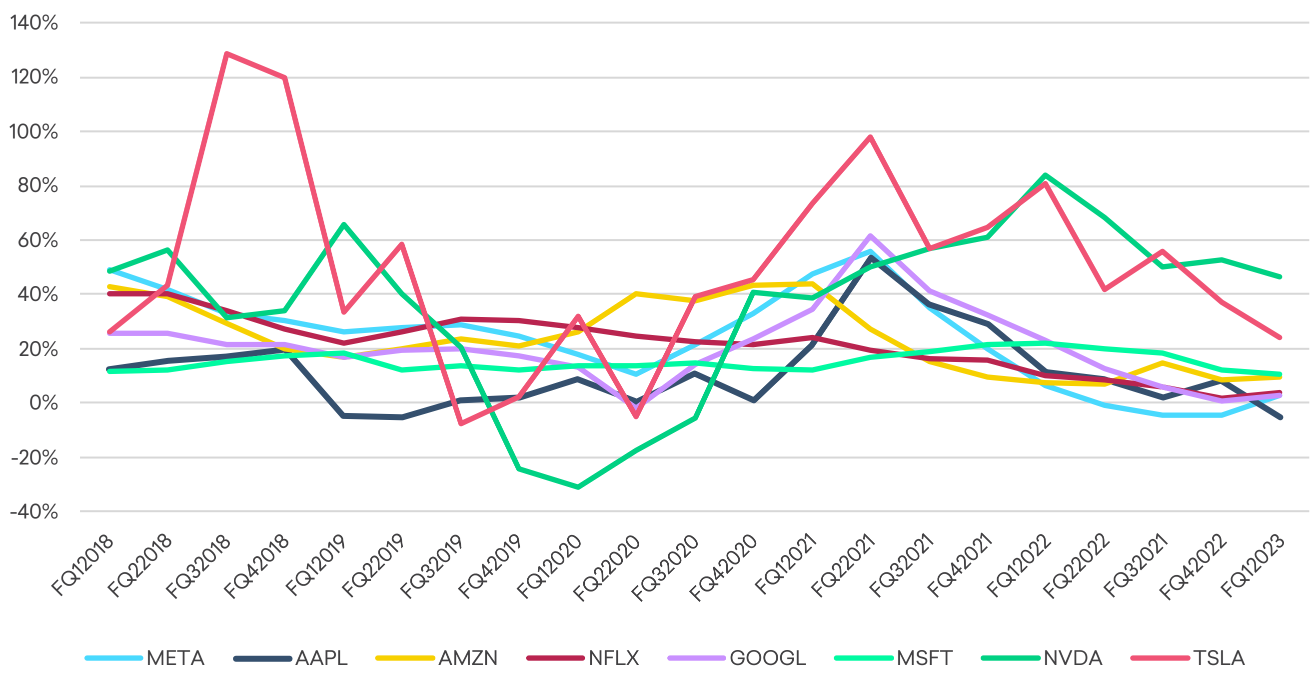
- Pure value is highly saturated with Financials, while Utilities share significantly decreased in comparison with the after-crisis 2022 and 2009 beginnings. On the other hand, Technology and Communication Services, viewed as the main source of growth stocks, share increased ~2 times since 2022.

[3]Under "N/A" label there are stocks, which are not trading now, or an issuer restructured/merged/sold-off/gone bankrupt etc and accordingly does not exist in the same way, as in 2009. Examples: Dell Inc, Merrill Lynch & Co Inc, McAfee Inc, NYSE Euronext etc. For overall picture,

- Value Index is historically the most diversified one, however, the Energy sector share is extremely low historically
- Growth Index became more diversified and Energy share became high, as in January 2009 (when WTI prices decreased more than 70% during the 1.5 year)
- And the most interesting: in the May of 2023, there is no single Communication Services company stock in the Pure Growth index – no Meta, no Alphabet. Technology share is also decreased more than 2 times since the last "zero policy interest rates" year of 2022 – from FAANG+MNT stock, there is only Apple remained in the Pure Growth index, while just 1.5 years ago all of them were viewed as "pure growth". And on the other hand, Chevron, Exxon Mobil, ConocoPhillips and Marathon Oil Corp shares are viewed as Growth stocks despite being traded on high single-digit or low double-digit forward P/Es. And if the presence of the mentioned oil-related stocks among "Pure Growth" stocks, with their low (relative to overall market) trading multiplies may be unexpected, the Healthcare sector is a different thing – if before 2020 amongst the growth stocks there were mostly "innovative" (most of which are really innovative) biotech like Vertex Pharmaceuticals, now you can see there gorillas of drug producing like Eli Lilly and Merck[4].

Just one look of magic FAANG+MNT revenue growth is enough to understand why 88% of them are out of the Pure Growth Index:

FAANG+MNT companies Quaterly Revenue growth (YoY %)



Bloomberg

Is it correct to consider large-cap tech stocks as a safe choice during uncertain times, even if S&P Dow Jones managers believe that Microsoft and Amazon are more like value stocks than pure growth stocks? It's likely, but there's one key factor that can explain almost all long-term changes in stock prices: expectations.

[4] It can be in some part explained by weight loss drugs like Ely Lilly's Tirzepatide, which really creates large new market opportunities for large pharma. But probably the expectations are too high – it is unclear yet, what is insurance companies' position regarding these drugs financing is.

Are markets now irrational?

In the previous section, we discussed growth and value stocks and how they have performed since the global financial crisis (GFC). The results show that value investing hasn't been successful for regular investors. Some may argue that this is not a representative sample and praise Warren Buffett's stock picks, but if we examine Berkshire Hathaway's stock portfolio, we can see that about half of it is invested in Apple, a stock that has been widely loved by the market in the past decade. It may not have been considered a value stock 4-5 years ago. Another example is Occidental Petroleum, which experienced a significant price movement when Buffett bought a large stake in the company. Buffett's trades have a similar impact on stock prices. This is not strange, good, or bad. Buffett is not just a random stock picker – he has the power to influence market expectations.

So, we come to the second question of “Investing like a Buffet” part: is it rational to participate in a bubble? And there is an explanation, why yes, even on a risk-adjusted basis.

Traditionally, risk in portfolio management is measured by volatility, which focuses on the potential for losing money. However, this approach only captures a limited aspect of risk and fails to account for the full range of potential outcomes. Not investing in an asset that eventually performs well is a missed opportunity and can lead to feelings of regret, which is a common emotional response to risk.

Many finance experts argue that to truly understand risk in portfolio management, we need to consider regret and the emotional impact of different outcomes. This means going beyond mathematical metrics like variance and considering how our emotions can influence investment decisions. By doing so, investors can make better choices that align with their actual risk tolerance and improve their results. For most investors, it can be rational to participate in market bubbles and take on higher risk, as long as they avoid being the last one caught when the bubble bursts (which is definitely not an easy task).

The ultimate truth that no one should ignore when aiming for success in the markets is not to overextend themselves and take on more risk than they can handle.

The most likely reason why value investing has performed poorly recently is due to market cycles. In the past decade, value investing hasn't been successful, but it worked exceptionally well in the 1970s and 1980s. It lost its appeal in the 1990s, had some success in the 2000s and then declined again. So, if you're considering buying a distressed "value" stock in the hopes of a recovery, it's important to remember what John Maynard Keynes said: "The markets can stay irrational longer than you can stay solvent." In other words, the market may not behave as expected and it's important to be cautious and aware of the risks involved.

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7 Marjanishvili Str., Tbilisi 0102, Georgia
Tel: +995 32 2 272727 | +995 32 2 272733
Email: Brokerage@tbccapital.ge
Email: TradingDesk@tbccapital.ge
www.tbccapital.ge
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