MARKETS

Fears About Tech-Stock Multiples Don't Add Up, Bulls Say

Buoyant performance of U.S. tech stocks is driving some fund managers to dismiss longstanding valuation concerns as short-sighted

Amazon trades at a lofty 85 times future earnings, and over the past three years its multiple has averaged around 115 times, according to FactSet. PHOTO: ABHISHEK CHINNAPPA/REUTERS

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The buoyant performance of U.S. tech stocks is driving some fund managers and others to dismiss longstanding valuation concerns as short-sighted.

While shares of companies including Amazon.com Inc., AMZN -0.23% ▼ Netflix NFLX -1.76% ▼ Inc. and Salesforce.com Inc. CRM -0.49% ▼ have surged this year to price/earnings ratios that are several times the market's longtime average, many fans of these investments contend that such metrics can overstate risks. They say they prefer a broader assessment of financial and strategic progress, arguing that this view can be more germane to those expecting to hold the shares for a longer period.

"I don't talk about multiples. That's where the conversation stops," Jonathan Curtis, a portfolio manager at Franklin Templeton's Franklin Equity Group, says of discussions with others about tech companies. "I tell them, 'Help me understand what this business looks like at maturity.'"

The question of how to value popular technology shares is coming into sharp focus because major indexes are on track to set a new intraday record for the longest U.S. bull market in stocks Wednesday. The nine-year advance recently has been led by furious, sustained rallies in Amazon, Apple Inc. and Google parent Alphabet Inc., among others.

Skeptics say high valuations and a lack of "breadth"—that is, outsize gains concentrated in a small number of popular stocks—leave the broader market vulnerable to a pullback. An analysis of data going back to 1964 shows that higher multiples have tended to be followed by weaker returns over 10-year stretches, according to Credit Suisse Group AG .

But some investors who say they see these investments as long-term holdings are digging in their heels. In their view, the scrutiny of valuations risks overlooking the future value of current investment spending at firms with substantial edges in key markets, such as Amazon’s expansion of its cloud-computing business and other firms’ acquisition of valuable subscribers in fields they lead.

Believers in this approach may have some market math on their side: The valuation of the average stock in the S&P 500 is now in the 97th percentile of historical levels, according to Goldman Sachs Group Inc., which analyzed 40 years of data. While that is down from the 99th percentile at one point last year, it shows that the concerns about valuation could be applied to a vast swath of the market, not just tech. Even consumer-staples firms, seen as defensive plays expected to do well in an economic slowdown, appear overpriced to many investors.

Of course, few question that higher multiples raise the risk of a near-term share-price decline in response to any given negative development, be it an earnings shortfall or a shock in a far-off market that hits sentiment. Investors in tech favorites Netflix and Facebook were reminded of this last month in the wake of sharp stock declines that followed profit-report disappointments.

“Valuations matter a lot more as you extend the time horizon,” said John Prichard, president of Knightsbridge Asset Management, who expects rising interest rates to lead to a shakeout at some point that “will depress high-P/E stocks.”

But the rise of interest rates this year has been slow and tech remains popular, with fund managers most heavily tilted toward tech of all 11 major S&P 500 industry sectors. The average portfolio manager holds about 1.2% of its fund in tech and internet stocks, according to a Bank of America Merrill Lynch report last month.

In part, that is because many of the largest tech firms have carried outsize multiples throughout a run to record highs, and have shown impressive earnings gains during recent years that have brought down their price/earnings ratios even as shares notch large gains.

Take Amazon, up more than 60% this year and trading at a lofty 85 times future earnings: Improving earnings in recent quarters have driven the firm’s price/earnings ratio down from its average level over the past three years of around 115 times, according to FactSet. In comparison, the S&P 500 trades at about 16 times earnings expected over the next 12 months.

Less than five years ago, Facebook was trading at more than 50 times forward earnings as it outspent rivals to dominate social media’s advertising landscape. Increased profits have brought its valuation down to 23 times today, even after the record market-value decline last month.

Salesforce is up more than 40% this year, yet fans contend the market is undervaluing its capacity to win long-term customers and penalizing the software firm for up-front marketing and sales costs.

“It’s very easy to analyze this year’s costs and say, Look at all this spend, it’s unprofitable,” said Matt Sabel, a portfolio manager for MFS Investments.

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