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The price of everything, but the value of nothing

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The US equity market has consistently traded at a premium to all other developed equity markets over the past 20 years. This is a difficult circle to square for many investors as history shows that higher valuations generally lead to lower future returns. We focus very much on the valuations of assets today but must also consider how this valuation could be impacted in the future. Not all expensive things get cheaper.

There is no right or wrong when considering the valuation of a company today with its potential returns in the future. The factors that influence whether a company trading on a price-earnings (P/E) ratio of 22 today performs better than a company trading on 13 can be specific to the company, its industry, its management, but is most likely to be driven by investors' whims especially over the short term, in our view.

The best investments over the longer term are companies that focus on managing their businesses and do not focus too heavily on quarterly profit targets and pleasing analysts. Heineken, the beer business, has always traded at a premium valuation to the market other than in periods of significant market stress. Its underlying earnings however have consistently outstripped competitors and therefore its share price remains at a premium having increased in value by 54 times since 1989. The MSCI World Index has risen a respectable 12 times during this period (source: Finsbury Growth & Income AGM Presentation 2023).

Growth in earnings and cashflows is ultimately what dictates whether an equity investment maintains its premium rating over the longer term. In the current inflationary period companies that can grow their cashflows in line with or above inflation will be better positioned moving forward due to the fact that they will have maintained their purchasing power. Cadbury is a solid example of such a company: during the period 1920-2022 the price of Diary Milk increased 167 times whilst the UK Retail Prices Index (inflation) rose 39 times.

Investing is about research and retesting your thesis continually. Understanding the dynamics at play in the global economy allows Tacit to focus our research efforts on specific longer term ideas that we believe will add significant value to client portfolios under our stewardship. The current valuation of these ideas is important to us, but we are not slavish to any one metric as market environments change.