The stockmarket crash and the detail investors have missed

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Some investors have pointed out that the one thing that them makes fearful of a second corona crash in stockmarkets is that Warren Buffett has been unusually quiet. In fact, his most high-profile decision during the crisis so far has been to admit he was wrong about airlines and sell their stock. Contrast that with the financial crisis when the Sage of Omaha made some high-profile purchases when the going was tough.

So was the 33 per cent crash in the S&P 500 in March just a taste of things to come? With so much covid-19 uncertainty remaining, it is no wonder many investors are fearful.

There is some precedent for how equity markets behave during a pandemic. During the first and second waves of the 1918 Spanish 'flu, US equity markets rose steadily, but dropped about 20 per cent during the third and fourth waves in 1919 and 2020. The 1957 'flu pandemic saw US equities lose almost 20 per cent during a steady four-month decline over the summer and spring before a steady recovery that took about a year to regain losses. Meanwhile, the 'flu pandemic in the late-1960s was associated with a stockmarket that essentially moved sideways.

So history may not be a good guide. Indeed, in the prior three pandemics, none of the market moves were wholly determined by the disease. And there was no crash as we saw in global markets in March of this year. Some reasons for this include the fact that the world has grown more interconnected, the lockdowns of 2020 were far more strict, while the internet has enabled commerce and work that was previously impossible.

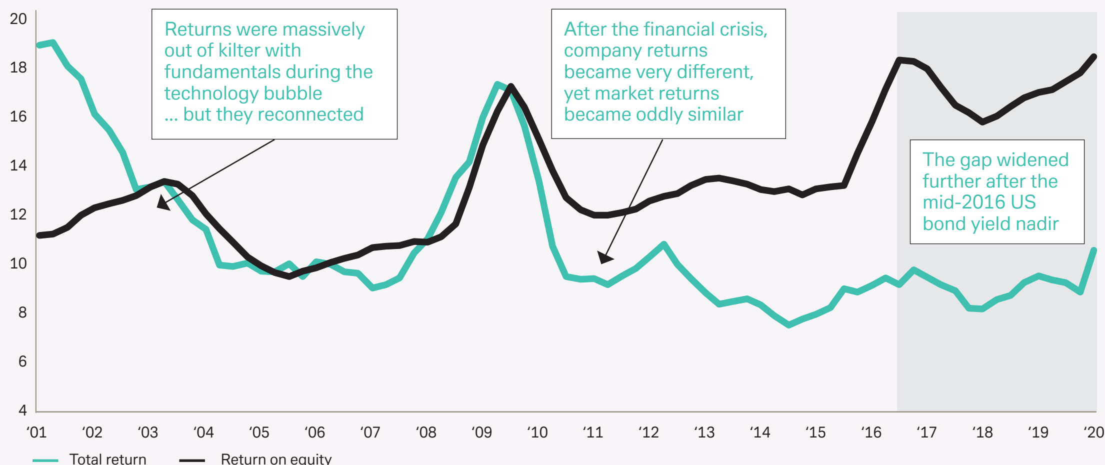
There are certainly some good reasons to believe sharemarkets will retest their lows. For starters, with a vaccine at least a year away, a second wave of the virus would necessitate more lockdowns, while concerns about oil storage and faltering demand could send crude prices crashing again. Furthermore, political relations between China and the US remain uncertain, and that is before considering that forecasts for second-quarter data – both economic and corporate – seem to be in a constant state of deterioration.

Frustratingly, there seem to be just as many reasons to be optimistic. After all, central banks have said they will do whatever it takes to support economies, the rebalancing at large passive funds has supported equities, and higher-income retail investors have been less likely to lose their job and thus have tried to take advantage of the market drop. Many also consider the bond market too expensive and thus have few other places to store their money but in equities.

A further oddity about the current recession compared with prior ones is that we can put a timeline on it. Assuming no new lockdowns are required, economies should start growing again later this year. Contrast that with the financial crisis where many commentators worried the event would bring about "the end of capitalism". The relatively specific timing of the corona recession means that stock valuations done using discounted cashflow models are not dramatically affected, as long as one assumes a return to normal growth over the next two years or so.

While it is hard to predict whether stockmarkets will experience a second corona-crash or simply rise steadily in anticipation of a recovery, there is one phenomenon that could be a double-edged sword. It concerns the strange way in which investors have been paying the same price for

Dispersion of total returns and return on equity – S&P 500



Source: Deutsche Bank, Factset

different companies. The first chart illustrates the point. It shows that, since the financial crisis, the prices that investors pay for stocks has been relatively similar (low dispersion between them) while the differences between companies' return on equity has been very high. Essentially, investors are paying the same price for different stocks.

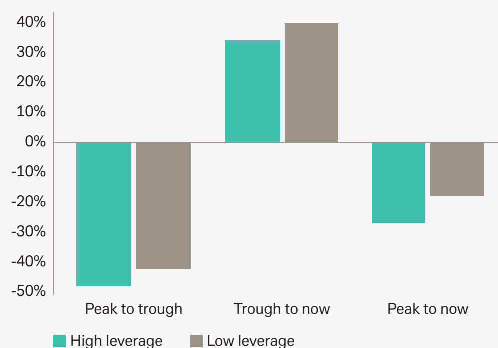
Stranger still is that the dispersion of prices has not jumped during the corona crisis. True, the above chart shows a jump in the last quarter, but it is still very low compared with the jump seen in the aftermath of the technology bubble and the financial crisis. Of course, the market drop associated with the technology bubble and the financial crisis were worse than the corona crisis. In both instances the share market dropped by about 50 per cent compared with 33 per cent this year. However, in both prior instances, price dispersion was very high before those markets dropped to their lowest levels.

It is true that a small number of stocks with high returns on equity skew the data somewhat. Indeed, if we omit the top 20 per cent of stocks, the spread between returns on equity drops by about a third. Yet, the spread between prices remains at similar levels and keeps an almost identical shape.

That means that even when the best-performing companies are excluded, investors have continued to pay the same prices for stocks during the corona crisis.

This lack of dispersion helps explain why stock prices of companies with different debt levels have behaved in similar ways. Indeed, one of the few investment themes that was almost universally accepted at the beginning of the corona-crisis was that companies with strong balance sheets would outperform those with weak balance sheets. To test this, we examined the median performance of stocks with high and low leverage according to the DuPont formula – so assets as a proportion of equity. High leverage were companies with a ratio over 4.0, and low leverage was companies with a ratio under 2.0. As the following chart shows, companies with strong balance sheets have outperformed their weaker peers, but the difference has not been dramatic.

Median share price performance of S&P 500 stocks during corona crisis



Source: Deutsche Bank, Factset

As the rest of the year unfolds, investors must be careful how the corona crisis leads to a potential unwinding of the low-dispersion phenomenon. The first reason is that it is has been supported by unsustainable dividend and share buyback promises. Indeed, just before the current crisis, the median dividend payout ratio for S&P 500 companies had risen to just over 40 per cent, a multi-decade high. Meanwhile, the median dividend yield was two per cent, in-line with its post-financial crisis average. At the same time, the dispersion of each of these metrics shows a wide gap. In other words, there is a much bigger difference between the dividend payout ratios of companies than between their dividend yields.

The issue is that corona crisis is leading an increasing number of companies to cut their dividends (and share buybacks). These had already risen to unsustainable levels and some chief executives may welcome the excuse to cut them and will be reluctant to immediately return dividends and buybacks to their old levels when the crisis subsides.

The second reason that could lead to investors being more discriminating between different stocks concerns second-quarter results. These seem certain to show that different companies are recovering (or not) in different ways. And given that the extent of those differences will likely be more dramatic than in previous quarters, it will shine a spotlight onto a phenomenon that investors have been ignoring for some time.

So active managers rejoice. Despite the forecasts of the death of their industry as funds have poured into passive vehicles, the corona crisis has showed that prices are set at the margin. Dramatic swings and recalibrations of value are not only possible, but they can occur in short order. So it may not matter whether the overall level of the equity market rises or falls from here. Rather, a focus on intrinsic value could well be the new theme for 2020. Those investors ambivalent to stock selection are the ones who should watch out.