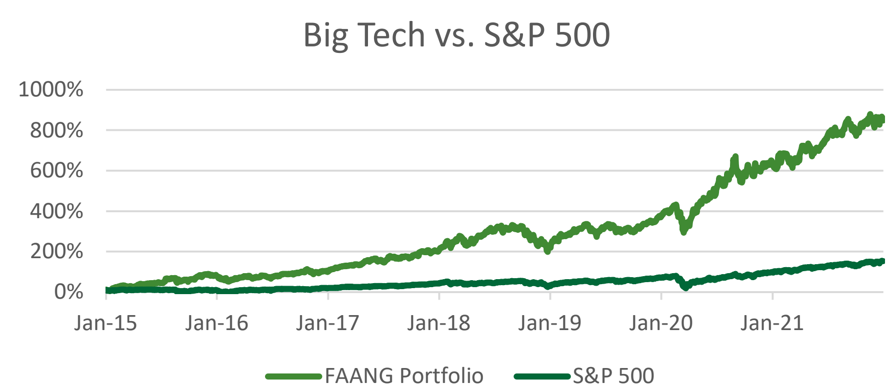
# Stock Picking: Art or Science

Last quarter saw markets continue their upward trajectory from the end of last year. Earnings remain strong, while there is increased hope that the Fed will soon begin the process of lowering interest rates, at least slightly. Global stock markets have nearly completed their recovery from the 2022 inflation-driven market downturn, and the major economic and financial models we monitor paint an optimistic picture for the future.

The last economic cycle (2009 – 2021) was largely driven by Federal Reserve policies of low rates and easy money. Combined with a more tech-savvy generation entering adulthood and a cultural desire for disruption and innovation, "Big Tech" stocks came to dominate global financial markets. While this is like other past market cycles that saw the rise of "Big Oil" and "Big Auto", the rate of growth and the resulting stock valuations experienced by a handful of last cycle's "Big Tech" companies was truly unprecedented. (FAANG Portfolio: Meta, Amazon, Apple, Netflix, & Alphabet).




*Source: portfolioslab.com*

As staggering as these companies' stock performances were in the 2nd half of the last market cycle, they were backed by the companies' underlying fundamentals. In the same period, the combined earnings (per share) of these 5 big tech companies grew 816% - closely mirroring the growth of their stock prices.

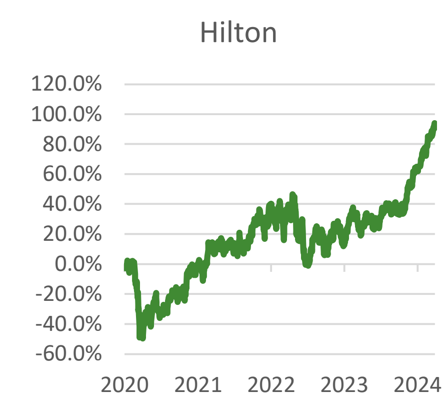
While these stocks became famous for successfully justifying their lofty valuations, they also raised the bar for investor expectations of technology growth stocks in general. This resulted in a 2-tiered methodology to pricing stocks – sky-high valuations for "growth" companies hoping to replicate the success of Big Tech, vs. mundane valuations for less exciting "value" companies.

It is worth noting that not all "growth" stocks worked out equally well. For each success story (ex. Facebook, Google, or Apple) there is often a competitor that severely disappointed its investors (ex. MySpace, Yahoo, or Blackberry). As diversified investors, our primary concern is not about identifying which individual stocks will win or lose. Instead, our interest is at a more macro-level, and what these increasingly disparate valuations between "growth" and "value" stocks might mean for future performance.

Fortunately, we have come across a wonderful case study from recent history to help illuminate this valuation difference, and to demonstrate the risk it can pose for investors. Let us examine two companies from prior to the global pandemic until now.

- **Zoom Video Conferencing** was an exciting "growth" stock that saw revenue skyrocket during the pandemic.
- **Hilton Hotels** was a long-time "value" company whose revenue and earnings were devastated by the collapse in global travel.

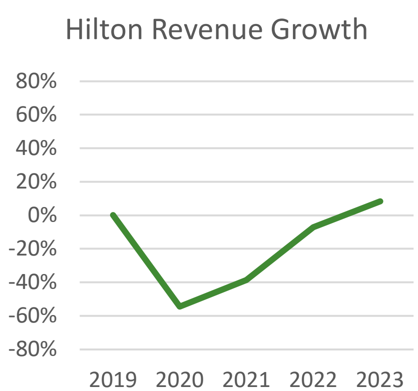
Here is how their stocks have performed since 2020:

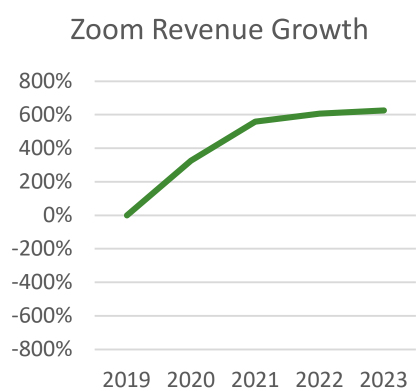




*Source: Yahoo Finance*

The charts read like the story of the tortoise and the hare – in the initial months of the pandemic the growth stock shot way up while the value stock fell behind. This was to be expected, considering the pandemic's impact on both businesses. In the longer term, however, we see their positions reverse, and an initial investment in Hilton would have gained 93% today compared to a loss of 5% for Zoom. This is clearly contrary to surface-level expectations, so let's examine the various possible explanations.

**Sales and Revenue.** The first possibility is that our expectations of the pandemic's impact on the two companies are simply incorrect. Perhaps Zoom's sales did not grow as much as we assumed, or Hilton's sales were not hurt as much as we expected.

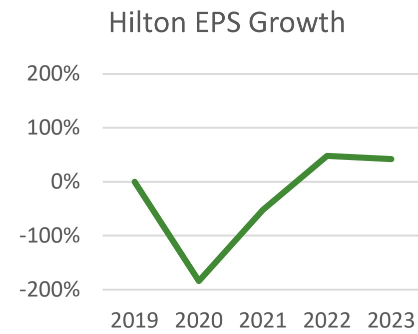


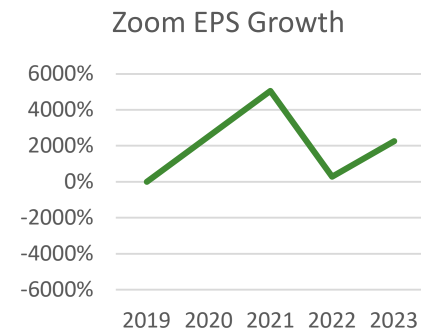




*Source: Macrotrends*

However, reality matched what we expected. Zoom's revenue skyrocketed in the initial years of the pandemic and has continued to grow. Hilton saw revenues plumet more than 50% and took 4 years to fully recover. Sales and revenue do not explain the discrepancy in their stock returns.

**Earnings and Profit Margins.** Revenue and sales only tell half the story; earnings are what investors truly care about. The other plausible explanation is that despite the total revenue growth, Zoom's earnings declined or Hilton's soared.




*Source: Macrotrends*

Once again, the reality matches our expectations, but defies the stock performances. Hilton's earnings turned severely negative and then took 3 years to recover. Zoom's earnings were volatile but still grew by 2,256% over 4 years; an exceptional growth rate.

**Valuations.** The final possible explanation is also the most likely one: the poor performance of Zoom's stock was not due to poor performance by the company, *but simply that the stock price was far too high to begin with.* Stock prices are not always rational; based on Zoom's own quarterly reports, its revenue and earnings both grew well beyond the company's stated projections. While Hilton's stock performance largely mirrored the company's actual revenue and earnings, Zoom's stock price shows very little correlation. While sentiment temporarily boosted Zoom's stock even higher, the beginning valuation eventually asserted its dominance in determining more rational pricing.

In the short term, stock prices are often irrational – meaning disconnected from the company's actual performance. This irrationality tends to be greater for growth stocks due to the difficulty in projecting future growth potential, and general investor excitement. Over time markets are highly rational, and those fundamental and valuation metrics eventually win out, as this case study illustrates.

At North Woods we are neither for nor against either "growth" or "value" stocks – our job is to do the math to determine the optimal allocation to both growth & value stocks.

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