TCM INSIGHTS

S&P 500: TANGIBLE VS. INTANGIBLE ASSETS

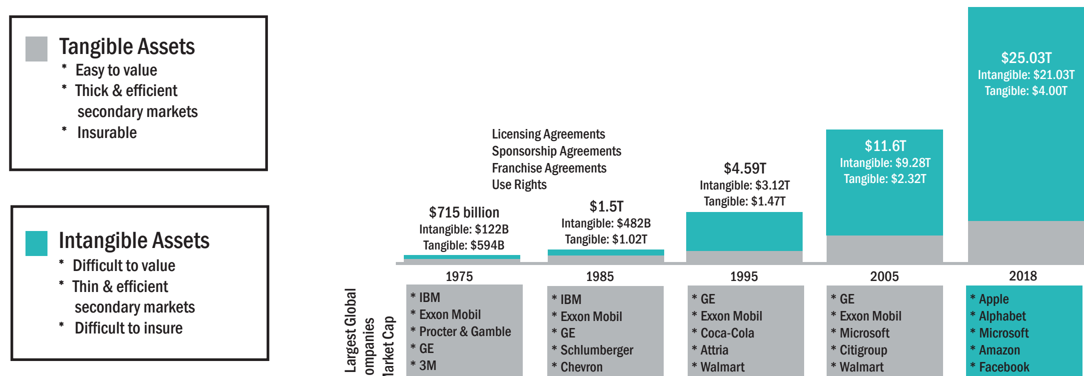
The S&P 500 is a stock market index that measures the stock performance of 500 of the largest companies listed on stock exchanges in the United States and is one of the most followed equity indices. Increasingly, and perhaps not surprisingly, technology companies have come to dominate the index, skewing the performance of the S&P 500 toward the performance of the technology sector. In fact, the FAMANG stocks (Facebook, Apple, Microsoft, Amazon, Netflix, Google) account for roughly 25% of the entire market capitalization S&P 500. Since they are rapidly growing companies, they seem expensive when using traditional stock valuation metrics, such as comparing the stock price per share to earnings per share (P/E), or the stock price versus the book value (assets minus liabilities) – the Price to Book (P/B) ratio.

However, Bank of America recently published research that suggests that traditional valuation metrics need to be updated as they ignore the resources that are most important today. As an example, enterprise software companies (e.g. Microsoft) generate cash flows in ways that are not easily recognized by conventional valuation metrics. Equally, research and development efforts have traditionally been recognized as an expense and investments in the skills of employees have typically only been recognized as administrative expenses.

Bank of America suggests that intangible items, such as proprietary algorithms, are worth more to companies like Google, than the physical buildings and network servers that the algorithms run on. In other words, whereas traditional book value makes sense in an economy composed of factories, farms, and shopping malls, it is increasingly irrelevant in an economy driven by intangibles like patents, licensing agreements, proprietary data, brand value, algorithms and network effects.

The chart below, courtesy of Aon, illustrates this point. In 1975, the five largest companies were predominantly industrial companies - IBM, Exxon, Procter and Gamble, GE and 3M, with combined intangible assets of $122bn vs tangible assets of $594bn. Fast forward to 2018 and the five largest companies are Apple, Alphabet (Google), Microsoft, Amazon and Facebook with intangibles of $21tn eclipsing tangible assets of $4tn.

Tangible Assets vs. Intangible Assets for S&P 500 Companies, 1975-2018



** Five Largest Global Companies by Market Cap as of December 31, 2018*

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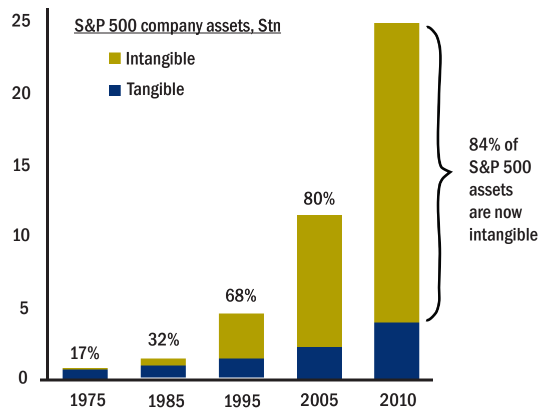
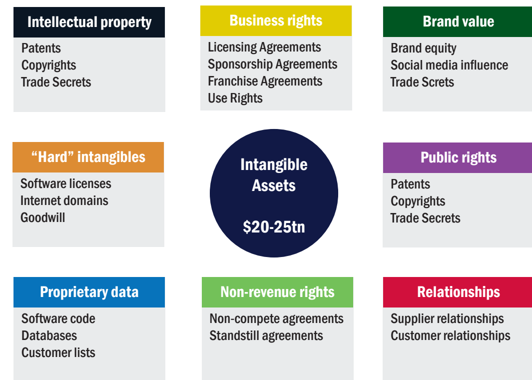
What does this mean for investors? The short answer is that when evaluating a mutual fund or exchange traded fund (ETF) whose strategy is based on a value-based philosophy, investors will do well to examine whether the fund company sticks to a ‘tried and true’ stock valuation method, or whether they have evolved with the reality that the world has increasingly shifted from a brick-and-mortar economy to an economy that values the categories of intangible assets such as those listed in the graphic below.





Failure to move with the times and recognize shifting trends can have the potential to materially impair investment performance for client stock portfolios.

Trent
Capital Management

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