What is happening with valuations?

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Historically speaking (pre-2015), stocks were selling for 16-18X net profits. Today, they sell for 30X net profits (https://www.multpl.com/). Walmart is currently selling for 42X net profits. Costco is selling for 54X net profits. This is not caused by temporary depressed earnings. O the contrary, these companies are hitting peak profitability margins. They are not growing that fast either.

Historically speaking (pre-2015), residential homes were selling for 12-18X rent. Today, they sell for 20-25X rent.

So, what is happening with valuations?

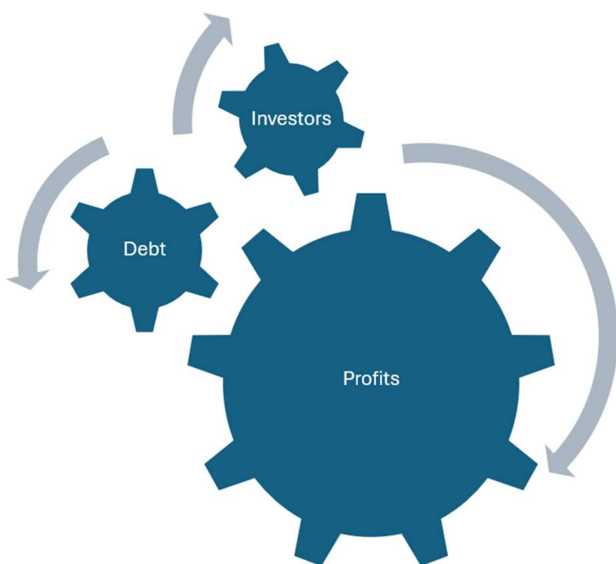
In this article, I propose a theory as to what is going on.

Valuations of the past

Companies have 3 ways of creating cash flow:

1. Profits (how they allocate those profits is key)
2. Debt
3. Investors (ownership capital / stock)

In the past, profits were the safest, most independent and largest source of cash flow and valuation. The stock price was mostly influenced by profits because debt and capital were harder to obtain. Lenders and investors were more demanding in terms of interest and dividends. To generate the money to pay higher interest and higher dividends, this meant that, again, higher profits were required. Profits were the key to the market value of the company. Repurchases of stock also had to be done mainly with the company's profits, reinforcing the impact of profits on valuations.



In the past, profit (including current profits, potential profits (for real estate) or expected profits (for fast growing companies) was the most important and determining factor for valuations.

Valuations in 2024

Companies still have 3 ways of creating cash flow: profits (how they allocate those profits is still important), debt and investors (ownership capital).

The difference: capital is now abundant, much easier to get and in most cases (through indexing), much less influenced by fundamentals.

M2, a measure of the money supply in the economy, is currently 43% higher than its historical average, in relation to nominal GDP. That huge amount of capital mostly came from 15 years of central bank money-printing that ended up in stocks, bonds and real estate.

Another massive source of capital that changes the game structurally: the trend towards S&P 500 and other indices "passive" investing.

Making profits is no longer the most important factor for your stock to go up. Your ability to get into the large indices (or creating the expectation that you might get there), to be in a sector that attracts tons of capital or to get easy debt (e. g. with real estate) is key.

To be part of the S&P 500, you need 5 consecutive quarters of profit, and you need a "market cap / float" of at least $18B. There is a very important nuance here: how much profit you make is not a criterion.

At least 1 study has calculated the amount of "passive" inflow into the market to now represent 90% of all activity. In other words, if you can get a high valuation and make some profit for 5 consecutive quarters, you will get tons more of cheap, no-questions-asked, capital.

Many of the companies in today's indices would not generate enough profits or real expectations of future profits to deserve that much capital, in the past.

Fundamentals are not as important. Momentum is more important. This may change eventually if "no-questions-asked" capital becomes less abundant.

So, what is the solution?

First of all, this is a theory, and it is worth what it's worth.

I would propose investing in companies that score high on all three cash flow sources:

1. They make tons of real profit, and they allocate those profits very well.
2. They have access to no-questions-asked equity-capital (by being on the S&P 500 for example, as this trend may likely continue) and debt.

Then, if you are able to:

- Buy at a reasonable valuation.
- If you are uncomfortable with the "easy-capital" group valuations or can't find enough opportunities in that group, you can go towards under-the-radar amazing companies where there are more opportunities. In this case, you may want to get control or more influence over their profits. This is not to tell management what to do with the business. It is to make sure the valuation that the stock deserves occurs eventually, for example with stock repurchases.

At the end of the day, in my view, making profit from your business activities is the surest, most independent and safest way to grow your capital. You then don't depend on speculative, irrational trends or massive central-bank money-printing to make money. The tricky thing: you have to do it the right way and be extremely well prepared and disciplined.

To participate in the S&P 500 mega trend, we wanted to do it our way: through the best companies of the index, characterized by handsome profits and sustainable competitive advantages. This is why we created the Diamond Fund. Check it out at www.mcleancapital.ca/diamant