# Dissecting the Great Growth Stock Drawdown

## Under the Hood of a Dot-Com-Like Decline

*Bear markets are often surprising at many turns, seemingly over before returning for another gasp; and, by the end, they'll separate the investors from the speculators.*

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DURING THE DOT-COM CRASH FROM 2000-2002, the Nasdaq declined nearly 80%. More than a trillion dollars in market value was wiped away. Bankruptcies shot up. Tens of thousands of technology employees lost their jobs. Companies that IPO'd around the turn of the millennium came public with great fanfare, only to mightily struggle in the downturn.

Here twenty years later, after a massive multiyear run-up, the Nasdaq has plunged. Several trillion dollars in market value has been wiped away. Layoffs are accelerating. And companies that came public via a Special Purpose Acquisition Company (SPAC) are struggling mightily.

Are we, as some commentators have suggested, in the midst of a Dot-Com Crash 2.0?

We set out to explore that question by dissecting the returns of Nasdaq components over the past year, to look under the hood of what has been a sizable—and painful—drawdown.

Yes, exuberance had run wild in the era of cheap money, where risk assets were strong because, as the saying goes, "There Is No Alternative." There is a lot that is similar between now and then, including some of the same exuberance for profitless companies. But looking at the data also shows why rules of thumb in investing can be hard to live by.

## The 2022 Nasdaq Decline by Sector

The Nasdaq index declined 13% from June 1, 2021 to May 31, 2022. But because the Nasdaq index is market-cap-weighted, a very different story played out under the hood.

There are 11 sectors in the widely used Global Industry Classification Standard (GICS) taxonomy.

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Information Technology (IT) was hit hard (the average stock was down 23%), but Health Care was by far the worst performer (down 49%). Communication Services and Consumer Discretionary were both off more than 35%[1].

Real Estate and Industrials weren't immune—with their mean return -17% and -21%, respectively.

Digging in to the 24 GICS industry groups, one step lower in the taxonomy, we see that the #1 and #2 performing categories were Energy (again, no surprise) and Banks (also no surprise, given the rising interest rate environment).

The worst industry group: Pharmaceuticals, Biotechnology, & Life Sciences, with the average stock down 52%. Close behind were Retailing (down 48%), which was hit by supply chain disruptions and rising inflation, and Automobiles & Components (down 43%)—remember, we're looking at Nasdaq components, so this industry group includes many of the speculative EV car companies (not **Ford**, **General Motors**, or other gas-centric brands).

To illustrate just how unloved health care is right now: Along with Pharmaceuticals, Biotechnology, & Life Sciences down an average of 52%, the Health Care Equipment & Services industry group, representing the other side of health care (devices, medtech, and so forth), was down a staggering 40%.

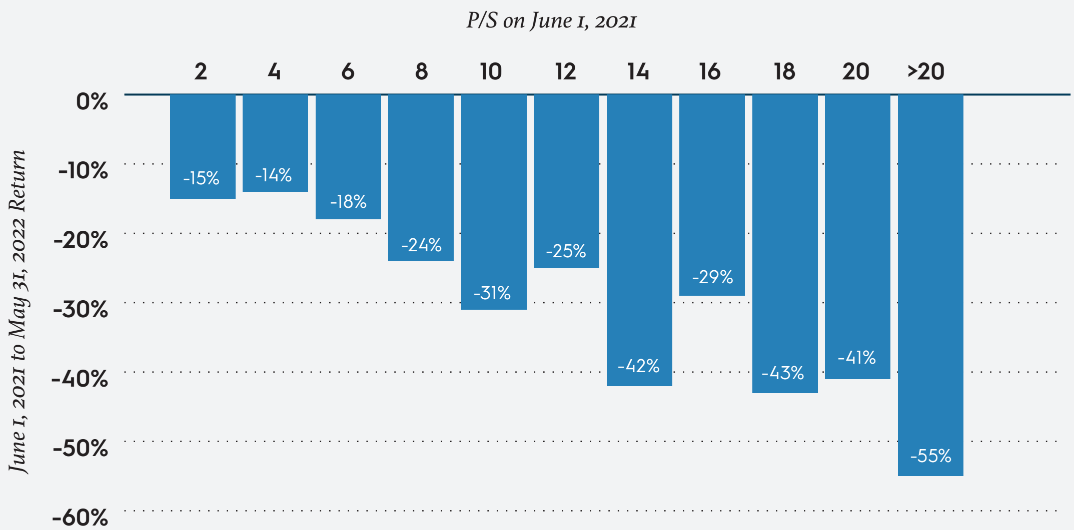
## Price Is What You Pay, Value Is What You Get

The sector and industry story explains where the pain has been felt. But this Nasdaq drawdown has largely been a valuation story.

Consider this important data point: Stocks with a price-to-sales (P/S) ratio of more than 20 on June 1, 2021 fell on average 55% over the next 12 months. Comparatively, stocks with a P/S of less than 2 have declined on average less than 15% over that same time frame.

1 Note: Average returns in this white paper refer to mean returns. Given the large sample size, the mean returns were not overly skewed by outliers and largely mirrored median returns for a given grouping and therefore didn't change the conclusions. In fact, in multiple instances—including Information Technology, Healthcare, and Consumer Discretionary—the median return was in fact lower than the mean return.

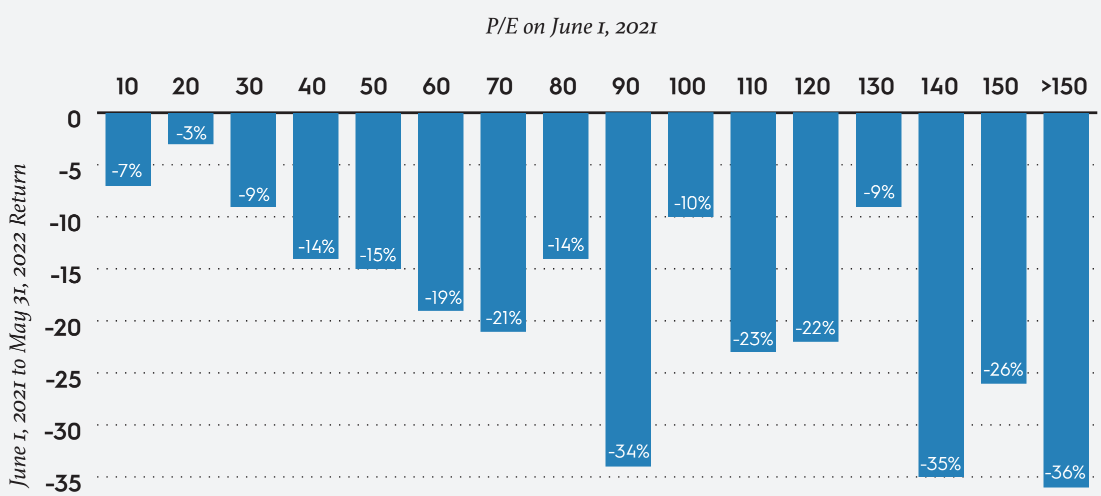
## Trailing 12 month average return based on starting P/S




*Data from Bloomberg. Results exclude entries marked "not applicable"; see disclosures at the end for more information.*

The trend line holds for price-to-earnings (P/E) as well. Stocks with a P/E below 10 as of June 1, 2021 declined 7% over the following year. Stocks with a P/E of 150+ declined 36%.

## Trailing 12 month average return based on starting P/E

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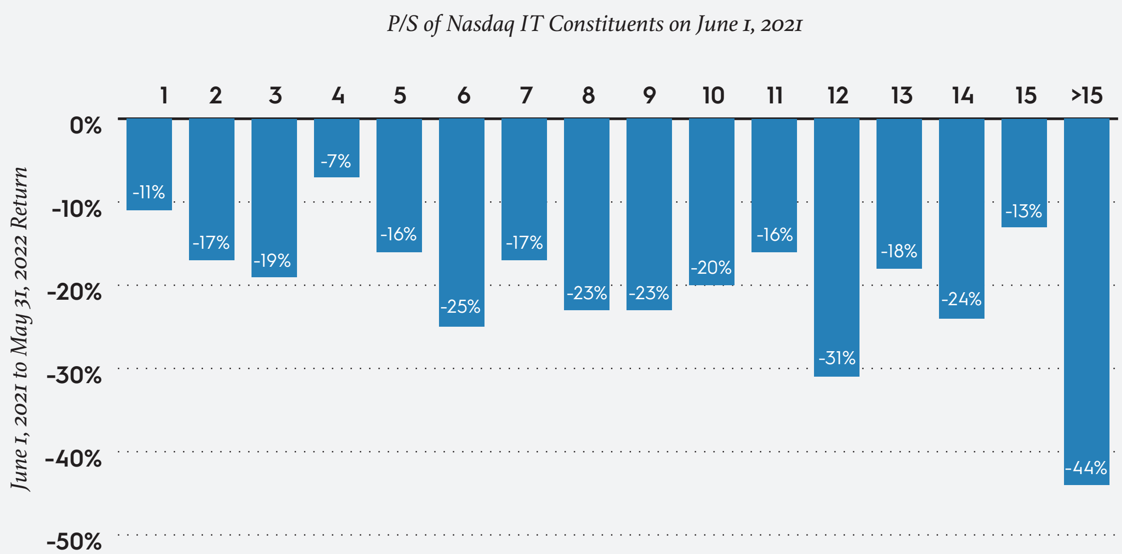
Perhaps the key distinction of this drawdown, and what would have been a predictor, is a simple test: Did a company have any earnings at all?

- Nasdaq component companies with earnings, average return: -11%
- Nasdaq component companies without earnings, average return: -39%

**The growth stock drawdown has primarily been a valuation story the past year. Consider: Nasdaq constituents that had earnings were down 11% over the past year. Those without earnings were down 39%.**

Again, this has primarily been a valuation story. Both quality and a lack of quality just seemed to have run up too far. For example, look at the P/S breakdown for the Information Technology sector. The worst-performing names were those with the highest valuation. The stocks that held up the best had the lowest P/S at the start of our time frame:

## Trailing 12 month average return based on starting P/S, Nasdaq Composite IT constituents

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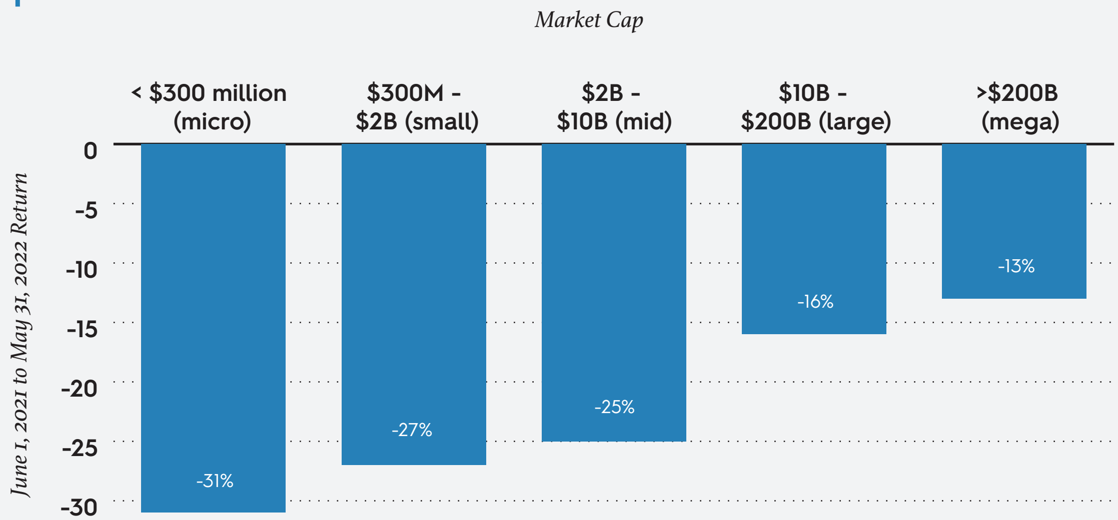
# A Flight to Safety—in Large Caps?

Academic research has shown that large-cap stocks outperform small-cap stocks during "flight-to-safety" moments. Given the market's decline so far in 2022, we think it's fair to count this year as one such flight-to-safety moment—and this trend line has held true for Nasdaq constituents over the June 2021 to May 2022 time frame.

Mega caps fared better than large caps, which fared better than mid caps, and so forth. Micro caps had the roughest go.

## Trailing 12 month average return based on starting market capitalization

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# Dissecting the Great Growth Stock Drawdown

It's dangerous to draw too many conclusions from a one-year time frame, and one that looks just at the Nasdaq. But in our view, the lessons of this drawdown are not new or unique to the 2021-2022 drawdown, or Nasdaq-specific. Here are a few takeaways:

### 1. Don't ignore valuation.

The most obvious lesson from this data set is simply that valuation matters. Famed strategist and author Michael Mauboussin explains in *Expectations Investing* that shareholder value is derived from expectations in value drivers, with sales growth being the main driver. It shows up in the P/S and P/E returns variances, and it shows up in some of the industry performance dispersions, where companies with higher sales in relation to market value (i.e., a low P/S) have performed better on a relative basis. The auto industry is a great example—because the Nasdaq's categorization of this sector is comprised mostly of speculative automakers, it was among the most punished industry groups of the measured time frame.

### 2. Starting and ending points matter.

This analysis has looked at a very tough one-year time frame for the Nasdaq. If we had started near the early days of the pandemic, the story would be different—the drawdown would have been cushioned by the large rise of the previous 18 months.

From June 2021 to May 2022, the Energy sector looks comparatively fantastic. But similarly, extending our lens would tell a different story: energy was one of the worst places to be in 2020.

Any rolling-12-month period could be very different—which energy-minded investors should remember right now. The good days likely won't last forever.

### 3. Diversifying helps.

The overall Nasdaq was -13% in this time frame, so diversification has its limits. But having some exposure outside of IT, Health Care, and Consumer Discretionary would have been a boost over the past year. And having exposure to mega and large caps would've cushioned against losses in micro and small caps.

It is *impossible* to predict the market—one year ago, certainly no one at 1623 Capital, and frankly most investors on the Street, were predicting inflation prints to run at four-decade highs or Russia to start a war in Ukraine. But this unpredictability is exactly why we believe diversification is so impactful: because you never know, you should always be prepared.

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### 4. A reversion to normalcy?

A final takeaway is that we appear to be returning to a sort of historical norm with respect to valuations and valuing companies based on cash flow and earnings—and not just how big a company says its total addressable market (TAM) is.

As highlighted earlier, one of the more telling data points from our analysis was the importance of earnings:

- Nasdaq component companies with earnings, average return: -11%
- Nasdaq component companies without earnings, average return: -39%

While every business is different, whether a company had earnings at all was a great predictor of success. That may not be true in all market environments, but in our view, it's likely to be true in most.

Current market conditions are tilting toward earnings and cash flows, and away from revenue growth and top-line leading indicators (like TAM).

# The Nasdaq Then Versus the Nasdaq Now

The Nasdaq's 13% decline over the past year is still quite a ways from the 78% peak-to-trough decline during the dot-com era.

However, that decline was notable for its persistence. The Nasdaq peaked in early 2000, and had a ho-hum remainder of that year—down just 17% from its all-time high (not even bear market territory!). It would take another two years for the trough to come, in October 2002.

At 1623 Capital, we believe our main advantage in the market is behavioral—reflecting upon the lessons of history, studying business models that have what it takes to win, and not overreacting (or underreacting, as can sometimes happen) to a financial press often designed to appeal to fear, uncertainty, or doubt.

We have no crystal ball, and can't offer any meaningful insight on what level the Nasdaq will be trading in another quarter or two.

What we can tell you with some level of confidence is that many of the businesses that are Nasdaq constituents are winning and retaining customers, engaging employees, and appear set to reward shareholders over time. The Nasdaq of today has some of the best-run companies on earth, delivering goods and services that are of vital importance to the world economy. They may not all make it out the other side, but most will—and our society and everyday experiences will be better for it.

## Market Cycles Are Accelerating

There may be no such thing as a "typical" bear market. Each one happens for different reasons, under different circumstances. However, a few things that bind all bear markets together are that they're difficult to predict, because warning signs can exist for years as stocks keep rising; **bear markets are often surprising at many turns, seemingly over before returning for another gasp; and, by the end, they'll separate the investors from the speculators.**

Since 1929, Bloomberg reports that the S&P 500 has experienced 17 bear markets, with an average decline of roughly 38%. Since 1946, the average decline has been less than 33%. Bear markets typically unwind quickly, with many lasting just over a year or so, and relatively few lasting longer than two years. During a bear market, earnings estimates are often declining quickly, making stocks look expensive even as they fall in price. But investors need to look beyond current dynamics and seek to ascertain how stocks will be valued when the environment normalizes, and earnings rebound. **You don't want to base your investment decisions on current conditions, but on the most likely future scenarios.**

Going into and during the 2000-2002 Nasdaq bear market, we focused on owning companies with free cash flow and strong earnings, and our focus today keeps this approach. In this regard, a bear market is a transient opportunity for long-term investors like us. Leaving shorting stocks to seek profits on falling prices for another discussion, bear markets represent a chance to buy more favorite companies at lower valuations, because two things have proven true in history: Bear markets end, and many strong, profitable companies have resumed growing and far surpassed old highs.

**Market cycles seem to be accelerating alongside the accelerating pace of our world, in which case the market's narrative may change from one of gloom and doom to what the recovery will look like sooner than you might expect.**

Meanwhile, market cycles are natural. For the market to function, bear markets are as necessary as bull markets. We need to keep this in mind during the good times, knowing that on average, historically, we'll see at least one bear market every decade. With that reality, we would be silly to not work to take advantage of them in the ways that we're able. It would also be folly to ignore that they happen. Having personally[2] invested during each bear market dating back to 2000, there's ample reason to believe that what we do now can increase our value in the years ahead, thereby turning the bear into an opportunity.

This seems more likely to us today than in prior bear markets, because today's leading technology companies (to focus on a favorite sector) are stronger than ever financially—with greater free cash flow, stronger revenue retention, more customers—thereby increasing our potential to spot strong leaders and benefit as they recover.

A final thought: Market cycles seem to be accelerating alongside the accelerating pace of our world, in which case the market's narrative may change from one of gloom and doom to what the recovery will look like sooner than you might expect. As we all know, the prevalent narrative can be a powerful driver of investor attitude toward stocks. We continue to invest to grow long-term value with the strongest companies we can find, and we seek to capitalize further as the narrative turns from bear market to recovery.

2 Jeff Fischer started his investing career as one of the earliest employees of The Motley Fool (TMF) back in 1996. He was co-manager of the original TMF long/short portfolio through the rise and fall of the Dot-Com era.

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*Data from Bloomberg, measuring the June 1, 2021 through May 31, 2022 time frame. Certain stocks may not fit into any of the GICS sectors and are therefore excluded from the data sets provided above—for example, Bloomberg data does not classify a Special Purpose Acquisition Company (SPAC) into any of the 11 GICS sectors, as such they have been excluded from the data set. The mean (average) is presented; our analysis of the Bloomberg data analyzed median returns as well, but the broad conclusions do not change.

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