A Comparative Valuation of Investments

August 23, 2021

We have commented on the growing cash reserves of corporate America over the past few years especially the buildup of cash on balance sheets of major technology companies. Recently, non-technology firms have been catching up with their "FAANG" brethren and are boasting record cash stockpiles. A recent report by the Wall Street Journal shows that global corporate cash reserves have swelled to a record of $6.8 trillion! The question is: What will corporations do with all that cash? There are a few options that are all attractive to investors in stocks. There is always the opportunity for dividend increases that often lure bond investors into the stock market since they are stuck with low interest income. Another possibility is mergers and acquisitions where big companies buy small companies resulting in a shrinking stock market. Another option is where companies buy back their own stock, a strategy that can increase dividend payments as well as earnings per share on a smaller capital base. Recently retail companies such as Macy's and Kohl's announced multi-million-dollar stock repurchases that will enhance their earnings per share.

Corporate managers are alert to increasing regulations that can negatively affect public companies. As a result, there may be more companies deciding to go private to avoid these regulatory burdens. If the overall stock market "shrinks" because companies accelerate buybacks and decide to go private, there will be less stock outstanding in an environment where savers need reasonable returns that can help them attain a nest egg for retirement. This shortage of equities should benefit investors who hold a well-diversified portfolio of stocks. For those investors who want to avoid short-term volatility, there is always the option to invest in several indices via mutual or exchange-traded funds where the investment risk can be reduced to just the risk of being in the overall market.

Many investors attempt to measure risk in the stock market as some function of company earnings or what is called the P/E ratio, the relationship between the price of the stock and the earnings per share of the company. When that ratio is "high" by historical standards, the market if overvalued or risky. So, how do you value other investments relative to this stock market metric? Take for example the more recent fad: "investing" in cyber digital assets or cryptocurrencies such as "bitcoin." How does one value such an "asset" that fluctuates in value by 50% both up and down and is coming under greater scrutiny by the regulators? For these types of assets, there is no such thing as a P/E ratio or a discounted cash (dividend) flow or the potential buyout expectation that are all valuation measures used for common stocks. The challenge for investors is to evaluate how these assets will survive in a digital world that continues to rapidly evolve. Think about investing in rare art as the basis for building a retirement portfolio. Beauty is in the eye of the beholder and who knows what someone will pay for this artwork in the future. Compare the fluctuating valuations of these other "investments" with a diversified portfolio of stocks that offer the potential for growing dividends over time. What is the "cloud"-equivalent of pie in the sky?