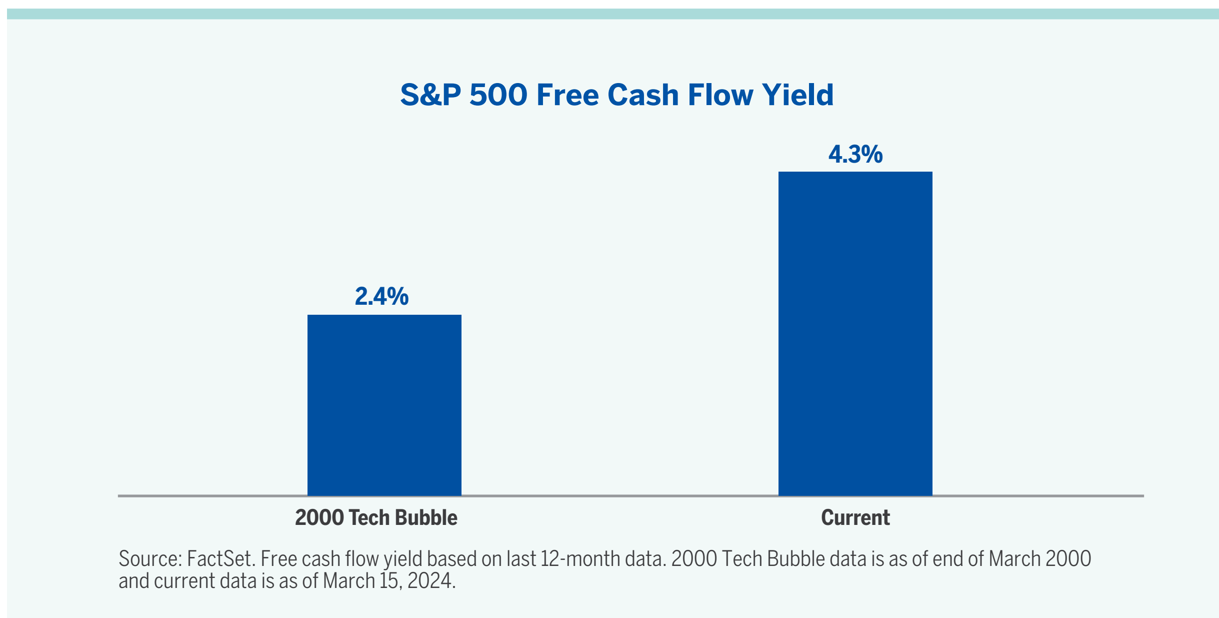
ALGER

Alger On the Money

# Boom or Bubble?

Stock market bubbles occur when investors collectively overvalue equities, often driven by uniform optimism about a new innovation. With AI enthusiasm driving markets higher, we assess if we're in a bubble by comparing the markets today to past instances of investor exuberance.




Source: FactSet. Free cash flow yield based on last 12-month data. 2000 Tech Bubble data is as of end of March 2000 and current data is as of March 15, 2024.

- The current S&P 500 price-to-earnings (P/E) multiple is elevated relative to history and approaching levels seen around the 2000 technology (tech) bubble; however, the current free cash flow yield is much more attractive, in our view.
- How can the market appear expensive based on earnings yet attractive based on free cash flow, as depicted in the chart above? The answer lies in the fact that companies today generate more free cash flow per dollar of earnings than they did during the tech bubble.[1] In the past, companies primarily invested for future growth through capital expenditures in tangible assets such as property, plant & equipment, which are not reported on a company's income statement and lower free cash flow relative to net income. Today, companies invest in their future more through intangible assets like research & development, where such spending is already reflected in the income statement and requires no further adjustment to cash flow.
- For example, the Russell 1000 Growth, which has above-average exposure to intangible investments, has a ratio of free cash flow relative to net income of about 100%.[2] Conversely, the Russell 1000 Value, with more exposure to tangible investments, has a ratio below 80%.[3]
- Compared to the 2000 tech bubble, the S&P 500 appears more reasonably valued based on free cash flow. Moreover, today's equity market also reveals higher net profit margins, higher return on assets, and a stronger interest coverage ratio.[4] In our view, these facts imply that the exuberance of the 2000 tech bubble is not present in today's stock market environment.

[1,2,3,4] Data from FactSet as of 12/31/23.

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Price-to-earnings is the ratio for valuing a company that measures its current share price relative to its earnings per share.

Free cash flow is the cash a company generates after taking into consideration cash outflows that support its operations and maintain its capital assets.

Free cash flow yield is calculated by taking the free cash flow per share divided by the current share price.

Return on Assets is a metric that indicates a company's profitability in relation to its total assets. It is calculated by dividing a company's net income by its total assets.

The interest coverage ratio is a metric used to measure a company's ability to pay its debt. It is calculated by dividing a company's earnings before interest and taxes (EBIT) by its interest expense during a given period.

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