Does Valuation Matter?

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Not long ago, a client of our firm with a concentrated position in one of the mega-cap technology names pushed back on a recommendation to gradually trim the holding. The case for trimming was straightforward: concentrated positions carry inherent risk, and the stock was trading at a level that implied heroic growth for years to come. The client was unpersuaded, asking, “Do you actually think valuation still matters in this market?” It is a fair question.

It is worth noting that the period during which valuation has genuinely seemed irrelevant is shorter than the current mood suggests. By most reasonable metrics, it is only 2021 and then again from late 2024 through today that markets have operated at levels that strain credulity. The intervening years looked expensive by historical norms but not irrational. That matters, because “valuation has been wrong for a decade” is a different claim than “valuation has been wrong for a couple of years at the tail end of a long bull market.” Whether valuation matters depends on whether you care about tomorrow's return, or the long-term risk/reward of the position.

What Market Efficiency Actually Means

Markets are efficient in one very specific and important sense, as volatility trader and Moontower founder Kris Abdelmessih has put it: making money is hard. That is not the same thing as saying today’s price accurately reflects the fair value of an asset based on the discounted value of likely future cash flows.

Consider what price discovery really means at the scale of today’s market: a company with a $3 trillion market capitalization that moves 5% in a session has nominally “created” or “destroyed” $150 billion in value, often on daily trading volume of $20-30 billion. The overwhelming majority of shareholders did nothing. Price was set at the margin by a fraction of the float, responding to a press release, an analyst note or a shift in sentiment that may reverse entirely next week.

When a speculative trade happens to work out, those same short-term moves can seem to vindicate whatever thesis the buyer had in mind. It is very human to reach for a fundamental explanation after the fact. Usually, it was noise. The tail is wagging a very large dog. Valuation, by contrast, does have some genuine predictive power for long-run returns. High starting valuations have reliably preceded disappointing decade-long results. Valuation has even greater utility as a risk gauge. As options trader Cem Karsan has observed, valuation tells you not when the plane will land, but how much air is underneath you if something goes wrong.

> ***Most of what moves prices day to day is noise, not insight. Mistaking one for the other is where investors get hurt.***

How we got here

That gap between price and risk has rarely been wider, and rarely more ignored. A rolling series of speculative episodes (meme stocks, ARKK, crypto, NFTs, MicroStrategy and crypto treasury stocks) has rewarded performance chasing often enough that a generation of investors has concluded that valuation-based caution is simply a quaint relic. The result is a cultural drift away from the discipline that truly generates long-run wealth: patient, diversified, systematically rebalanced portfolios.

Investors have moved toward behavior that looks superficially like investing but is closer to gambling: buying whatever has recently gone up, at whatever price it has reached. Meanwhile, the tools available to act on that impulse have never been more accessible: leveraged and inverse ETFs, zero-day-to-expiry options, widespread margin, and platforms engineered to make trading feel like gaming. Sports betting, once illegal in most states and widely considered morally questionable, is now a normalized daily activity. The line between investing and gambling has not just blurred, it has been deliberately erased by the products and platforms that profit from volume. Hyman Minsky observed decades ago that stability is itself destabilizing. Prolonged periods without crisis sow the seeds of the next, as investors grow progressively more comfortable taking on leverage and abandon caution. The post-GFC era, with its repeated policy rescues and conditioned dip-buying reflex, is setting up a near-perfect laboratory experiment in Minsky dynamics, and we are still waiting for the results.

A more sympathetic explanation

It would be too easy and too glib to dismiss all of this as greed or irrationality. There is a more sympathetic explanation. For younger investors especially, the traditional slow-and-steady path to wealth has become genuinely harder to walk. The number of hours of work required at the median wage to purchase a home or a single share of the S&P 500 has never been higher. Housing affordability, student debt, and wage stagnation relative to asset prices are real constraints, not excuses. Social mobility has been declining for decades while inequality has risen steadily.

Data from the Bureau of Labor Statistics shows that labor's share of GDP, the slice of the economic pie accruing to workers rather than capital, is near its lowest level in the postwar era. The effective corporate tax rate, by contrast, has not been lower since before the Great Depression. Post-Covid inflation has compounded the pressure on household budgets, and credit card default rates have climbed to their highest level since the financial crisis. It seems little wonder that consumer sentiment has remained deeply depressed despite an economy that, by conventional measures, appears to be performing well. When the conventional on-ramp to prosperity is closed off, lottery tickets start to look rational. The desperation trade is not irrational given the choices some people face. That does not make it less dangerous.

Performance chasing versus the momentum factor

The most seductive mistake in today's market is confusing performance chasing with the momentum factor. Systematic momentum is a disciplined, rules-based strategy that buys recent winners and sells recent losers with defined rebalancing and risk controls. This approach mines a real and well-documented anomaly in financial markets. It works precisely because it is mechanical, not emotional, and because it includes an exit. Professional momentum strategies are not about buying what is hot and holding it indefinitely; they are about harvesting a persistent pricing tendency with the same rigor you would apply to any other quantitative strategy. What most retail investors practice is something entirely different: buying whatever is loudest in the news, at whatever price it has already reached, with no plan for what comes next. By the time an investment idea is on the front page, you are almost certainly buying at or near a potential peak in price.

Often, this is the point at which the informed money is already considering an exit, leaving retail buyers holding the bag. There is a structural reason this keeps happening: as Dan Rasmussen of Verdad has observed, one of the most reliable principles in finance is that excess returns attract capital, and capital compresses excess returns.

The trade that worked is already being arbitraged away by the time it becomes conventional wisdom. Academic research documents not only momentum but its cousin, the reversal factor: assets bid up by performance-chasing crowds tend to subsequently underperform as that crowd exits. Buyers who arrive because a move is visible rather than because they have identified a genuine edge tend to be less committed and more prone to sudden exits. As I discussed in my prior note on gold, buying into parabolic price moves and aligning oneself with price-insensitive flows are related errors. Both involve arriving after the edge has already been competed away, often by the very enthusiasm your own purchase is joining.

The hopes and dreams problem

The SpaceX IPO is the latest "shiny object", and it brings up a related phenomenon worth naming. Bloomberg macro strategist Cameron Crise has constructed what he calls the "hopes and dreams" ratio: the percentage of an asset's market value that cannot be attributed to any earnings expected in the next few years. This is value that exists entirely in the speculative long run. Michael Mauboussin at Morgan Stanley has developed similar frameworks for decomposing what portion of a stock's price reflects near-term fundamentals versus open-ended future optionality.

For companies like SpaceX, or Tesla, or any other vehicle attached to a compelling but distant vision, that "hopes and dreams" component can be enormous. This is not inherently wrong; Amazon looked similarly speculative for years and eventually justified every penny. But it creates a particular trap: because the payoff is so far out and the range of outcomes so wide, there is no near-term catalyst that forces price back toward any reasonable fundamental anchor.

The bull case is always "just wait." That makes these assets easy to hold through painful drawdowns and easy to justify buying at almost any price. That is why they attract speculation and why caution is warranted.

The case against concentration

The risks of concentrating in any single name, whether a speculative "hopes and dreams" story or a seemingly safe blue chip, are more severe than most investors appreciate. Research by finance professor Hendrik Bessembinder found that four out of seven individual stocks underperform Treasury bills over their lifetimes. The extraordinary long-run returns of equity markets are generated by a small minority of exceptional companies, while most stocks are mediocre or worse. Identifying the future winners in advance is extraordinarily difficult even for professionals, which is why the most rational baseline for equity exposure is a diversified basket that captures the market's returns without betting it all on any single name or sector.

JPMorgan's long-run analysis of Russell 3000 components found that approximately 40% of stocks suffered a catastrophic loss of 70% or more from their peak, never to recover. Individual companies, including many that were once considered blue-chip market leaders—can experience permanent declines of 70% or more, and some ultimately fail altogether. Broad indices composed of diversified holdings rarely do, barring catastrophic civilizational disruptions.

The implication is not that you should avoid equities. It is that concentration in any single name, however great the company, is a risk that rarely gets compensated proportionately. The natural human tendency to fall in love with a past winner is one of the more reliable ways to give back gains you earned.

> ***Concentration feels bold until the math reminds you most stocks never deliver the dream.***

How much air is there?

How much air is there beneath the plane right now? Quite a lot. By earnings yield relative to real interest rates, the S&P 500 is approaching but not quite at the extremes of the dot-com bubble. Strategist Joachim Klement, taking a different analytical approach, argues that adjusting the Shiller CAPE for earnings that are currently multiple standard deviations above their long-run exponential trend puts the true cyclically adjusted valuation closer to 64 than the headline figure of approximately 40, implying a Z-score of 4.6 relative to historical norms, the most extreme reading ever recorded.

Expensive is the baseline condition across almost every asset class, with no obvious cheap corner to hide in as there was in 2000. A companion piece explores the macro and portfolio construction implications of that observation in full. The short version is that navigating this environment requires more than the standard prescription of diversify and rebalance.

At SGI, our response is built around three tools that go beyond conventional asset allocation. The first is genuine diversification across return sources that are structurally different: real assets, trend-following and carry strategies, and factor exposures applied with enough concentration to actually matter. The second is tactical asset allocation calibrated to work across multiple crisis types, not just the last one, managing risk actively while amplifying beta intelligently when conditions warrant. The third are options overlays designed to be genuinely additive on a standalone basis, not a repackaging of the investor's own capital dressed up as income. None of this eliminates uncertainty. What it does is tilt the odds toward better outcomes than a portfolio built for the last decade is likely to deliver.

Which brings us back to where we started.

We applied our process and trimmed the client's concentrated position gradually over the course of the year. Not because we knew the stock was going down. We didn't, and it didn't, at least not yet. We trimmed because the gap between price and any reasonable estimate of intrinsic value had grown wide enough that the asymmetry of outcomes had shifted.

The upside required things to go very right. The downside required only that the optimistic assumptions embedded in today's price work out anything less than perfectly. That asymmetry is precisely what valuation measures. Not a timing metric, but an honest accounting of risks that may not be evenly distributed.

To answer the question, we started with yes, valuation still matters.

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