'Dean of Valuation' Aswath Damodaran on FAANG Stocks, the Economy, and Companies Worth Buying

"Over the long term, I think winners and losers will be seen more in terms of sectors rather than countries," asserts the NYU business school professor.

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Not long ago, many investors considered WeWork's CEO Adam Neumann a shrewd visionary. Analysts were trumpeting WeWork stock as a "must buy" before it ever went public.

WeWork was seen as offering the template for the future of office space by being able to meet the needs of young, flexible startups looking to share space with like-minded entrepreneurs in thriving cities where new ideas and potential clients could be harvested and cross-pollinated.

What could go wrong?

Plenty, said NYU Stern School of Business Professor of Finance Aswath Damodaran. Even before the company's mishandled IPO was announced last year (then indefinitely delayed), Damodaran asserted that WeWork challenged the basic principles of asset and liability matching. "You have a firm that signs pricey long-term leases then sublets them to short-term tenants," explains Damodaran. "This is a model built on a knife's edge of precision that by design will be vulnerable to the smallest economic turbulence."

Damodaran's concerns about WeWork pre-dated the pandemic and even the firm's IPO when the company revealed key faults not only in its financials but its operations. "The firm's investment thesis was driven by the CEO's personality and belief that he was the next Steve Jobs, not sound valuation," says Damodaran.

He estimated the pre-IPO paperwork suggested a corporate valuation of $14 billion — a fraction of what was being pitched by Softbank, Goldman Sachs, and other private investors who anticipated a $50+ billion market cap. In hindsight, he admits even his $14 billion was overly generous when the IPO laid bare the arrogance of almost everyone involved in the IPO and the company's systemic risks.

"Another key problem," explains Damodaran, "is valuations were being determined by what early investors were paying, making its valuation a house of cards that collapsed when the market started to seriously question the company's fundamentals and forecasts."

Professor Damodaran is outspoken when he sees things that don't make sense, because, as he explains, "I'm a teacher first and foremost. WeWork was a classic example of how critical it is for investors to distinguish between compelling story telling and hard financial metrics." Discerning between signal and noise is at the heart of what Damodaran does.

Being born into a secure, well-educated family in the southern Indian city of Chennai enabled Damodaran to pursue his education in the U.S. While studying for an MBA at UCLA, Damodaran imagined his next move would be into investment banking.

But his thinking turned when he became a teacher's assistant. It didn't take long for him to realize that teaching was his calling.

Damodaran holds the Kerschner Family Chair in Finance Education and is Professor of Finance at New York University Stern School of Business. He has been the recipient of Giblin, Glucksman, and Heyman Fellowships, a David Margolis Teaching Excellence Fellowship, and the Richard L. Rosenthal Award for Innovation in Investment Management and Corporate Finance.

His passion for teaching earned him Stern's Excellence in Teaching Award in 1988, the Distinguished Teaching award from NYU in 1990, and his MBA students voted him *Professor of the Year* five times.

In addition to writing for various academic journals, Damodaran is the author of several highly regarded academic texts on valuation, corporate finance, and investment management. This has helped earn him the moniker, "Dean of Valuation."

Damodaran looks at the world differently than many of his colleagues. Instead of narrowly focusing of specific subjects and themes, he tends to look at the big pieces of a puzzle to see how they are all connected. This keeps him from getting distracted by the latest fads and claims of future market share, instead focusing more on business models in assessing what a company's value should be.

Moving to a different beat led him to strike a unique arrangement with the Stern School that's enabling him to reach a global audience. In return for teaching large classes, he has been allowed to upload his classes online for free to anyone who is interested in learning.

This has enabled Damodaran to transform his lecture hall on West 4th Street in Manhattan into a global forum. He receives hundreds of emails a day~~s~~ and sees the scale of people he's reaching as an extraordinary opportunity to potentially shape minds all over the world.

In August, I was able wedge my way into this modern day peripatetic's busy schedule to see, after four decades of studying markets, companies, and investors, what he makes of these most unusual times.

You approach finance and investment a bit differently than your colleagues. Why is that?

I dabble in many things because I am curious about so many different things without being an expert in any of them. I think this gives me a different, less biased perspective. When investing, I feel safer sticking with the companies I know and don't try to make judgments about the markets and the economy because I'll be more often wrong then right.

Where is the U.S. economy?

It's in trouble. Closing down the economy is an experiment that the world has never tried. This is an immense machine, where the engine has been turned off. The fear is that the economic engine might not start up or sputter for a while. So far—looking at the initial evidence from Germany, much of Scandinavia, and parts of China where they've reopened back up—the experience has been better than expected. South Korea has been more cautious and slower to recover. The U.S. is a few months behind these countries. The question is if the U.S. economy will expand back towards its previous norm.
The U.S. has one advantage other economies don't have: big tech stocks, which have been thriving and represent a larger segment of the market. They don't need the kind of capital intensity that traditional companies rely on to function and create revenue. Without these companies, we'd be in much deeper trouble.

This suggests to me that when the economy starts back up, we're going to get a new set of winners and losers. This isn't going to bring everybody back up to where they were before the crisis. Some of the largest companies are going to get even stronger and bigger, but at the expense of smaller, weaker competitors. This should allow the U.S. economy to come back faster than the rest of the world. But it will come with a cost – a more top-heavy economy, dominated by big winners.

The venerable economist Henry Kaufman believes there will be the permanent destruction of capital and that risk taking will take a while before it returns to pre-crisis levels. This will slow the return of the economy to pre-crisis performance. Do you agree?
That may be so. But here's the interesting thing. Private risk capital — venture capital money, IPOs, other risky ventures — has been quite active, which is contrary to what happens during typical crises. There's usually a flight to safety. Utilities and low P/E companies typically do well under such circumstances. But that hasn't been the case during this crisis. It's been just opposite. There's been more venture capital invested in 2Q20 than in 2Q19. Maybe risk capital is in denial or in delusion. But there's something different in this crisis that's not scaring them away.

A number of leading allocators fear the market's recovery feels more like a bear market rally rather than a true recovery. What do you think?
I think it's easy to dismiss the market rally on that basis. But I don't think that's the case. This has been the most orderly crisis I've ever seen in terms of how it has behaved across the period. It's a crisis that actually mirrors the virus: it has punished older, more mature companies that used to pay healthy dividends, and it has rewarded younger, more flexible companies that don't pay dividends. That's almost never the case during a crisis. I try to think of the last crisis where utilities are down far more than the rest of the market, and I cannot think of one.

Investor hope has returned, but business hope hasn't. How do you reckon the difference?
Investor hope is always ahead of business hope. Business hope has to wait for the vaccine.   So the biggest market risk is if the release of an effective vaccine is delayed and consumer and business confidence drops. The market is being more optimistic than I am. But I've discovered over time to trust the market instead of my beliefs because I am a terrible economic forecaster.

Assuming the FAANGs + Microsoft continue to thrive, how will they help the rest of the economy regenerate or are you suggesting a bifurcated recovery?
The vast majority of new growth is in the big tech sector. These companies are cash machines. And companies like Apple, which generated $60B in free cash flow, will be able to buy promising new technologies. There will be bad news for brick and mortar retail, and you will see bankruptcies every day. There will be big losers in the process, which is going to create a very uneven recovery across the economy and across the country.

What are your thoughts about active versus passive investing?

I have little faith in active investing, at least as practiced today at hedge funds and mutual funds. They have been undercut by ETFs and index funds for more than a decade for a simple reason: active investing does not deliver the goods, and I don't think that's going to stop. I think the end game here is that we're going to see a smaller group of active managers that have consistent investment strategies, who actually bring something to the table rather than trusting in mean reversion to bail them out.

I am not a Warren Buffett acolyte. But the one thing you can say about Warren is that you know what he believes, you know whatever he does comes from that same "thought well." It might not work every time, but at least he has a consistent philosophy. The world has changed under him, and that may explain why what worked so well for him in the last century has not for most of this one.

Hedge fund managers would seem to have more latitude to respond to crises then other asset class managers — of mutual funds, ETFs, real estate, and private equity. Thoughts?

That is true. But there's well-established evidence that the more a manager can do, the more damage he or she can do. More freedom has often worked against hedge fund managers. And it's unclear if this freedom does provide hedge fund managers competitive advantages to enhance performance. There isn't a single hedge fund manager with which I would trust my money. There's a reason for this: many hedge funds are run by people convinced their models and methods are unassailable. Arrogance and markets don't go together. Markets are stripping experts of their expertise, and I think it's going to be interesting to see how the hedge fund business comes through this crisis.

You're planning a book about the crisis.

Yes. I'm keeping regular notes about how I'm feeling and thinking during this crisis in laying the groundwork for explaining what it was like to have lived through the pandemic — unbiased by the fog of memory. I'm doing this because I'm a teacher. This is my passion. And crises are when I learn the most. And crises help me refine what I'm thinking about markets and valuations. Every day I'm calculating an implied equity risk premium for the S&P 500. I do this instead of listening to pundits and market strategists, which I believe is noise.

Has there been a seminal event during the crisis?

March 23 was the day the Fed announced it was backstopping the private lending market. At that time, the price of risk in the equity market (equity risk premium) peaked. Almost to the day, we saw risk capital pivot back into the markets. By August, risk premium had virtually returned to pre-crisis levels.

When one looks at what the Fed has actually spent in support of the economy, it's almost nothing. I describe the Fed as the Wizard of Oz. It understands power comes from perception, not always the actual use of such power. I give Jerome Powell credit for how he has used that perception of power to drive markets. I think that's essentially the role of the Fed: to create change without actually doing much.

Is part of the reason investors have been returning to the market due to a search for yield not available in other assets?
I don't think so. If that were true, stocks that pay higher dividends would have been performing better than stocks that pay less or no dividends. The market is building in an expectation that dividends will be cut by 25% and stock buybacks by 50% this year. This is close to what happened during the Great Recession. The interesting question: how much of this reduction in dividends and buybacks will be permanent?

What do you expect 2020 Full Year GDP to be?
We would be lucky to see a decline that's less than double digits. But I'm expecting the number to be between -10-20%. We'll be lucky if the third quarter is down only 15% year-over-year. So my full-year projection is really dependent upon how the last quarter plays out.

What gives you reason to hope that the fourth quarter will be materially positive?
I really can't put a finger on it. I just get a sense that more people are showing greater mobility, they are in stores, and that economic activity is growing. I think we'll see a Christmas bonus.

Where will the market be at the end of the year?
I think we could see a positive single-digit return for the year. If that happens, that's cause for celebration.

In my recent global hedge fund survey, allocators across the globe were expecting a second sell-off? Do you?
The fact that so many allocators were expecting a second sell-off makes me very optimistic that there will not be one. It seems to be driven more by the belief that investors will wake up one day and realize that they've driven up prices far too high and they need to selloff. If this was to happen, it will not be driven by sentiment but by something fundamental that has happened.

What's your worst-case scenario for the market?
The virus turns out to be even nastier than expected, that treatment and vaccines are elusive, and if there are second and third waves of infection that forces the economy to again shut down. If that were to play out, I would think we could see the market drop by 25% for the year. But at this moment I would not expect this.

Does the government have the resources and firepower to deal with the fallout of a second or third wave?
Not without creating huge inflationary pressures for the next decade. We already have to be wary about how much money has been thrown at this problem. The impact of what we've spent already is the big unknown.

Whether we'll see significant inflation or debasement of the currency is yet to be seen. The response to the Great Recession didn't appear to trigger significant inflation--almost to the contrary.

I think the key question that the Fed will have to contend with is knowing when to stop fueling money supply and to start reeling it back in. The Fed did this very well post 2008 and maybe they will do that again…but that's yet to be seen. But the amount spent this time will exceed what was spent in the last crisis. We've never seen such an infusion of liquidity and don't know how managing such liquidity will play out.

Do you fear we could get trapped the way Japan has been for more than 25 years where there's permanently low interest rates and paltry growth?
I think Europe should be more fearful of the Japanese experience repeating itself on the continent than here in the U.S. because its demographics are less favorable than ours. The European economy is more fragile and less resilient than ours.

Are you worried about the revival of a sovereign debt crisis like we saw after the Great Recession?
I don't see how it can be avoided across Southern Europe, which looks more like an emerging market. Northern Europe is perhaps the strongest market region.

Does that put the Euro at risk of breaking up?
Yes. That divergence is tough to sustain when you all share the same currency and monetary policy. Politically and economically, it's going to create challenges we don't have here. Germany and other wealthy northern countries are being asked to back bonds that are largely trying to save Southern Europe. If there's a second wave and further shutdowns, that could put an awful strain on the euro regime.

Where would you recommend investors look for opportunities at this time?
Over the short term, I like the prospect of the Chinese and Vietnamese markets. But over the long term, I think winners and losers will be seen more in terms of sectors rather than countries. We live in a world of global companies. So even with the FAANGs being U.S. companies, their success has more to do with their respective industries rather than where they are domiciled. If you're capital light and flexible, then you have an advantage over companies that are more mature and capital intensive, and that's how I would differentiate investment opportunities.

Are there a couple of foreign companies you are high on?
Alibaba (ticker: BABA), Tencent (TCEHY), JD.com (JD). I would look across the world for companies like these. They may seem a little richly priced (as of the end of August), but there will be a selloff, which will provide buying opportunities.

Do you see the current investment environment as attractive or extremely risky?
Challenging and enriching often go together. When an environment is relatively low in stress, there's probably less undervalued opportunities in which to invest. Heightened levels of uncertainty are when the best investment opportunities show up.

So for a competent investor who does his homework, this is not a time to stay on the sidelines?
Staying on the sidelines has never worked for me because I've never been good at market timing--when to pull out when there's panic and then deciding when it's appropriate to return to the market. I don't make decisions to stay out of the market because I'm scared. I feel I need to be invested at all times. I call market timing the impossible dream. We all want to do it. But it never seems to work.

You're 62. You may be near retirement. Like others in that position, do you think it may be wise to take some money off the table after such a long bull market rather than to be exposed to what may lay ahead?
I don't personally need the liquidity. But if one does, you should sell now. If you have health issues, worried about your 401(k), then I definitely think you should listen to your gut. If you lie awake at night wondering what's going to happen to your portfolio, then you've already failed what I call the "sleep test," which should tell you to sell. Nothing in investing is worth getting an ulcer or a heart attack over. Don't listen to the experts, just divest a portion that you need so you feel better about yourself and your financial stability. And get some rest.

What did you do in 2008?
I rode the market down and back. I feel I'm better off staying in the market regardless of how uncomfortable I may feel about the market.

It took five years for the market to reclaim its former highs in 2007. Looking back at that time, do you think that was the best way to approach the market collapse?
Yes. I did move some money between some stocks I owned. But I stayed in the market. When people pull out of the market in the middle of a crisis, it's really difficult for them to get back in because it's too monumental a decision. It's easy to get paralyzed wondering what's the right time to reinvest. If one has pulled out the market and wants back in, just put your decision on autopilot. Put back 10% of what you want to reinvest every three or six months. Otherwise, you will be sitting on cash.

What are the likely permanent systemic changes that will result from the Covid crisis?
Big tech companies will get bigger and regulators will revisit issues of antitrust laws. Amazon, which was dominating the market before Covid, think about what it now controls. Google and Facebook will dominate online advertising even more. And this might stifle other independent innovation. A more interesting question will be the underlying reason for applying antitrust regulations. They were originally written to

protect consumers. No Amazon customer is up in arms because they are paying for Amazon Prime. The problem is antitrust laws were geared to breakup 20th century conglomerates. We need to rethink these laws so consumers don't get hurt. Most big tech companies, while powerful, are not conglomerates. Breaking up Microsoft or Facebook doesn't make sense. But it could happen, affecting the largest market cap firms and therefore the market.

If big tech doesn't get broken up, will they be exposed to greater regulatory oversight?
I think so. This may not evolve into utility-like regulation. Actions will be taken to address issues involving political speech and privacy matters. But I do think there will be regulatory constraints that will restrict how they can grow.

Do you see price controls coming into play?
I don't think so. These companies don't charge high prices now, at least to their customers. To the extent that advertisers are willing to pay high prices to be on their platforms, I think that will remain between them and the companies.

Any other systemic changes likely to evolve?
There will be an accelerated shift away from less flexible, traditional industries, like steel, oil, and coal, into more flexible companies. Manufacturing industries will continue to lose out to less capital-intensive, technology-based variations. Tesla, for example, is much less capital intensive than GM. Big labor-intensive manufacturing companies will continue to lose out.

Are you concerned if Trump is reelected, tariffs could interfere with the free flow of capital and innovation across borders?
Trade wars, no matter who initiates them and how they play out, are troublesome, especially as companies and countries are increasingly dependent upon global growth. It's been a concern we've been living with for the last four years, and the market seems to have found a way to live with the friction. It's already a material issue, moving in ebbs and flows. I think the issues between U.S. and China run deep enough that I would be concerned about this regardless of who is president.

Do you fear the banking system is at risk?
On March 23, before the government announced the start of its massive stimulus, I was more concerned than I am now. Banking systems suffer when risk capital dries up, when banks alone are left bearing the burden of risk capital. That's what made the Great Recession so catastrophic for banks. The fact that risk capital has stayed in play, that Boeing was able to tap into the corporate bond market, has been a very positive sign for banks. This doesn't mean banks haven't been hurt by the crisis. Their stocks are down more than any other sector. But I don't expect a banking crisis as of this moment.

Will there be any long-lasting impairment of the economy that worries you?
I think manufacturing employment, which is in a permanent downward spiral. Two things are going to hurt commercial real estate: more remote working will reduce the

demand for city center property (and all the multiplicative affects that will have) and the decline in brick and mortar retail. There's a global shift working against commercial real estate. This doesn't mean their prices are going to drop overnight. But this will be a test to see if retailers are going to pay premium rents as they had done so in the past.

How would you assess the risk of both household and government debt on the future of the economy?

If the virus comes back and the economy shuts down for any significant time, I don't see how you avoid a debt crisis. But I don't believe there's going to be a severe second wave that will shut down the entire economy. But if that happens, banks will suffer being in the front line. They will be the canary in mine shaft. And backstopping banks again will be tricky and therein lies a very dangerous scenario.

Thank you, Aswath.

Eric Uhlfelder has covered global capital markets and asset management for the past 25 years, authored "Investing in the New Europe," published by Bloomberg Press, and is a recipient of a National Press Club Award for journalistic excellence.