

When valuations appear unrealistic: seeking and focusing on mispriced beta

Profit margin sustainability could be overemphasised, while role of low cost of equity may be underappreciated

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Much energy has been spent debating whether hyperscalers' profit margins are unsustainable. The typical response: even if they are, trying to time a correction of any inefficiencies is too costly and thus not worth attempting. After all, even professional investors struggle to call an end to market mispricing.

At the same time, it is also possible that we are asking the wrong question. Perhaps the sustainability of profit margins is overemphasised, while the role of low cost of equity is underappreciated.

If markets are treating currently elevated margins as permanent productivity rents—assuming cash flow returns on investment (CFROI) will stay elevated— such an assumption becomes particularly problematic when paired with the assumption that the cost of equity will remain permanently compressed. In other words, if the latter is doing more of the "heavy lifting" in boosting valuations than the former, valuations may eventually need a significant adjustment.

For example, if we are using the classic Gordon Growth Model, earnings growth is undoubtedly a crucial factor in valuation (the numerator). However, an unsustainable rate of growth only becomes problematic for valuing firms when we consider the long-term costs of maintaining that growth. The proportion of valuation attributable to "terminal value" (rather than near-term growth) can also be extremely sensitive to assumptions about the cost of equity (the denominator).

In a very basic model, we can break down cost of equity into:

*Risk free rate + beta * equity risk premium*

Although basic, this type of model still involves some moving parts. Even with the equity risk premium unchanged, assuming an overly low equilibrium risk-free rate means a much greater proportion of current value may be attributable to the terminal value rather than earnings from the current high-growth, high-margin period. Meanwhile, if "neutral" real rates have risen post-pandemic (for example, due to higher investment demand or persistently applied fiscal policy), then this would become a headwind for valuations, all else equal.

Next, there is beta. As we know, the composition of US market capitalisation has changed substantially with the growth of big tech. It is argued that big tech's lower beta is a byproduct of stable, predictable free cash flows and reduced sensitivity to the business cycle. But the evidence is incomplete. Indeed, free cash flow growth has been extremely strong over the last decade, yet we have not seen a substantial down cycle to test this hypothesis. The pandemic shock was not only brief, but it was also specifically characterised by a surge in digital demand. Even when the Federal Reserve hiked rates in 2022-23, credit spreads stayed tight and corporate funding rates remained anomalously low—largely insulated from the tightening cycle.

It matters greatly whether your beta is compressing cyclically (as market caps grow and liquidity continues to gravitate toward them) or whether you have structural beta decay.

Consider this: with a 4% perpetual growth assumption, cutting the cost of equity from 10% to 7%—while keeping long-run growth unchanged—could easily double your theoretical multiple, whereas adding a percent or two to earnings growth would have a smaller valuation impact.

As long as companies are not retiring their equity capital entirely, cost of equity across a full business cycle remains critical for valuation. The cycle could extend further, and profit margins may stay high, but cyclically low cost of equity cannot last forever.

The most prudent approach may not be trying to time the markets, but to focus on identifying areas where valuations appear heavily dependent on unrealistic long-term assumptions of cycle-independence.

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