# Level Set: It Makes Sense that Valuation Doesn't Work to Pick Stocks

## The Demise of the Efficacy of Valuation Isn't Surprising

We have been thinking and writing for a long time about the various reasons why valuation has largely been ineffective as a metric. This past week while on the road meeting institutional investors, this topic came up several times. Here is our view - it makes sense valuation doesn't work, and we don't think valuation should be a signal investors pay much attention to, unless it gets incredibly extreme.

**Here are six reasons (and some caveats) explaining why we think using valuation to pick stocks, and buying cheap stocks and selling expensive stocks, actually doesn't make sense, and is likely a losing strategy**

## #1 AI

We think Artificial Intelligence will impact equity investing in a number of ways. The "holy grail" would be if we could "tag" stocks as being in certain AI-related buckets. Knowing what bucket a stock is in, or likely to be in can inform a lot about how investors should think about its valuation.

- **Revenue Beneficiaries from AI:** There are many companies that are revenue beneficiaries from AI, and virtually all have seen materially revenue growth and / or multiple expansion in the last two years. AI Semiconductors, AI Software, Power and Infrastructure are among the obvious winners. The most obvious example is Nvidia (Ticker: NVDA). Below we show their revenue trajectory since they reported the largest upward sales revision of any mega-cap company in May 2023. Many investors ask us about hyper-scaler capital spending and the timing for the realization of return on that capital spending. Their concern is that much of the spending will prove to be low return, and that will damage the growth path of these revenue beneficiaries. Our judgment is that it is premature to get concerned about that. Alphabet (GOOGL) reported this past week and raised its capital spending guidance, commenting that it can't spend enough in certain areas. Our general reminder to investors is that it was barely 2.5 years ago when very few people knew what AI even referenced. Illustrative of this, we read the year-ahead outlooks for economics and equity strategy from Morgan Stanley, Goldman Sachs, JPMorgan, and UBS written in November 2022 for their projections for 2023. In these lengthy eight documents written by experts at four of the most important firms, the letters "AI" were written ZERO times. That's right - virtually no one thought just a bit more than 2.5 years ago that AI was worth mentioning, and six months later, NVDA posted their big upside number. What's our point? We have been consistently told that many of these initial investments have a 3-4 year lag until we see benefits. We expect the revenue beneficiaries to continue to produce solid fundamentals here, largely immune from other macro issues. NVDA's revenue path (shown below) is the most obvious example.

**Adam Parker**
Founder
646-734-7070
adam@trivariateresearch.com

**Maxwell Arnold**
Analyst
347-514-1234
maxwell@trivariateresearch.com

**Chang Ge**
Analyst
614-397-0038
chang@trivariateresearch.com

**Colin Cooney**
Head of Sales
617-910-7934
colin@trivariateresearch.com

**Ryan McGovern**
Director of Research Sales
973-271-8017
ryan@trivariateresearch.com

**NVDA Is the Poster-Child for AI Revenue Beneficiaries**

**NVDA Revenue by Calendar Quarter**
**Through Q4 2025E, As of July 25th, 2025**
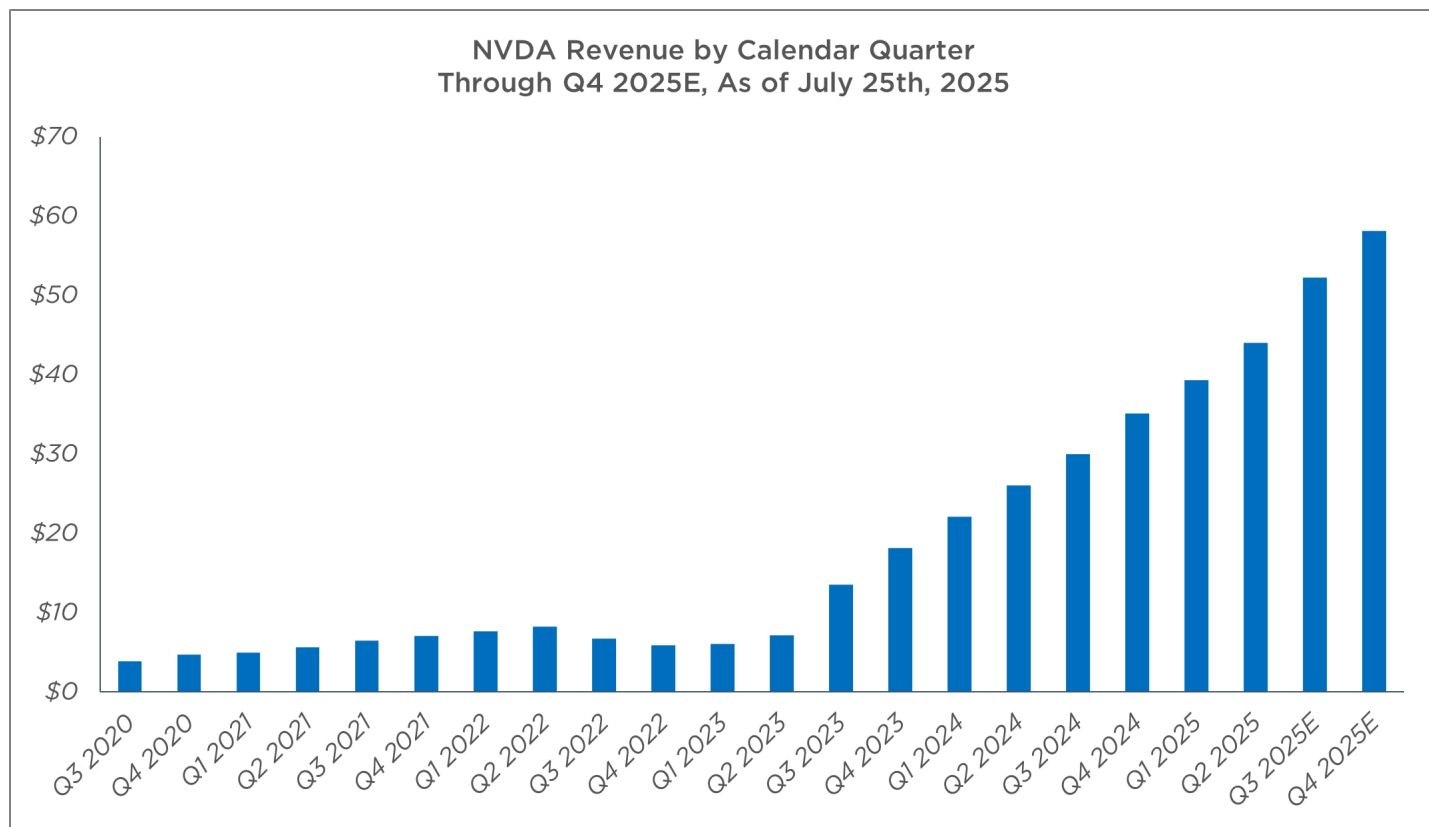
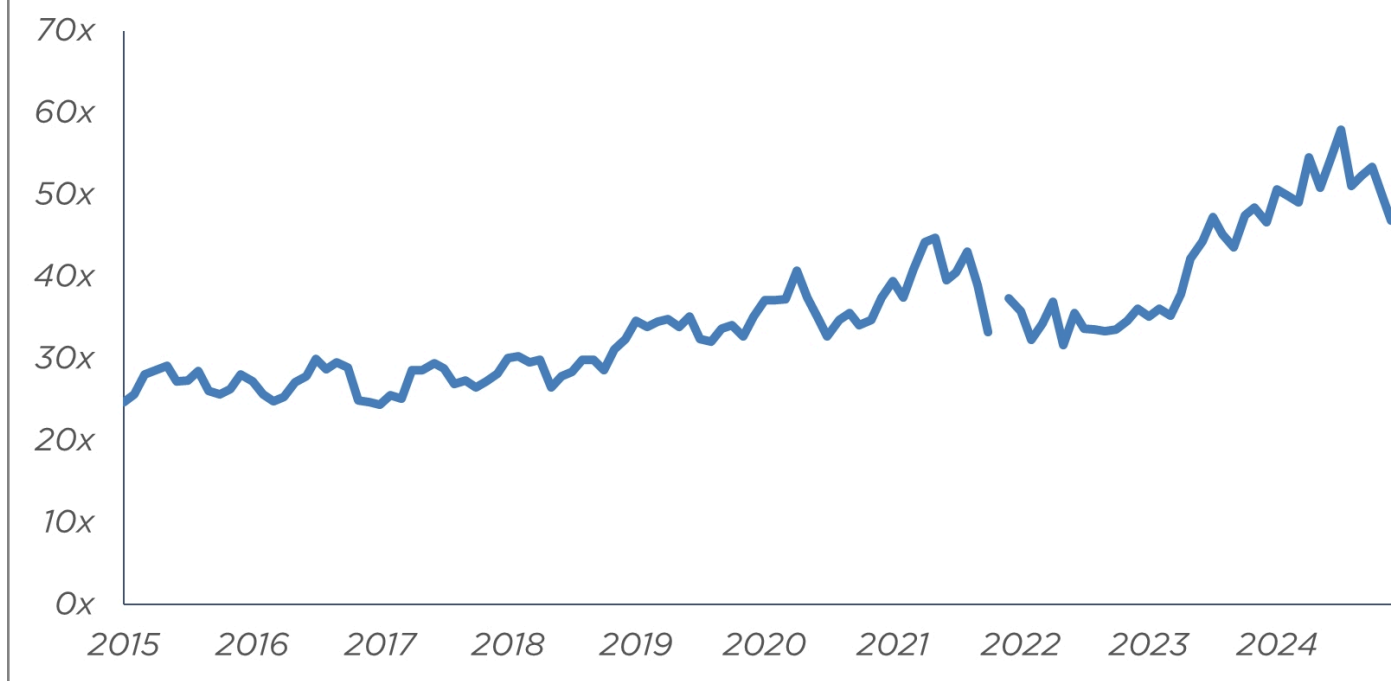

Source: Trivariate Research, LP

While we may see some short-term sentiment issues affecting AI Semiconductors in the next couple of months, of which ASML's comments about tariffs could be a harbinger, we don't believe that valuation will be helpful longer-term for picking stocks that are AI revenue beneficiaries. Below we show the EV-to-forecasted sales for NVDA over time. Clearly, investors would have missed a lot of upside if they had used the ten-year average valuation of 13x sales as an indicator for timing the performance of the stock.

**NVDA EV-to-Forecast Sales Over Time**
**Through July 23rd, 2025**
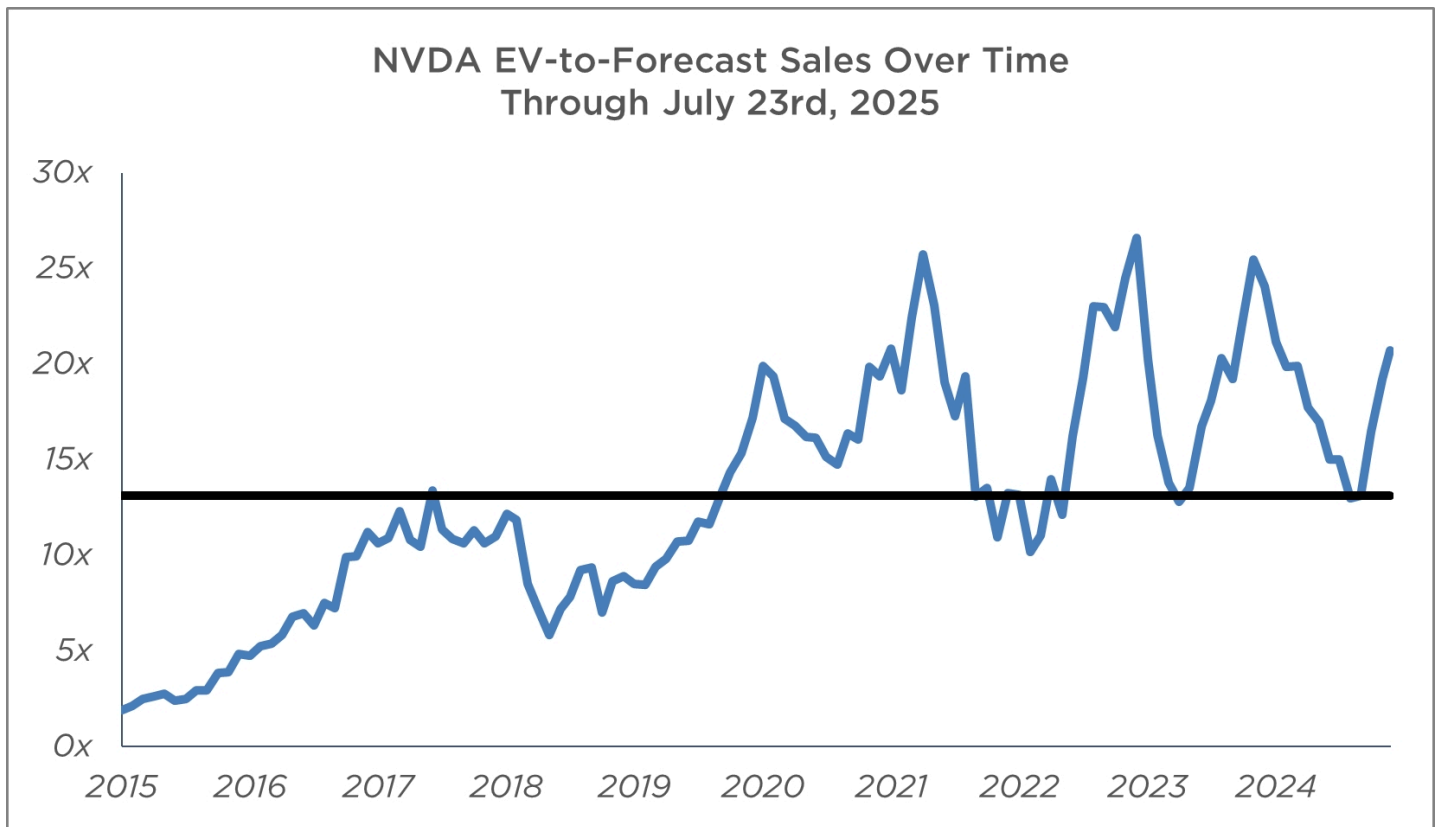
- **Productivity Beneficiaries from AI:** While significantly harder to label systematically, there is| also a large basket of stocks that are perceived to be potential productivity beneficiaries from AI. These are companies that have large numbers of employees and low margins that can benefit from predicting their employee and customer behaviors to garner efficiencies. The idea is that at a minimum many of these businesses can grow their revenue over the next few years without any incremental "net" hiring. We have seen several examples of companies with low but increasing net margins trade at very high price-to-forward earnings multiples. Costco Wholesale Corp (COST) is probably the most obvious example that comes to mind: as its net margins expanded, the price-to-forward earnings multiple peaked around 58x earlier this year (see below).

## COST Price-to-Forward Earnings Over Time
## Through July 23rd, 2025

Hence, the logic follows that low margin businesses with the specter of AI-induced productivity gains will also trade at ever higher multiples, and selling them because of inflated valuations vs. history will likely be premature. The Drug Distributors appear to be a good example. McKesson (MCK) is a $360 Billion revenue company with just over 1% net margins. If margins can expand as they predict customer behavior slightly better and benefit from other measures, they may not need 51,000 employees. The market has begun to reward this dream of net margin expansion, and MCK now trades at all-time high valuation levels (see below). Our view is that if you use valuation and short stocks that are recently more expensive, you are at risk of shorting stocks the market thinks are likely to be AI productivity beneficiaries, NOT shorting things that are likely to have mean-reverting valuation in the short-term.

## MCK Price-to-Forward Earnings Over Time
## Through July 23rd, 2025
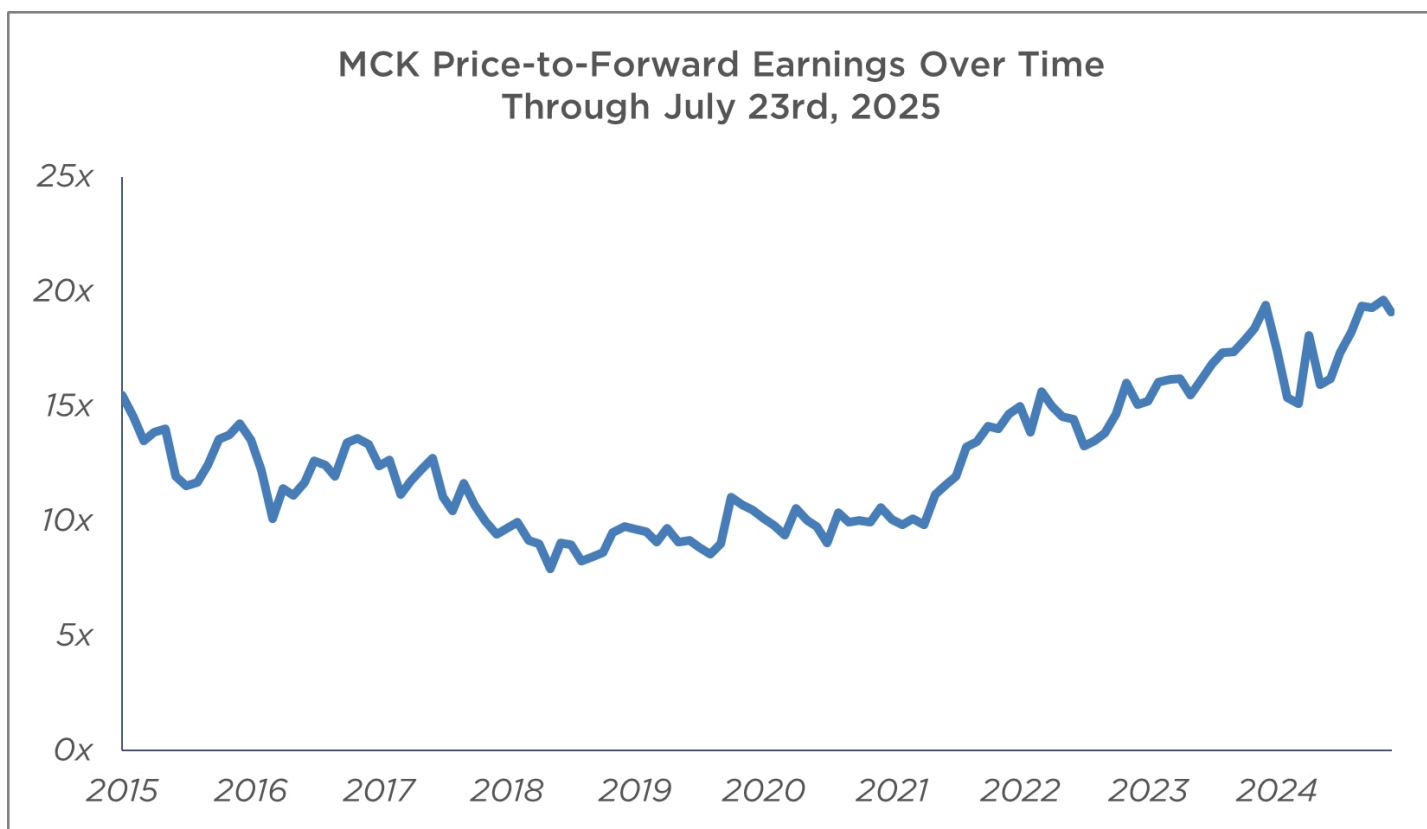


Source: Trivariate Research, LP

- **Impregnable to AI:** There is another part of the market that might not benefit from AI on the revenue line, and may not be early adopters to benefit on the productivity side, however, they also could see multiple expansion because of AI. What are these stocks? They are companies that have revenue models that are highly likely to be impregnable to AI. Why would this cause relative multiple expansion? Because these companies should have more achievable long-term estimates, say 2030 revenue estimates, than stocks that have revenue lines that are not impregnable to AI. Toilet paper, water, aggregates, waste disposal, and nicotine-like products are among those that currently come to mind as unlikely to be disrupted. Below we show the price-to-forward earnings of Waste Management Inc (WM). Shorting it (or not owning it) because it has gotten increasingly expensive would have been counter-productive because the perceived sustainability of their business model in an AI world is above average.

WM Price-to-Forward Earnings Over Time
Through July 23rd, 2025
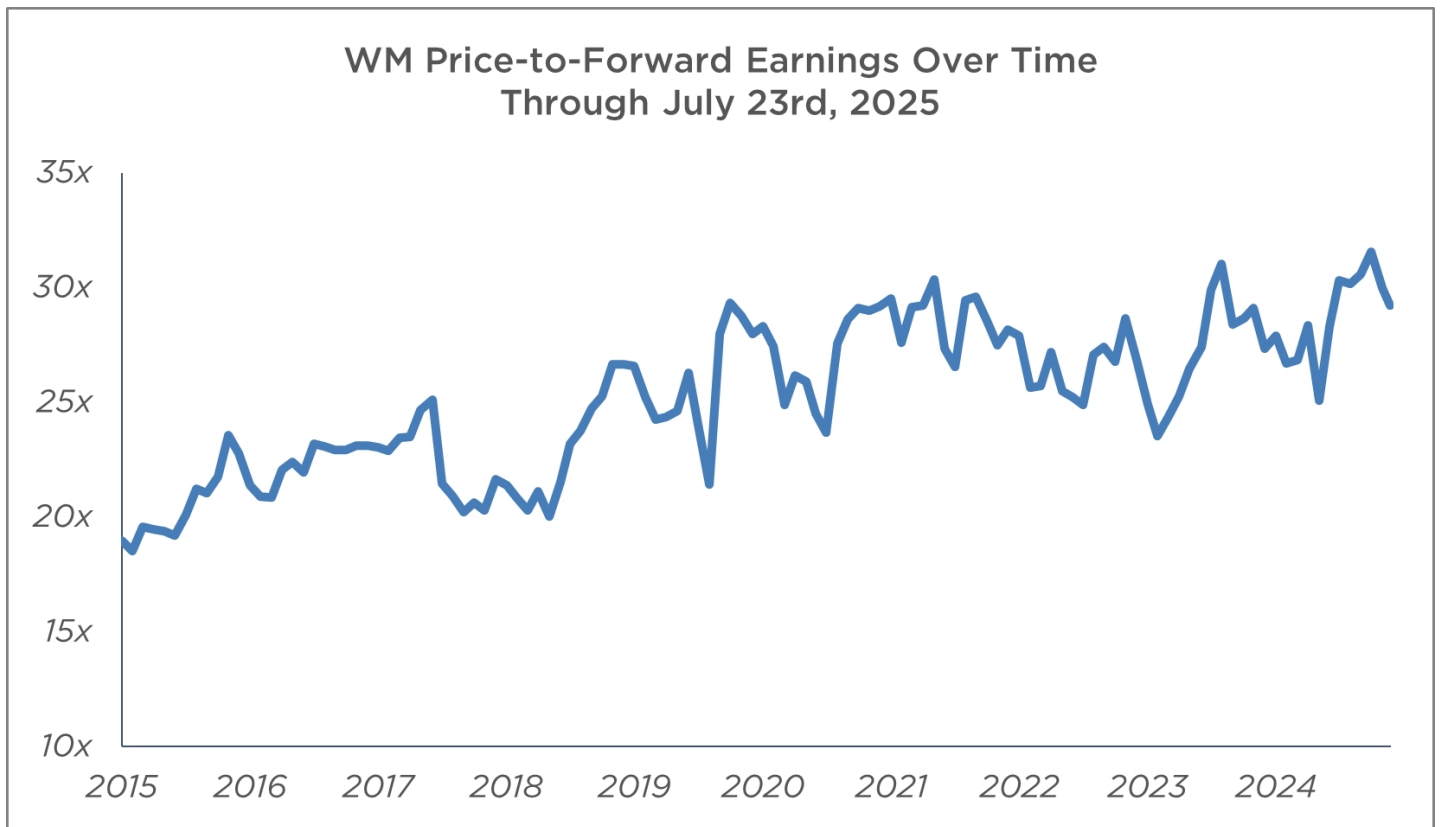
Source: Trivariate Research, LP

- **Potentially Disrupted by AI:** Lastly, there are stocks where the revenue model is potentially disrupted by AI. Naturally, the valuation has gotten cheaper. While years ago stocks with cheaper valuation might have been opportunities as investors bet on mean-reverting multiple expansion, AI probably means the opposite - that these stocks are cheaper for a reason - and that reason is a high potential of an impaired outlook. A good example of this is Getty Images (Ticker: GETY), where AI-generated content will create a threat to their model. The fact the multiple has steadily eroded for three years isn't a signal to buy it because it is underappreciated, it is on average for stocks like it, a sign that things could go wrong.



GETY EV-to-Forecast Sales Over Time
Through July 23rd, 2025
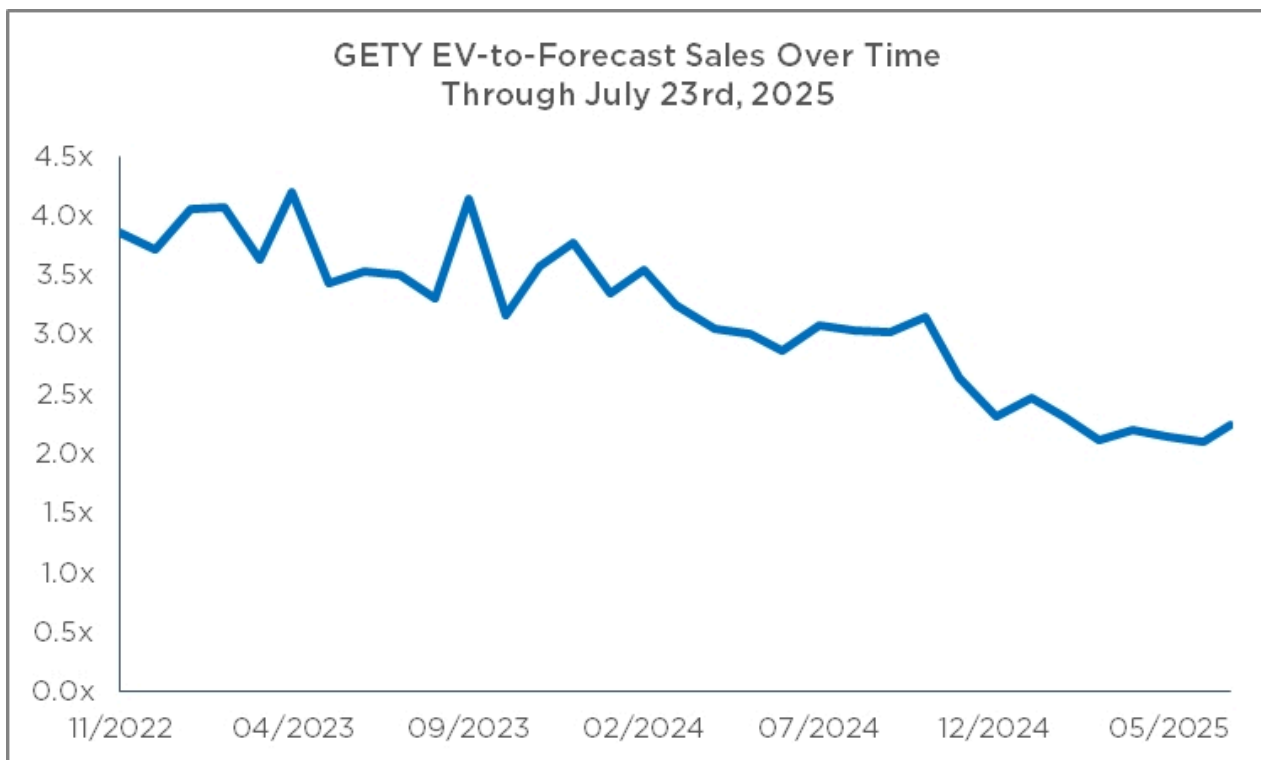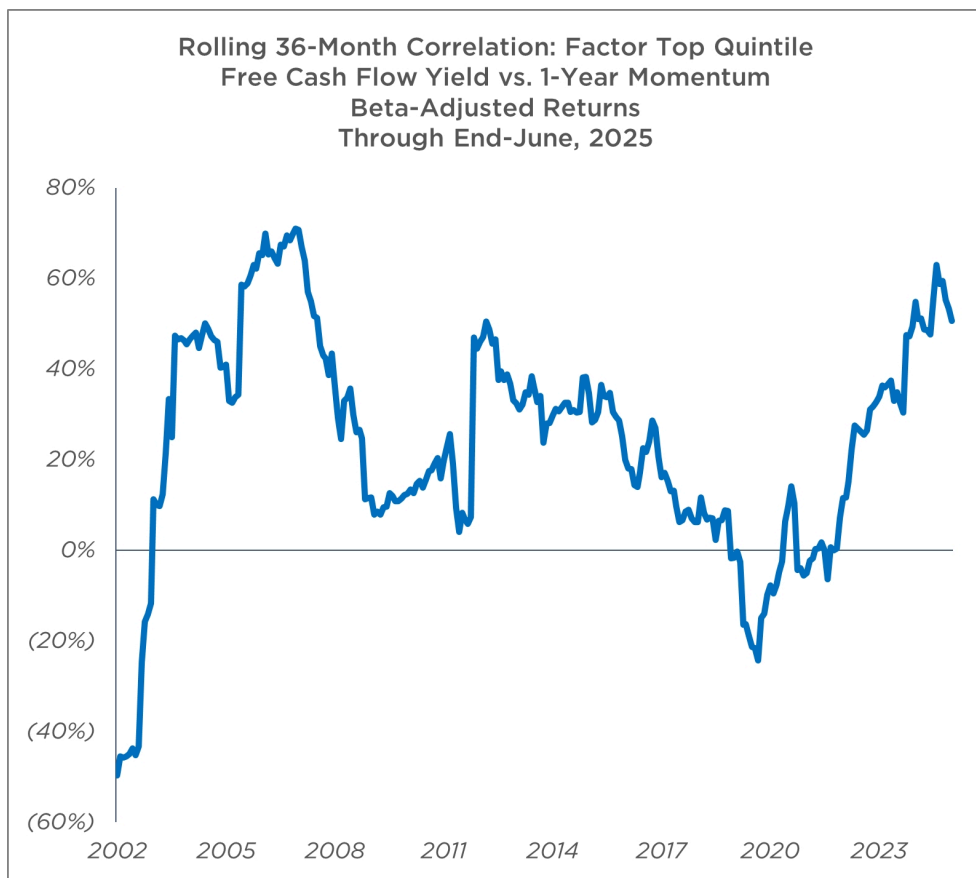
Source: Trivariate Research, LP

**In summary, the evolution of AI, through companies that benefit on revenue, benefit on margins, are impregnable, or are disrupted by AI will create changes in valuation that are NOT necessarily signs to sell expensive and buy cheap - but in fact, the contrary.**

## #2 The Way Quantitative Money Is Managed

Another contributing factor to the lack of efficacy of valuation as a stock selection metric is the change in the way much of the quantitative or systematic strategies have evolved. Years ago, many quantitative investors would take basic factors from the balance sheet, income statement, and cash flow statement and combine them with valuation and momentum to rank stocks in a quantitative model. For years, in the 1980s and 1990s, these top vs. bottom quintile quantitative approaches generated 8-10% un-levered returns. But that approach is a tale of yesteryear. Most quantitative money is now run with a high amount of leverage, 6-12x, market, sector, and importantly factor neutral, with extremely diversified portfolios (100s of longs and 100s of shorts), and with a 3-hour to 2-day time horizon. Importantly, these strategies, which most multi-strat firms have as many as three dozen teams employing, purposely do not participate at all when a company reports earnings, as something about the P&L of the company being updated DESTROYS the alpha of the algorithm. Following the earnings reports, the quantitative strategies then reemerge, and use the extra liquidity that often occurs to implement the strategy. This is why often fundamental investors own a stock, it beats earnings and appreciates, then in the subsequent days it bleeds back much of the earnings-day alpha. The valuation is not relevant for all these investors, because they are intentionally valuation neutral, and have incredibly short holding periods. **They can be long and short stocks in each valuation decile, and be completely and purposely indifferent.**

## #3 Retail investors Are Less Valuation Sensitive

Retail flows are clearly influencing markets more recently. We saw this post- the "Red Sweep" last Fall, and in Q2, when low quality or "junk" growth stocks outperformed. Years ago, we hosted a Quantitative Conference at Morgan Stanley with World Quant's Founder Igor Tulchinsky. He was presenting in front of a group of nearly 300 quantitative-focused investors on how the team produces millions of signals a year. I asked him to give us one such signal, and he replied "low price." Everyone in the room laughed. When I walked out of the meeting, I realized he wasn't kidding. In many emerging countries of the world, and frankly among some retail investors we talk to, the investments in equities appear to be denominator-less. That is the reason why stock splits work. A group of investors thinks lower price means it is a better value. Or, they mostly care about prior momentum, not knowing in most cases that this trend following / factor timing world is filled with many researchers. Historically, valuation and price momentum were considered anti-correlated, and hence these signals were regarded as diversifiers in systematic investment approaches. Today however, the correlation between the two is near a 20-year high. The 36-month rolling correlation between the top quintile on Free Cash Flow Yield and the top quintile in 12-month price momentum is at its highest level since before the Financial Crisis. Expensive growth stocks keep working.

**Rolling 36-Month Correlation: Factor Top Quintile**
**Free Cash Flow Yield vs. 1-Year Momentum**
**Beta-Adjusted Returns**
**Through End-June, 2025**

Source: Trivariate Research, LP

## #4 Valuation Has Not Worked for a Long Time

Another reason to think valuation is not likely to work is that frankly, it really hasn't worked to pick stocks for a long time. In fact, the performance of the cheapest quintile of stocks on price-to-forward earnings is inferior to those in the most expensive quintile over the last decade (see below).

**Price-to-Forward Earnings Q1 vs. Q5 Spread**
**Top 500 US Equities**
**Through End-June, 2025**
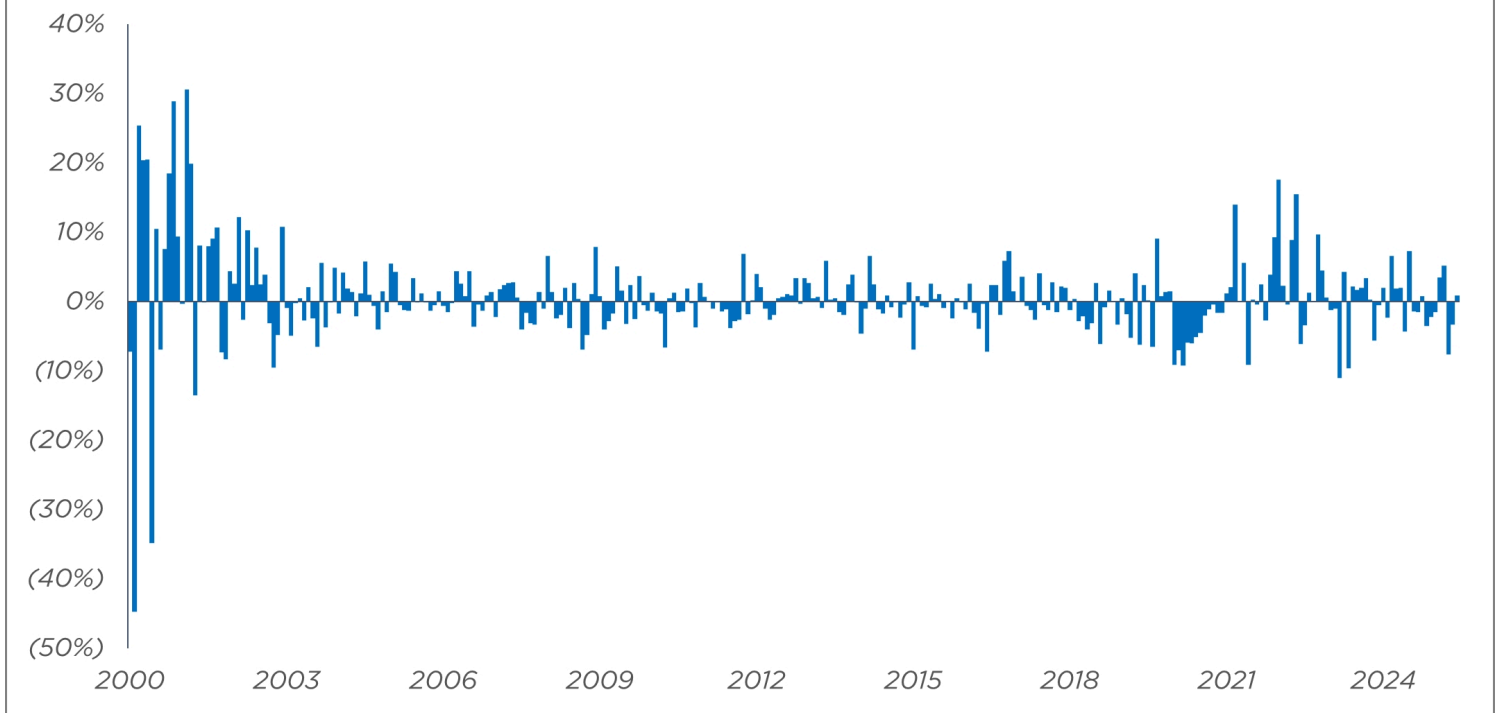
Source: Trivariate Research, LP

## #5 Behavior into a Recession

Over 25 years ago, it was common to buy stocks prior to a recession if they had gotten cheap. The argument put forward at that time was that you could buy them because they were already discounting a recession. Analysts would look at historical loss rates, and argue that above normal recession losses were in the price to accompany their company upgrades. But that behavior is no longer relevant to today's markets. We studied multiple expansion, multiple contraction and relatively little movement on valuation prior to the several recessions to see if the prudent investment ideas were to buy those stocks that had seen recent multiple contraction. In fact, the results were the opposite. Stocks with the most multiple contraction prior to recessions still performed the worst during the recessions, because on average the market was right to take down their multiples in an anticipatory fashion, because their fundamentals got most impaired during periods of economic weakness. That same logic applies more broadly to investing today, as we described in how we think about AI's impact on valuation levels. **Getting cheaper isn't an opportunity, it is a sign the distribution of future fundamental outcomes are less optimal.**
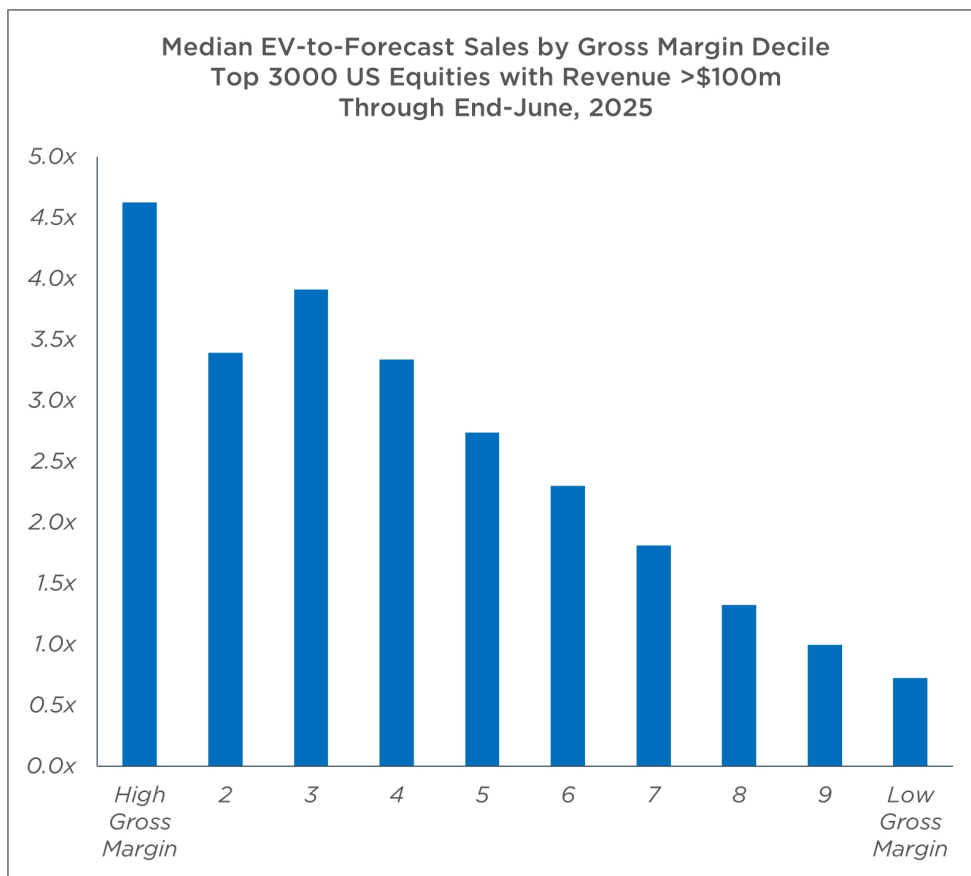
## #6 Valuation Is Related to Margins

Another reason valuation hasn't worked well is that multiples are highly correlated to gross margins, and profitability is high across the board for most US companies. Believing overall market valuations will come down is equivalent to saying that margins will come down. This is why most who follow our work have likely observed that we focus our analysis on themes that introduce volatility into the outlook for margins. Mega-cap margins have been volatile but have steadily risen over the last 25 years (blue line below). The rest of the top 500 companies have also experienced an upward trend in profitability, but are not back at the highs achieved prior to the inflationary period after COVID.

**Median Gross Margin by Market Cap. Group**
**Ex-Financials & Real Estate**
**Through End-June, 2025**
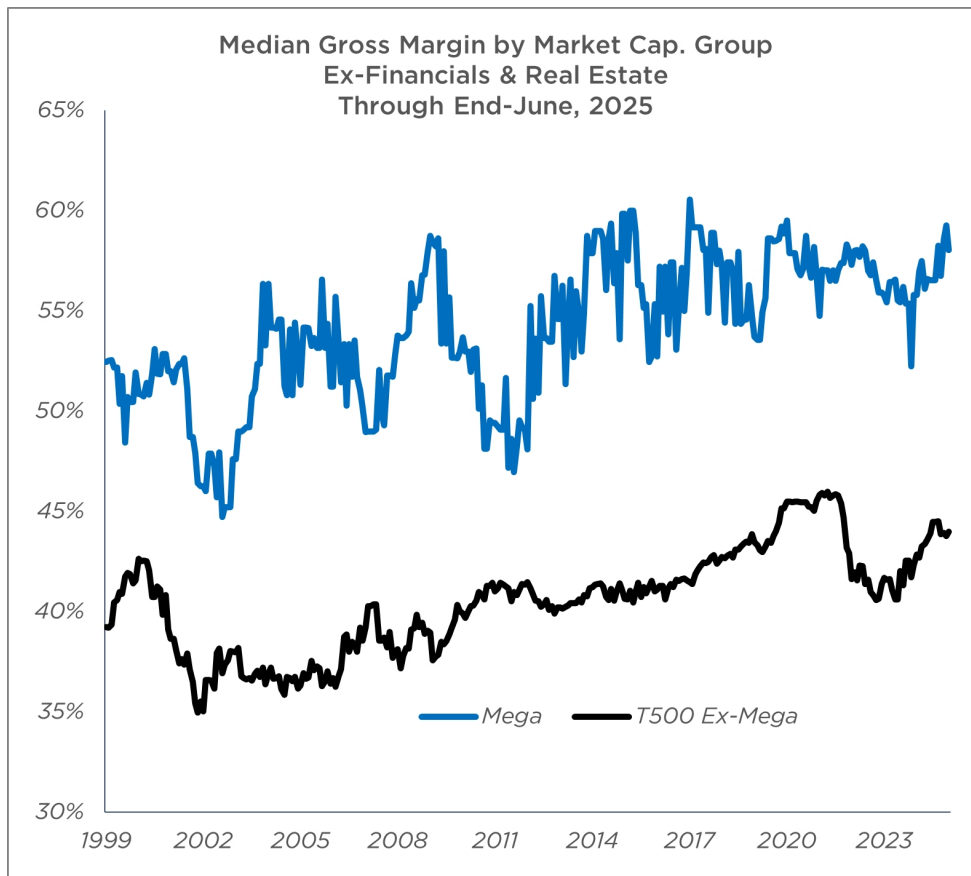


Source: Trivariate Research, LP

We think gross margins are likely to go higher for the median company. The economic backdrop seems reasonable, many companies are maintaining pricing power, and the dollar has weakened, all fueling the base case of margin expansion. A combination of lower capital intensity for the median company, less wage pressure, and lower input costs, also clearly helps. So valuation might continue to fail as an overall metric as long as gross margins can trend higher. The relationship between gross margin level and valuation is shown below.
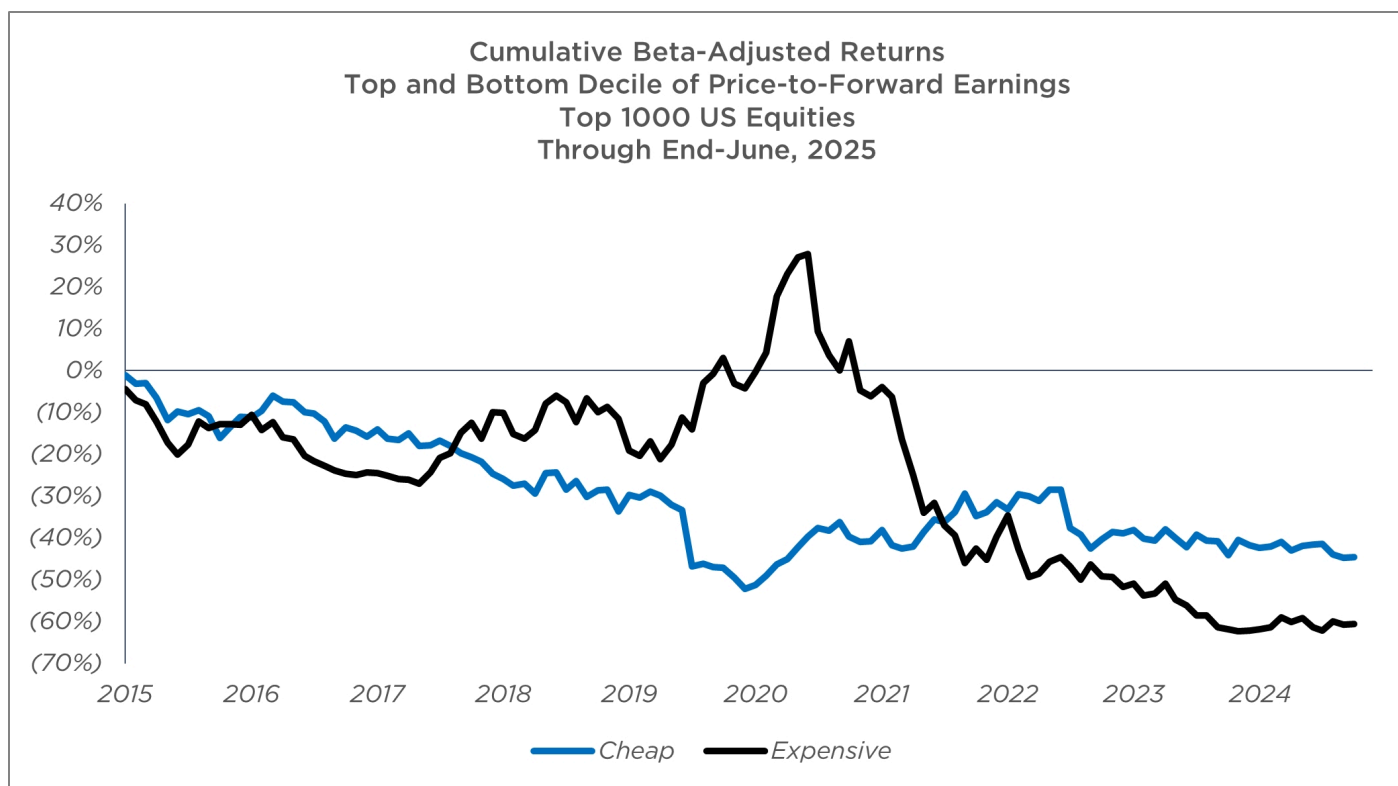
**Median EV-to-Forecast Sales by Gross Margin Decile**
**Top 3000 US Equities with Revenue >$100m**
**Through End-June, 2025**



Source: Trivariate Resarch, LP

## Important Caveats

**There are three major caveats we have studied about valuation worth mentionin**g.

1. Extremely expensive companies should be avoided. We have written in the last year about new ascendants to above 50x earnings (like COST above), and context around extremely expensive stocks like PLTR. In fact, the most expensive decile on price-to-forward earnings does materially lag on a beta-adjusted basis (see below). But, the cheapest quintile also materially lags. We wrote late in 2024 that 12x price-to-forward earnings was *cheaper* than 6x price-to-forward earnings to hammer home that point. So, the caveat is EXTREME valuation (top and bottom decile) should be avoided, but in between, valuation is not likely to be a great metric to distinguish winners from losers. **Other metrics, like gross margin expansion, free cash flow growth, revenue acceleration, and price momentum, are likely to be better!**

**Cumulative Beta-Adjusted Returns**
**Top and Bottom Decile of Price-to-Forward Earnings**
**Top 1000 US Equities**
**Through End-June, 2025**



Source: Trivariate Research, LP

2. Another important point is that investing seems to be a lot about changes to the perception about growth and changes to the perception about rates. Interest rates and a hawkish Fed were statistically significantly associated with changes to the price-to-forward earnings of growth stocks in 2022, as an example.

3. Years ago, with former colleague and legend Marty Leibowitz, we published some work on the efficacy of equity risk premium to choose S&P500 allocations. We found ZERO predictive power in time frames less than three years, some usefulness in the 3-5 year time frame, and reasonable efficacy in periods 5–10 years in the future. Our suspicion is that this is also true for valuation efficacy. If we (and investors) were able to predict growth and margins 10-years from now, we would likely have a pretty good grip on valuation multiples at that time. But, alas, the average growth stock has less than a 5-year half life, so this isn't that easy!

## CONCLUSION

**Using valuation to pick stocks can almost be thought of as arrogant or incompetent in many cases at this point.** A powerful combination of AI's influence on multiples, quantitative investors being valuation-neutral, retail investors' insensitivity, the impact of rising margins, the predictive and anticipatory nature of investors akin to pre-recession trading, and the sustained period of inefficacy are all logical reasons to be skeptical that current valuation metrics and levels matter for stock selection. That being said, we would avoid very cheap and very expensive stocks.

# Important Disclosures

## Analyst Certification

The analysts, Adam Parker, Maxwell Arnold, Chang Ge, Colin Cooney and Ryan McGovern, responsible for the preparation of this research report certifies that: all the views expressed in this research report accurately reflect the research analyst's personal views.

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