"Efficient market theory says that millions of people doing research following every movement of every company is how they come close to predicting earnings. If you are buying an ETF or passive investment in an index, you are not doing that kind of research. ETFs and passive investments by their very nature are beginning to build inefficiency in the market and that I don't believe will be resolved happily."
– Art Cashin, UBS

October 31, 2017

FAANG Envy

We are currently suffering an acute case of FAANG envy.

We have not felt this disconnected to the stock market since the height of the dot-com bubble. At its apex, valuations accorded to many technology companies could not be justified utilizing any commonly used analytical methodologies, so analysts devised a brand-new set of metrics, such as "eyeballs," and largely abandoned tried-and-true methods such as price-to-earnings and price-to-book. In justifying these valuations, analysts frequently uttered the five most dangerous words in an investor's lexicon: "It is different this time."

A few years ago, CNBC investment pundit Jim Cramer came up with the acronym FAANG as a buzzword for five of the most popular and best-performing tech stocks: Facebook, Apple, Amazon, Netflix, and Google (now Alphabet). As of mid-September, these five stocks accounted for approximately 40% of the S&P 500's gains this year.

The valuations of these five companies, as well as those of some other high flyers, are beginning to become troublesome and are approaching levels not seen since 1999. For example, Netflix currently has a market capitalization of ~$83 billion, which equates to a price-earnings ratio of 195x. Compare that to Time Warner, which owns HBO (among many other valuable assets such as Turner Broadcasting and Warner Brothers Studio) and has a market capitalization of ~$77 billion and a price-earnings ratio of 16x.

Another example is Tesla. Once again, fundamental analysis is being replaced by hopes and dreams with little in the way of substance. Tesla requires repetitive capital raises to fund persistent capital losses. This necessitates bullish analysts and holders to keep the stock aloft with projections of imagined earnings from future products while ignoring the existing business, which continues to lose vast sums of money.

Tesla de-emphasizes earnings under generally accepted accounting principles to make results look better, and much of Wall Street blindly follows along. For example, stock options are widely distributed to Tesla employees as a form of compensation, diluting the holdings of existing shareholders, yet they are never counted as an expense (which they most certainly are).

After Tesla's last bond offering, nearly $10 billion in debt stands against $5 billion in equity for a company that burns through billions of dollars each year. *The number of shares outstanding rose to 165 million this past June, up from 140 million a year earlier.*

Tesla enjoys a market capitalization of almost $57 billion, slightly less than General Motors' $65 billion. As already mentioned, Tesla loses billions of dollars, while GM earns over $900 million a year. General Motors, the largest automaker by sales, delivered about 10 million vehicles globally last year, or more than 27,000 a day. Tesla delivered 84,000 vehicles last year and expects to deliver 500,000 next year, a sizable leap (which involves significant execution risk). Tesla shares are up 57% this year, while General Motors shares have advanced 30% during the same time frame.

Value investing is mired in one of its worst stretches on record, prompting concerns that this investment style, favored by generations of fund managers, might be losing its relevance. Value stocks have significantly lagged behind their growth stock counterparts this year, extending a gap that has persisted in many of the years since the end of the financial crisis. Since the Great Depression, the notion that a new paradigm would replace value investing has repeatedly surfaced. Those predictions have, until now, always ended poorly. We see no reason why this time should be any different.

As mentioned earlier, the market's attraction to high-flying stocks punished value investors in a similar fashion during the dot-com bubble. Growth stocks beat their value peers toward the end of two major bull markets that peaked in 2000 and 2007, before large market selloffs reversed the trend, putting value ahead. During the dot-com mania, we did not purchase a single internet stock and were repeatedly referred to as dinosaurs. We were frequently told that buying intrinsically undervalued businesses had lost its relevance.

Needless to say, it was frustrating watching companies with no earnings and questionable prospects become market darlings while businesses with solid balance sheets and favorable long-term potential were neglected. However, we stood by our investment philosophy, and while we did not participate in the upside, we more than made up for any underperformance when the dot-com bubble burst and our investing style came into vogue again. The NASDAQ, a technology-laden index, gained 85.6% in 1999, the largest annual percentage gain for a major market index in U.S. history—but during the following 30 months, that index plunged 78%.

As indicated earlier, we are beginning to experience that same lonely feeling as stocks like Tesla and Netflix have become the market leaders and our style of investing has underperformed. Our bet is that history will once again repeat itself and that purchasing companies at discounts to their private market value will prove to be the best way to invest over the long term.

Performance Results

While most of our accounts increased in value during the third quarter, we trailed the leading indices. The S&P 500 and the Russell 2000 returned +4.48% and +5.67%, respectively. Our underperformance was largely due to our cash position, as well as by our lack of exposure to high flyers such as Apple, Facebook, Amazon, and Tesla.

As we have discussed in previous letters, in a robust bull market, a large cash position will likely impede performance, particularly in a low-interest-rate environment where cash generates little or no return. However, if we had not had cash during the financial crisis in 2007 and 2008, we couldn't have taken advantage of the incredible bargains that became available. So, we are willing to let cash weigh on our performance in bull markets. While there's a significant chance that we will underperform, we believe that a good investor can more than make up for it during severe market disturbances. Remember, market corrections are an integral part of the investment process: without them, you could never buy quality businesses at bargain basement prices.

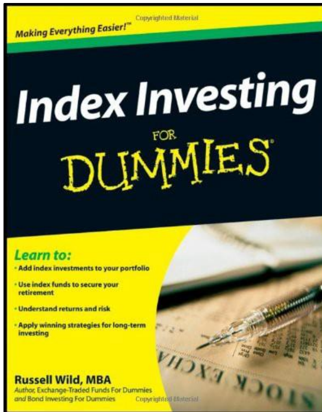
Some Thoughts About the Market

Over the past five years, index funds have outperformed the vast majority of active managers, causing even more investors to realize the now obvious answer to what they should do with their money: put it in an index fund.

Can this go on forever? We think it highly doubtful. While indexing is efficient and currently effective, there has never been a very good investment idea that hasn't been taken to a foolish extreme (the nifty fifty, the internet craze, conglomerates, and mortgage-backed securities, just to name a few). As Warren Buffett likes to say, "What the wise man does at the beginning, fools do in the end."

So where do we go from here? Indexing seems to presume that all companies should be purchased regardless of their current valuation and future business prospects. That is most assuredly not the case. As indexing grows in popularity, the valuation spread between great and mediocre companies should continue to narrow. This development ought to bode well for value-oriented stock pickers.

As we indicated in our last letter, the five largest companies within the S&P 500 and the Nasdaq 100 generated the bulk of the market's returns during the current year. This can partially be explained by the significant inflows that index funds experienced over the same period. The S&P 500 is market-cap-weighted (meaning that the largest companies are given significantly more weight than smaller companies). For example, Apple, the world's largest public company, is ~3.6% of the S&P 500, and News Corporation, which is the smallest stock in the S&P 500, constitutes ~0.0069% of the index.



This means that Apple's weighting is ~521xs that of News Corporation. As money flows into the index funds, these vehicles become "forced buyers," as they are mandated to buy stocks in the exact proportion that the index they track prescribes, regardless of a given company's underlying fundamentals. XYZ Company could be on the verge of bankruptcy, but if it has a 1% weighting in the S&P 500, index funds must purchase a 1% position in the company. These "forced buyers" have, in part, caused some of the largest companies to trade at levels that cannot be justified by traditional valuation methodologies.

History Tells Investors to Stay Clear of Apple Shares

A recent *Wall Street Journal* article penned by Colin Barr shows that historically, it has been prudent for investors to steer clear of the most valuable U.S. company. The S&P 500 listed company with the largest market value has steadily lagged behind the broader index over the past 45 years, accumulating a deficit of more than 8,000 percentage points, according to data compiled by Ned Davis Research Inc.

That means that the decision to buy the most popular U.S. stock—which at various times has meant AT&T Inc., Alphabet Inc., Cisco Systems Inc., Exxon Mobil Inc., Altria Group Inc., General Electric, IBM, Microsoft Corp., or Wal-Mart Stores Inc.—has almost invariably cost investors significant sums. Some of those firms continued to excel as businesses, and others began to cool off. But performance is only part of the story.

More likely, the large gap (a cumulative gain of 8,773% for the S&P 500 total return index vs. 700% for the largest stock group) points to the limits of prospective returns on investments that have already appreciated significantly (as, by definition, the largest company's shares have already done). ***Momentum is a powerful thing, but eventually, the law of large numbers starts to work against you.***

If history is any guide, it is probably a good time to sell Apple. Since Apple represents almost 4% of the S&P 500, a selloff in the name could be a future drag on that index.

That dynamic may well extend to firms beyond Apple. Four out of the five largest S&P 500 stocks currently are the technology firms often extolled in the press and on Wall Street for their supposed alacrity as "disrupters" of the competition. Each of these high-flying technology companies is up at least 17% this year, causing many investors to question whether the biggest tech stocks are "priced for perfection."

Analysts continue to expect Apple shares to soar, and why not? The firm's future revenue outlook, bolstered in part by the 10th-anniversary iPhone, looks promising. Despite having posted a 14% annual return since 2012, Apple shares still trade at a discount to the overall market. Even so, the company's value implies some hefty expectations. With almost $800 billion in market value, you could purchase the entire S&P small-cap index and still have some $90 billion in walking-around money. We think we would rather own the latter.

Below please find an excerpt from an article that recently appeared in the New York Times which we found to be particularly interesting. Much have been made of so-called "unicorns" which are private businesses that are worth at least $1 billion. With ~135 companies that have supposedly achieved unicorn status, they are not nearly as rare as their name would imply. However recent academic research puts into question if these companies are nearly as valuable as their investors (and the press) claim them to be.

How Valuable Is a Unicorn? Maybe Not as Much as It Claims to Be

Uber is said to be worth $62.5 billion. Airbnb is valued at $31 billion. Elon Musk's SpaceX Technologies is valued at $21 billion, and Pinterest at $12.3 billion.

Those eye-popping valuations regularly fill articles and water-cooler conversations in Silicon Valley, all under the umbrella of "unicorn" companies — a term for private companies that are said to be worth more than $1 billion. That moniker now applies to at least 135 businesses, making the descriptions of them as unicorns, well, less apt. (Maybe donkeys?)…

Here is some bad news for them: Those valuations may be a bit of myth — or perhaps wishful thinking….

Ilya A. Strebulaev and another professor working with him, Will Gornall of the University of British Columbia, have come to a startling conclusion: The average unicorn is worth half the headline price tag that is put out after each new valuation.

And if the special side deals that most unicorn companies offer to certain investors — more on this sleight of hand in a moment — are taken into account, almost half of the companies would fall below the $1 billion threshold… Big mutual fund companies like T. Rowe Price and BlackRock have aggressively begun investing in unicorn companies in recent years on behalf of public investors — yes, you may own a stake in Uber and not even know it — helping to increase the valuations even further.

And even the big public mutual funds, the researchers contend, are not properly valuing the assets. "It is inappropriate to equate post-money valuations and fair values," the professors said, explaining how, more often than not, public funds use the headline price that comes after a round of financing, and don't distinguish between various types of shares.

One of the many ways that some companies inflate their valuations, for instance, is by offering certain investors guaranteed valuations in an initial public offering. In other words, if a company doesn't reach a certain valuation at the time of an I.P.O., it will issue the investor more shares to make up the difference between the guaranteed price and the one that was attained. Effectively, all the other common shareholders end up paying the difference — and often don't know it…

Mr. Strebulaev said he was shocked when he dug into the contracts of the different fund-raising rounds. "The overvaluation is so large because many of these companies use sophisticated contracts that benefit some investors at the expense of other investors," he said. Without identifying a particular company, he said some of the deals were "mind boggling."

When Mr. Strebulaev first circulated a draft of his paper, he said, “a number of companies contacted me, or, rather, their general counsels contacted me.” He encouraged them to point out mistakes or factual errors. “I haven’t heard back from them,” he said.

To cite one example from the research: In 2015, Appdynamics issued a Series F round with special terms for certain investors, including “a provision offering a 20% bonus in down I.P.O.s,” meaning one that fell in price. Legg Mason, already an investor, then revalued its shares in the company at a higher price, “despite not being eligible for the 20% bonus,” the professors wrote…

In another example, the professors found that sometimes a fund-raising round painted an overly “rosy picture.” As an example, the professors used a particular fund-raising round from nearly a decade ago for SpaceX, arguing that “SpaceX’s value actually fell in 2008” while its reported valuation went up. The researchers said investors that year “were promised twice their money back in the event of a sale, with that claim senior to all other shareholders.”

“That guarantee increased the price those investors were willing to pay for SpaceX shares,” the professors said, “but did not alter its true value.”

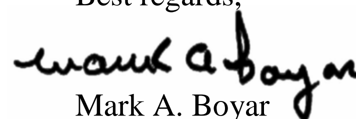
Still, the professors were quick to say they did not believe that these terms were meant to manipulate investors.

And therein lies the rub: It is not clear that the intent of these “headline” valuations is to trick anyone. But they may very well be doing just that.

Excerpt from an article that appeared in The New York Times on October 17, 2017

If you have any questions or comments, please do not hesitate to call.

Best regards,


Mark A. Boyar

Jonathan I. Boyar

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