Bubble Investing:

October 19, 2020

The "Downside" and Upside of Value Investing in Frothy Markets

There is a basic side effect of value investing that has been on my mind for the past few months. Viewed from one perspective, it can be seen as a "downside" of value investing, but looked at properly, it is actually one of value investing's strengths. In one word, I am referring to missing out on Momentum. In a harsher, often more accurate word, I am referring to "missing out" on Bubbles.

One of the most powerful investing combinations is when a company not only grows its business rapidly, but at the same time its stock is re-rated from a "value" stock to a "growth" stock. In such a fortuitous intersection of events, the investor gains in three distinct ways. One, the investor gains from having bought the stock cheaply and its multiple returning to fair value. Two, the investor gains from the intrinsic growth of the underlying business. And three, quite often, the investor additionally gains from the stock multiple rising to the high levels afforded to "growth" stocks. This trifecta pushing the stock valuation upwards can often net the investor multiples of his original investment within the space of months.

At times, this re-rating goes even further, as stock multiples and valuation metrics reach stratospheric bubble levels, giving investors their investment back many times over. This is not at all uncommon. As a value investor, we understand that markets are not at all efficient, and just as stocks tend to overshoot their true valuation to the downside, they often overshoot on the upswing as well.

But true value investors miss out on much of the re-rating and the massive upside that comes with it. Because as valuation rises and multiples stretch, and as the risk/reward profile starts to tilt more heavily in the high-risk low-reward direction, value investors will lighten and eventually exit their position, even as it continues to skyrocket onwards. This is the "downside" of value investing – that even when they are on the right side of a new trend or change in momentum, even when the masses flock to a stock that they are already invested in for all the right reasons and their investment becomes the new "in", the value investors themselves often miss out on a large share of the gains, sometimes even the lion's share.

This is exactly as it should be. Because if the value investor falls prey to the temptation to hold on as his position becomes trendy, if the value investor does not sell his position when it reaches a conservative estimate of intrinsic value, then what will tell him when to sell? If the value investor no longer practices value investing, what then is he practicing? Yes, the value investor misses much of the run-up, but he also sidesteps the bubble bursting – and when stock multiples reach unwarranted stratospheric levels, the bubble inevitably bursts, and painfully so. ***Valuation always matters.***

Why am I thinking about this now?

Well, a couple of positions that we narrowly missed investing in or that we exited "early" prompted the majority of these thoughts, as well as certain general trends in the broader market today.

Exhibit number one is Peloton. For those unfamiliar with their story, Peloton sells connected exercise equipment (exercise bikes, treadmills, etc.) with large screens that connect to live and on-demand fitness classes covering the gamut of class types, skill levels, and lengths. They sell their high-end equipment for a premium price, with the gross margin intended to cover the marketing spend needed to attract new customers and the meat of the business being the recurring monthly subscription revenue. Even before they went public, we were intrigued by their products and business model, and we spent significant time researching the company. Ultimately, we chose not to buy stock when they went public a year ago, mostly due to valuation.

Somewhat predictably, Peloton benefited from general lockdowns and gym closures, but perhaps less predictably, they benefited to an extent few dreamed. In the months of April-June, subscriber growth charged ahead, revenue almost tripled, and the company swung from a moderate loss to strong profitability. And even as lockdowns have waned, business momentum remains strong. The stock responded by skyrocketing from a March low of about \$20 to its recent close of about \$140, a market cap of ~\$40 billion and a gain of 7x! Would I prefer to have been invested in a stock that shot up 7x? Absolutely, but only if I don't have to forgo my deeply-held investment principles to do so. At present inflated prices, Peloton is a ridiculously speculative and risky investment. The amount of growth that must occur in the future to sustain the present price is extreme, and I, for one, do not want to be there if and when that bubble bursts.

Exhibit number two is Apple. Long-term investors in Focus Capital Management know that Apple was our longest held position, going back to the Fund's inception (and for the Fund Manager in his personal investing, going back even further to 2005) until we finally sold our position at the end of 2017. At the time, we explained our thinking behind our decision in our 2017 Q4 letter.

> Apple is a great company. Truly a great company. But valuation matters. Valuation always matters. And with the stock having almost doubled over the last eighteen months, we no longer see Apple as deeply undervalued. Please note that I am not saying that Apple is overvalued. With a P/E of 18.9 and a P/E ex-cash of 16.3, we see Apple as fairly valued. It is possible, indeed likely, that Apple will continue to rise. Compared to the S&P 500's P/E of 22.4, Apple is certainly more attractively priced. But when looking to invest, we at Focus Capital Management do not search for value on a *relative* basis. We search for opportunities to significantly grow our and our investors' capital on an *absolute* basis, with a high margin of safety. In short, we look for *deeply undervalued* companies. And although Apple may be fairly valued, we no longer see Apple as deeply undervalued, and we do not see it as an attractive opportunity for the Fund going forward.

Since the fund sold Apple, the stock at first drifted sideways for about eighteen months, at which point it took off and, except for a brief drop together with the overall market in March, has not looked back. In less than sixteen months, the stock has tripled. Did we sell too early? Let's take a look at where the recent stock gains have come from. Have they come from super-amazing performance of the underlying business or from a sudden switch in market sentiment? Well, Apple the company has seen impressive EPS growth over that time period, up about 37%. But that's a far cry from the triple their stock price sustained, which is mostly attributable to a massive re-rating of their multiple to the present P/E of 37. Is Apple a great company? Absolutely. Was it deeply undervalued three years ago at a P/E of 19? Is it deeply undervalued now at a P/E of 37? Absolutely not. I have no regrets.

Are we in a bubble now?

Which brings us directly to the present stock mania surrounding big tech. A person looking at the S&P 500's performance for the year could be forgiven for thinking that everything is fine. As of the end of Q3, the S&P 500 is up for the year, by about 4% (not including dividends). But hidden beneath the surface of the headline number, all is not well. The majority of stocks in the S&P 500 are down for the year, with the entirety of the positive performance attributable to just a very few companies.

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Everyone likes talking about FAANG (Facebook, Apple, Amazon, Netflix, and Google/Alphabet, sometimes with Microsoft thrown in as an honorary member), so we'll start there as well. These six companies comprise a whopping 24% of the S&P 500 by weight, as much as the bottom 375 components of the index combined. For the first nine months of the year, these six companies rose 41% and between them were responsible for about 8% of the S&P 500's rise. Which means that the rest of the index, excluding these six companies, is actually *down* about -4% over the same time period!

But far more important than the bifurcation of the market's performance is the valuation being afforded these extremely large stocks, valuations quite unusual for behemoths of their size. Valuations range from P/Es of ~35-40 for Facebook, Apple, Microsoft, and Google to 93 for Netflix and 133 for Amazon! But it's not just these six stocks. Throughout big tech, we are seeing inflated valuations, be it Nvidia, Paypal, Salesforce.com, or Adobe, as well as many others.

This is not going to end well. These are great companies. World-class companies. Companies with bright futures. ***But valuation always matters.*** And these stocks are priced for perfection and beyond. I highly doubt that all these companies will perform beyond perfection. It's a bubble waiting to burst, one that we want no part of, not on the way up and not on the way down.

Some might mistakenly think that this isn't a bubble. They'll tell you that this is nothing like the dot-com bubble of the turn of the century. In the dot-com bubble, companies without profit and sometimes even without revenue were trading for absurd valuations. But these companies are stalwarts of the world economy, highly profitable, with rock-solid balance sheets and significant competitive advantages. And they're right. This is nothing like the dot-com bubble. But not every bubble looks like the dot-com bubble.

If we were to look for a historic precedent, the best comparison would probably be the Nifty Fifty fad of the early 1970s. Money poured into "blue chip" stalwarts of the economy, with high growth rates and even higher valuations. There is no official list of what comprised the Nifty Fifty, but it consisted of companies like McDonald's, Walt Disney, Coca-Cola, IBM, Digital Equipment, Xerox, 3M, Black & Decker, and JC Penney, among others. The P/Es went as high as 40-50 and some even reached 80-90.

The end wasn't pretty. When the bear market of 1973-74 arrived, these high-flying stocks crashed and crashed hard, some dropping as much as 90%. Over the long-term, some of these stocks ultimately justified their valuation over decades, while others did terribly even over the long-term or even went bankrupt. As a rule, the higher the P/E to start with, the worse off the long-term performance.

In the present situation, I'm sure *some* of the stocks will end up justifying their present valuation in the long-term. Others will not be so fortunate. Valuation matters, and when paying such high valuations for growth, the risk becomes extremely elevated.

When will this bubble end?

I have no idea and no one can have any idea. Bubbles can last far longer and can go far higher than anyone would imagine. Honestly, the present bubble feels like it's in early innings yet, and compared to the Nifty Fifty, valuations have not gotten quite as out-of-hand yet. But I do know that the good times will end. How will it end? I don't know what will be the pinprick that deflates the bubble. I don't know whether it will burst with a sharp crash or whether the stocks will just stagnate for years and years as the business fundamentals finally catch up to the stock price. What I do know is that paying super high valuations for growth raises risk to extreme levels and hurts long-term performance.

If there's one thing I want you to take away from this piece, it is this. ***Valuation always matters.*** Do not get swept up by the latest hot stock, by the latest trend, by "this time is different". This time is *not* different, and eventually unwarranted stratospheric valuations *will* come crashing down, decimating portfolios and investors relying on them. We do not intend to be among them.