Learning Moments & The Experience Premium

March 9, 2021

As February ended and March began, evidence that the market rotation and correction that we have been anticipating for several months was beginning to occur. We have been so confident in the certainty of market rotation, which results in a change in equity market leadership, that we slowly began making portfolio changes several months ago. Market leadership rotations are not uncommon and when they do occur, volatility increases and a downward correction of 5% to 15% in the broad market averages typically results. However, the correction in the previous cycle big winners can be as much as 50% or more. In such a correction an active manager will welcome the opportunity to take advantage of the inefficiencies of the market and find opportunity in the "babies thrown out with the bathwater" that do not deserve to get lumped in with the over-loved, over-owned, and over-heated darlings of the previous cycle.

Warren Buffett is credited with the following quote which must be kept top of mind when markets correct:

"A market downturn doesn't bother us. It is an opportunity to increase our ownership of great companies with great management at good prices."

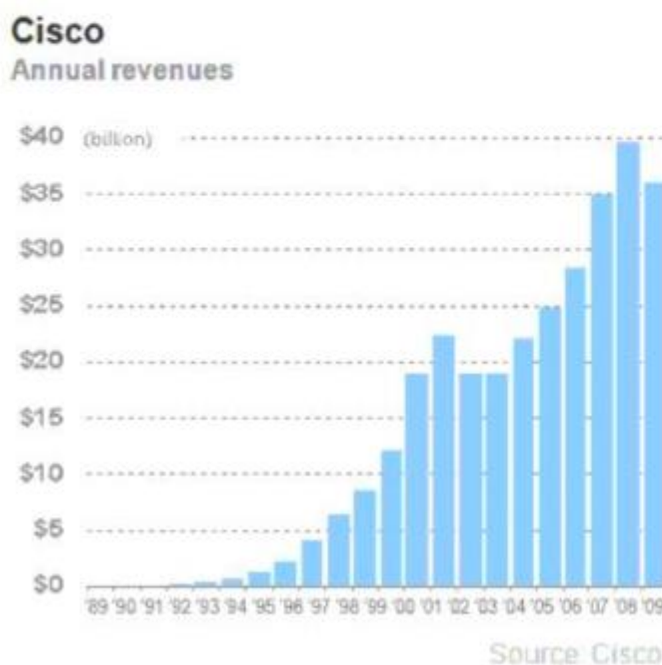
There have been few times in market history which have provided invaluable learning moment starker than the end of the "Dot.com bubble." This period, which began in 1996 and culminated in a dramatic market crash in the first half of 2000, is one of a few storied periods in the long history of our stock market. The excitement of a new age of internet, email, and networked computing blinded big and small investors into believing that traditional equity valuation metrics had been rendered obsolete. Making paper fortunes overnight on the latest pioneering internet company was commonplace for novice investors who threw caution to the wind and joined in this casino-like market. As the bubble got larger, the exuberance of investors pushed up the valuations of

both no revenue IPO's, as well as companies building out the backbone of the internet and the fiber optic networks that this new frontier was going to be built upon.

Hyper growth rates of large companies like Cisco Systems (CSCO), which were growing revenues in the late 1990's at near 50% per year, were being extrapolated forward as if they were sustainable and the "new normal." I was working at the time both managing investment portfolios and supporting a mutual fund company as one of three equity analysts. One of my sector assignments was the technology sector. I remember all the contorted justifications being made at the time for the previously unthinkable company valuations that we were seeing at the time in the technology sector. Cisco Systems, a large "new economy" technology company became identified as one of the four horsemen of the internet age. The other three were Microsoft (MSFT), Intel (INTC), and Dell Computer. Cisco was a great company, with one of the best and most visionary CEOs of that time. By 1999 Cisco was generating over $10 billion per year in revenues and its market opportunities in the U.S. and around the world appeared almost limitless. It was no wonder that by the end of 1999 Cisco's market value was nearly $350 billion, which was approaching 30X its 1999 revenues. Fifty percent growth was being priced into this stock for as far as the eye could see.

Just a few months into the year 2000 the unthinkable happened. Technology company CEO's, including Cisco's CEO, John Chambers announced that they were beginning to see a slight slowdown in growth on the horizon. This slowdown and some questionable high-profile mergers, such as upstart internet service provider AOL announcing the acquisition of Time Warner for $164 billion, signaled the beginning of the end of this epic stock market bubble period.

The lesson investors should have taken away from this period was that even the greatest most well positioned and best managed companies can get unsustainably over-valued during periods of revolutionary and transformative technological innovation. Most people, when they think about the late nineties remember the over-inflated concept companies which became worth billions when they went public, only to implode to zero when the bubble burst. However, the more valuable lesson from this period is the one illustrated by companies like Microsoft, Intel, and Cisco Systems. These were and remain great companies. For these companies, the bubble was isolated to their share prices, not their business model. As can be seen in the chart below, Cisco Systems did not stop growing after the bubble burst in 2000, in fact 2000 and 2001 revenues continued to grow substantially. For the 2000's decade, Cisco saw its revenues grow to a peak of almost $40 billion in 2008, before the slowdown caused by the Great Recession. In 2019, Cisco's revenues totaled nearly $52 billion, which is better than a 300% increase over the company's revenues in 1999.



The most remarkable graphical representation of the gross excesses that can occur when investor exuberance overtakes practical reality when it comes to stock price derived market values is shown below in Cisco System's 20-year stock chart (QUODD real time):

Over the last twenty years, despite Cisco Systems growing its top line revenues by over 300% and its profits from $2 billion in 1999 to $11.6 billion in 2019, Cisco's stock price has yet to come close to eclipsing 1999 levels. The investment lesson to take away from Cisco's twenty-year history is that great companies are not great investments at any price and at bubble valuations, great companies can be wealth destroying investments.

Just to point out that Cisco Systems was not singled out to illustrate this point, it took Microsoft stock over 15 years to reach 1999 highs and Intel, like Cisco Systems, is still waiting.

Today the revolutionary and transformative technology is an extension of the internet computing revolution of twenty years ago. Today investors are looking forward to a new world of 5G communications built upon the backbone of fiber optic networks and high-speed semiconductors, which will enable, using artificial intelligence and cloud computing, autonomous driving and high-speed internet connecting every aspect of our world. Investors envision such a future where those autonomous vehicles are powered by high output batteries and hydrogen fuel cells instead of gasoline. Like the internet in 1999, this today's technology is not science fiction, it is already transforming our lives and the excitement that this transformation is generating is not far off. Being that investors can see innovation changing the world in real time, it is not preposterous for investors to conclude that today's innovative leaders will continue to dominate for the foreseeable future.

Like Cisco Systems, Microsoft, and Intel of twenty years ago, investors were only half right. These technological leaders continued their dominance for a very long-time, but with the stock prices stretched as far as they were in 1999, these dominant technology companies could not possibly grow enough to justify such lofty expectations.

Are some of today's innovative leaders such as Elon Musk's Tesla Motors going to suffer the same fate as Cisco, Microsoft, and Intel? It is impossible to know for sure, but there are many similarities between the optimism placed upon Cisco ahead of the internet revolution and the optimism being place on Tesla Motors ahead of today's innovation driven future on which Elon Musk appears uniquely positioned to capitalize. Some have defended Tesla's "nose-bleed" level valuation by pointing to the rise of Amazon and the fact that Amazon stock always appeared very over-valued. There is no question that Amazon stock has historically been very difficult to value, but I will point out that Tesla's stock is in an entirely different league. Tesla, like Amazon was for a very long-time, is not yet consistently profitable. Tesla, like Amazon in 2012, has revenues in the low $30 billion range. However, unlike Amazon in 2012, which had a market value of roughly $100 billion, Tesla's market value at its peak 2021 stock price was north of $800 billion.

Over the last week or so, beginning during the last week of February, the market has seemingly begun what I would characterize as a rotation led correction. Companies like Tesla, and other 2020 high-flyers have come under selling pressure as investors perceive that the end of the pandemic stricken economic conditions are close at hand. This perception, along with the promise of more fiscal stimulus, is putting upward pressure on the interest rate of longer dated government bonds. This combination has seemingly triggered a rotation out of many non-dividend-paying hyper growth stocks into dividend paying companies that are more attractively valued, such as consumer cyclical and industrial companies. Thus far, the rotation is quite orderly and predictable, and we can only hope that it continues this way. Coming out of this rotation, one can expect new market leadership and stock price momentum moving over to the equities of companies which were sidelined in 2020 by the economic realities of the pandemic.

We do not expect the current rotation to be expedient and entirely orderly. Meaning, those who have come to believe that the big winners of last year will continue to outperform all other stocks for years to come will not give up their devotion to these companies easily. Thus, we expect these investors to "buy the dip" before we see the bottom of this rotation correction. The rotation cannot be completed until the will of the "buy the dip" investors throw in the towel and give up. This process can happen incrementally over several months or it can happen more abruptly with a sharp capitulation type of downward move. We are leaning more toward the incremental rotation due to the reopening and stimulus driven economic backdrop that lies ahead. Either way, rotations provide active managers opportunity to acquire and add to unduly punished stocks that get swept up in the selling frenzy.

Our message to clients, as we anniversary last spring's pandemic market plunge, is to remember that the strong portfolio gains of 2020 were born from the opportunistic actions that we took during that period of fear-induced panic selling. We have managed money through more than twenty years of market crashes, recessions, financial crisis's, and rotations. Our approach is the same. We look to take advantage of investor fear and panic to acquire ownership in companies at a significant discount to our assessment of their real-world enterprise value. Successfully implementing such a strategy requires conviction, which results from the lessons accumulated during learning moments in market history. This conviction is what enables clients of such money managers to benefit from the experience premium.

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