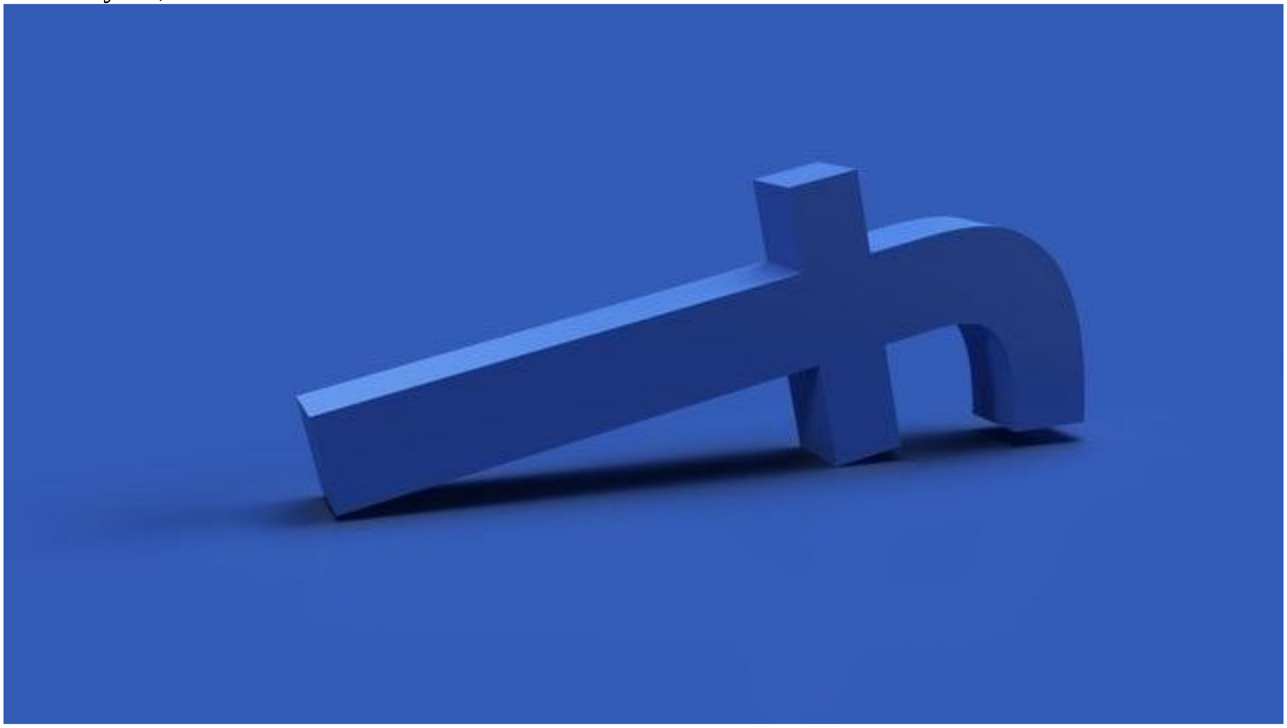
The Market Fact Checks Facebook's Market Value

Curt R. Stauffer
February 10, 2022



It is the morning of Thursday, February 3, 2022, and the stock of Meta Platforms, aka Facebook (FB), is down over $80 per share, pricing the shares at under $250 per share, after posting a very disappointing fourth quarter 2021 earnings. Put another way, Facebook entered 2022 at $336 per share, equating to a market capitalization that was $255 billion higher than it stood at on February 3rd. Facebook has given up more in market capitalization over the last 33 days than the entire market value of the Walt Disney Company.

At the end of 2021, Facebook's market capitalization, the value that its stock price implied for the company, was roughly $950 billion. I have been very concerned with the ease at which mega-cap tech companies have been awarded market values at or greater than $1 trillion. The market has rapidly elevated the value of a hand full of companies north of one trillion dollars since the recovery from the short-lived pandemic generated bear market in early 2020. These companies are Apple (AAPL), Microsoft (MSFT), Alphabet aka Google (GOOG), and Amazon (AMZN). There were a few companies at the end of 2021 that were on the cusp of breaching the one trillion market capitalization threshold; these were Meta Platform aka Facebook (FB), Tesla (TSLA), and Nvidia (NVDA). To put these market-generated values in perspective, the following companies currently have market capitalizations under $275 billion or less than 1/10th of Apple, 1/5th of Alphabet (Google), and 1/3rd of Meta Platform (Facebook) and Tesla.

Disney (DIS)	Intel (INTC)
Boeing (BA)	General Motors (GM)
Merck (MRK)	Toyota (TM)
AT&T (T)	Volkswagen (VLKAF)
Verizon (VZ)	Oracle (ORCL)

Caterpillar (CAT) Lockheed Martin (LMT)

The "mega-cap" tech-driven companies are indeed in a league of their own when measured through the lenses of revenue growth and cash generation. They likely deserve to be the most highly valued public companies from a discounted cash flow standpoint. The critical consideration for investors is how accurately one can forecast future period growth and cash flow generation. Should their growth rates slow due to market saturation, competition, management missteps, and regulatory constraints on mergers and acquisitions, I contend that there is a sizable air bubble under current market prices and market capitalization levels for these companies. Facebook's latest quarterly results show how fast share price and market capitalization can fall through such an air bubble of unrealistic growth forecasts.

When we think about the margin of safety in a particular stock, we are not basing that assessment on stock price volatility per se. We are basing it on the expected market capitalization trajectory over a period of years from current levels. Suppose a company that we own has a market capitalization of $1 billion but has a total addressable market many times that size. If we believe such a small company can capture a meaningful market share over time, we do not fear short-term volatility in its share price. However, when a large company like Apple, which has a $2.75 trillion market value compared to the total S&P 500 tech sector's market value of $7.5 trillion, the sheer size of the company could limit its growth. Like Facebook, any growth disappointment or reset of future expectations can expose investors to a market capitalization reset that could mark a long-term downward shift in a company's valuation.

It is clear to us, and many investors who have been in the markets for decades, that much of short-term price moves are now driven by computerized algorithmic trading. Think of algorithms applied to trading as multi-factor limit orders. These formulas can be designed to set buy and sell orders to execute intravenously when certain factors such as interest rates, earnings announcements, money flow metrics, and technical stock indicators such as moving averages and other statistical measures of price. These algorithms are designed by mathematicians, not fundamental investment analysts, and thus are inherently short-term and price-focused, not value-focused. If an individual investor is a short-term and price-focused trader, they are utterly "outgunned" by the large institutional "high frequency" algorithmic program trading operations.

At Seven Summits Capital, we have never attempted to time market price moves or individual stocks. Our focus has always been to identify variances between price and intrinsic value, which are inherently leveraged to company fundamentals, not stock price technical behavior. Before the advent of algorithmic trading technology, institutional price trading was driven by individuals who study the market and stock "internals" known as technical analysis. This type of trading is entirely focused on "anticipating" and betting on a security's price moves over a relatively short period of time. This practice of technical analysis has largely been replaced by algorithmic and artificial intelligence program trading, which no human trader can compete with in terms of speed and factor analysis.

Because we have never attempted to compete with technical analysis traders or programmatic trading, the evolution of trading technology poses no long-term threat to our approach. However, the dominance of programmatic trading in the markets requires an expectation adjustment related to the speed and magnitude of price adjustments compared to markets before the prevalence of programmatic trading. In prior times investors were taught that stock price movements were important indicators of changes in fundamental strengths and weaknesses because fundamental investors were a much more significant contributor to price movements. Today, price moves in highly liquid markets must be discounted by fundamentally focused investors as simply a function of overwhelming non-fundamentally based trading strategies.

The advantage for long-run fundamental investors in a rapidly moving non-fundamentally driven market is that the resulting price volatility will periodically undershoot and overshoot prices that approximate intrinsic value. For investors like Seven Summits Capital, the search for price variances from intrinsic values remains unchanged compared to past times; however, these opportunities now materialize and disappear much faster than in the past. This dynamic has changed the "feel" of the public equity markets but has not, in our opinion, changed the long-term function of the markets. Over the short term, these more machine-traded markets have shown us that wild price swings around our intrinsic value range for security can be more abrupt and more violent than in the past.

We hear from concerned clients during periods of volatility and price weakness. This recent market correction has been uncomfortable and disconcerting for some. We understand that seeing the numbers on an account statement decline abruptly is concerning for many investors. Because of our experience and objective of managing to long-term wealth accumulation goals, we see volatility, market corrections, and even bear markets as both unavoidable and opportunities. We ascribe to the time-tested wisdom of investors such as Warren Buffett as opposed to the trading-oriented conventional wisdom that has unfortunately conditioned investors to equate volatility with risk. Below are a few of Warren Buffett quotes specifically addressing how a serious investor should view volatility:

"We regard volatility as a measure of risk to be nuts." (2001)

"As an investor, you love volatility. You love the idea of wild swings because it means more things are going to get mispriced." (1997)

"The true investor welcomes volatility. A wildly fluctuating market means that irrationally low prices will periodically be attached to solid businesses. It is impossible to see how the availability of such prices can be thought of as increasing the hazards for an investor who is totally free to either ignore the market or exploit its folly." (1993)

I will end this commentary by providing some insight into how we are responding to our premise that the world has most likely seen the trough in interest rates coincident with the onset of the COVID-19 pandemic. The period that followed, which included unprecedented fiscal and monetary stimulus combined with pandemic derived supply constraints, appears to have awakened investors to the risk of inflation. Although we do not see deep-rooted inflation becoming structural, we see a higher normalized post-COVID inflation environment compared to the period before the pandemic. Thus, we envision an environment where traditional fixed income securities will face total returns that are somewhat less than the prevailing income yield over the next several years. In other words, although yields will be increasing among many fixed-income sectors, rising interest rates will put downward pressure on the value of many fixed-rate bond securities.

Combining our view that traditional fixed income will not provide a satisfactory total return with our view that the broad equity markets over the next several years are not likely to produce total returns anywhere near the returns that investors became accustomed to between 2010 and 2021, we are looking for a non-equity "market neutral" allocation for our balanced accounts which has the capacity to deliver non-correlated total return when adjusted for inflation. We will be looking to introduce this "market neutral" allocation to our balanced accounts once we see a meaningful recovery from the current equity market correction. Work on this new allocation for balanced accounts is well underway. We believe this allocation will perform well in the envisioned higher inflation, rising interest rate, and volatile equity market environment. I will write more about this "market neutral" allocation over the next several months.

Curt R. Stauffer

President & CIO

Seven Summits Capital

Disclosure:

Advisory services are offered through CS Planning Corp., an SEC-registered investment advisor.

The views and opinions expressed are for informational and educational purposes only as of the date of writing and may change at any time based on market or other conditions and may not come to pass. This material is not intended to be relied upon as investment advice or recommendations, does not constitute a solicitation to buy or sell securities, and should not be considered specific legal, investment, or tax advice. The information provided does not take into account the specific objectives, financial situation, or particular needs of any specific person. All investments carry a certain degree of risk, and there is no assurance that an investment will provide positive performance over any period of time. The information and data contained herein were obtained from sources we believe to be reliable, but it has not been independently verified. Past performance is no guarantee of future results. References to market indices do not represent investible securities.

Exchange-traded funds (ETFs) are sold by prospectus. Please consider the investment objectives, risk, charges and expenses carefully before investing. The prospectus provides a balanced analysis of the investment risks and benefits. Read it carefully before you invest.