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## *Secular Winners and Value Investing*

There are very few growth investors that stayed in business long enough to become a household name in the investment community, and even less of them that ended up writing books about their lifetime experiences.

This observation, in our mind, says something about the long-term benefits, advantages and promise of paying attention to value as it relates to price. From old timers like Ben Graham, Warren Buffett or Charlie Munger, to the next generation (e.g. Julian Robertson, John Neff, Michael Steinhart, John Templeton), and again to the current generation of Seth Klarman, Howard Marks, Mohnish Pabrai and David Einhorn; none of them were or are investors that owned "quality" or "winners" at any price, and the most important factor driving their investment decision was whether or not the stock was cheaper than it should be.

Granted there are the Joel Greenblatts of the world, and there were the Phillip Fishers[1] and Thomas Prices of the world (aka T. Rowe Price), and even style-chameleon Peter Lynch famously was able to embrace growthy ideas alongside his valuey ideas; but each of them still cared quite a lot about the price they were paying, and not a single one of them would own a stock at any level.

In other words, there are very few who have become wealthy in the stock market, and stayed there, who didn't care about value.

As happened in 1999, the performance of some specific growth stocks has a lot of smart people asking hard questions. Our firm view is that the parallels between 2017 and 1999 are not terribly strong actually, yet there is no denying that the FAANG (or FAAMG) stocks have captured a lot of attention (and a lot of market cap). The performance of a handful of these so-called "winner" stocks is forcing (or should force) a lot of experienced investors to consider these (in most cases, lost) opportunities within the context of the tenants of value investing that made them rich and famous enough to write books about them.

**So Why Didn't We Buy Amazon at $6 in 2001, and Just Hold On?**

A lot of investors are asking themselves this question. Anyone that plunged just $10K into Amazon in October of 2001, and then stuck the share certificates in a drawer, would be sitting on $1.6 million today. You can add or subtract zeros to both sides to see what it might have meant for people with less or more money than $10K to invest in the next winner.

Heck, these same investors are probably asking themselves why they didn't buy Amazon just five years ago at $225. Similarly, five years ago, you could have bought Netflix for $10. Today it is 20x higher. Tesla was at $30 in 2012. Today it is 10x higher. This article isn't really about Amazon or Netflix or Tesla per se; it's about opportunities, and why they were lost.

And here is the first point. If we had a crystal ball in 2001 (or even 2012), we might have learned what sort of business-lines Amazon would expand into, and what sort of revenues they might generate. If we



*That spread is so wide, I can even drive this truck through it.*

knew those things, the only thing left to determine would be what the market would want to pay for those revenues and/or earnings. **_And here is the point_**, as hard as it might have been to predict the multiple people would pay for Amazon five or 16 years down the road, it turns out that Amazon's multiple still would have been much easier to accurately predict than the long-term fundamental opportunities.

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[1] *To some, Fisher's book "Common Stocks and Uncommon Profits" is the bible of growth stock investing. If you haven't read it, there are incredible insights on how not to minimize or understate the fundamental potential of a winning business model and to "buy and hold" that long-term winner. In particular, the "When to Buy" and "When to Sell" chapters are invaluable. The book is in our library, and can also be ordered at: https://www.amazon.co.uk/Uncommon-Profits-Writings-Investment-Classics/dp/0471445509/ref=sr_1_1?s=books&ie=UTF8&qid=1503152805&sr=1-1&keywords=common+stocks+and+uncommon+profits*

Think about that. Amazon has a market cap today of over half a trillion dollars. In determining its value relative to intermediate-future fundamentals, some people use revenue multiples, some use cash-flow multiples, and others may even use P/E multiples. Using 2020 as a benchmark today, for example, Amazon trades at a P/E multiple of ~30x, and a revenue multiple of about 1.6x. Now, to the dyed-in-the-wool value investor, 30x earnings may seem a little pricey. However, there are plenty of people who think 30x is too low. They implicitly think this because they actually own the shares. They not only may be right, and not only have been right for the past five or 16 years, but they may keep on being right. These growthy Amazon bulls may think that something closer to 60x makes more sense, while the valuey Amazon bears may think that something closer to 15x makes more sense.

Well, what if we transported these same value and growth investors back in time just ten years. What if we asked them then, "hey, ten years from now, in 2017, how much do you think you would pay for Amazon based on your expectations for revenues, cash flows, or earnings in 2020?"

Some of the value guys might have immediately blurted out "hey I'll give you 15x" while the growth guys may have quickly retorted "whatever dude, I'll give you 60x." And that would have seemed like a huge gulf.

**Next Level Thinking**

The smartest among the bunch, however, may have said "Well, I'm not sure that is the most important question." The smartest among the bunch may have said "for a business entering so many markets, even unknown markets, facing such potential upside (or downside) isn't it more important to know what sales or earnings are going to be than what the multiple might be?" The most experienced of the "smart-guy bunch" might have even added "isn't it at least possible that the range of potential fundamental outcomes (aka the range of potential revenues or earnings) is much wider than whatever range of multiples people will pay for this thing, and thus shouldn't we be spending all of our time trying to determine the most accurate picture of revenues or cash flows or earnings; rather than guessing what multiple Mr Market will ascribe to them?"

And let's say these smarter, second-level thinkers won the argument, and then everyone thereafter sat around and said "okay then, let's figure this out." The first thing they would have done is to look at the current level of revenues, or perhaps the forward estimates at the time. In early 2007, the hoard of expert sell-side analysts covering the stock all pretty much loved Amazon already, and had lofty opinions of its potential. These bullish analysts looked into their crystal balls and saw $16 billion of revenues three years out (full year 2009 expectations).
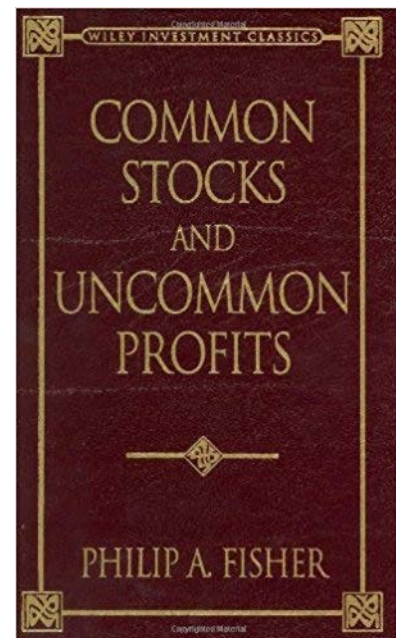
*The Growth Bible*

Let's say that our value and growth investors actually agreed with this bullish assessment. Then the value guys all got in a huddle and said "okay, this is the big growth phase for these guys now, and everyone with any experience is well aware of the law of large numbers, and that eventually, growth cannot exceed GDP growth, and additionally there is a limit to how large a single company can represent of the total economy." Then they continue "but let's give these guys the benefit of the doubt, and make an assumption that they will be able to grow their revenues at 2.5x the rate of GDP growth (assuming 2%), so 5% top-line for 11 more years, and we'll assume they can do 3% margins selling these books and things." And their final answer is "okay Amazon is going to do $27 billion of revenues in 2020, and $820 million in earnings."

The growthy guys can't control their laughter. They say "you stupid old guys just really don't get it, do you?" "Amazon is going to grow revenues at 4x GDP growth for 11 years straight…," they scoff, "…and they can print any margin they want when they get there, and that margin will probably be 6%, twice as profitable as you clowns believe today." "Consequently," they say, "we believe Amazon is going to generate $37 billion of revenues in 2020, and will generate net profits of a whopping $2.2 billion."

**Observations, So Far**

So, point one, is that there is a range of fundamental outcomes which is very wide.  One group thinks they'll print almost three times as much profit as the other group.

Point two, is that they both were horribly wrong.  <mark>Even the wildly optimistic growth investors ended up being much too pessimistic about Amazon.</mark>  Amazon isn't on target to print $27 or even $37 billion of revenues in 2020; they are on target to print $320 billion.

And <mark>to put it as succinctly as possible, that's why Amazon has been a great stock.</mark>

**Fundamentals Get the Credit, Not Investor Appetite**

Amazon not only continued to surprise the consensus investor for the ensuing ten years, they even continued surprising the bulls.  That's why the stock moved higher.  Sure, we can have the debate today about whether or not people should pay 15x or 60x for forward earnings, or wherever in between, but that is a second order argument.  The primary reason that Amazon, Facebook, Netflix[2] and the rest of them have done well is because their fundamentals have not only done well too, but done better than people expected.

And our view, which we think is right, is that in order to go higher, stocks have to show fundamentals which surprise people positively.   Of course there can be a change in appetite for a particular type of asset, maybe interest rates move higher or lower, or maybe we even get into a period of extreme market bearishness or bullishness and multiples can contract or expand, but <mark>the most important thing to know – particularly for these long-term winners – is what their revenues and earnings will look like down the road, and how different those are to expectations today.</mark>

If people had known in 2007 with the stock at $40 that Amazon would print $330 billion in revenues in 2020, they would have paid a lot, lot more for the shares.  Take our growth guys above.  Back then, armed with their estimate of €2.2 billion of earnings, and an assumption that the stock would still trade at 30x in ten years' time, they might have guessed the stock would be trading at about $185 a share in 2017.

And yet it is changing hands for over $1,100.



*I'm going that way.*

**Winners vs Losers**

Admittedly, Amazon is a special story.  We're talking about a winner that is seeking-and-destroying winner-take-all verticals.  Similar arguments can be made for Facebook and Netflix, for what it's worth.  And we should of course be careful not to draw parallels that are too strong to any or all other securities, no matter how much potential we think they have.  This has been a special time for these specific names, and we may never see anything like it again; but we need to have this concept in our framework.

**The Impact of Fundamentals on Multiples, and Multiple Expansion**

So, back to the task at hand, we've established that the first order argument needs to be about fundamentals, and the next order argument needs to be about what Mr Market will pay for these fundamentals.  Within this second point, however, there is something we must illuminate.  Improving or deteriorating fundamentals can explain part (sometimes all) of a multiple's expansion or contraction.  If a 10% grower trades at 15x, and then all of the sudden becomes a 20% grower trading at 30x, that indeed is optical "P/E multiple expansion" of 100%, but it is PEG multiple expansion of exactly 0%.  The faster something grows, the more people should (generally) pay for it.  If things slow down (aka the fundamentals deteriorate), people should pay less.  So, even within this nebulous concept of predicting multiple expansion, there are strong elements of fundamental modelling which should be brought to bear.

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[2] *We're not going to count Tesla in this bunch, because we can't figure it out.  2017 revenue expectations have basically been the same for five years, and even the out year expectations are only up 50% during a period of fifteen-bagging.  This is not a stock recommendation, but - unlike AMZN, FB, and NFLX - TSLA would at least appear to very much exhibit similar behaviour and features where parallels can be drawn to the late '90s tech boom and subsequent bust in 2000.  Of course Apple could buy them, and change all that… ☺*

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