

# TJIM QUARTERLY INSIGHT

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Tom Johnson Investment Management, LLC

I will be the first to admit that this current market is perplexing to me, but as I dig deeper, I begin to realize it is because everyone can appreciate a good story. We hear narratives about electric vehicles dominating transportation, AI taking over the world, and Apple's insurmountable lead in mobile phones. While at the same time most people aren't very good at math – only about a quarter of 12<sup>th</sup> graders are considered proficient in math, which means that 75% of 12<sup>th</sup> graders are not proficient at math – presumably that carries over to the broader population.

To illustrate this point, let's review A&W's failed campaign back in the 80s. They introduced a 1/3-pound burger (larger than the standard quarter pounder), promoting it with the slogan "Third is the Word", but it failed miserably as the burgers just didn't sell. A&W eventually conducted a focus group and determined that consumers were unwilling to pay the same price for a one third pound burger as they were for a quarter pound burger because they thought one third pound was less than a quarter pound.

Scott McNealy, the CEO of Sun Microsystems, aptly captured the absurdity of certain markets with the following quote -

*"At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at \$64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"*

For reference Apple currently trades at 8x sales, Tesla 10.4x, Nvidia 40.9x, Microsoft 12.2x, Google 5.97x, Amazon 2.55x and Meta 6.7x. In contrast the weighted average price to sales on TJIM's equity portfolios is right around 1x.

The current market is being driven by a very small cohort of companies presumed to be significant beneficiaries of artificial intelligence and other narrative worthy trends – Meta, Amazon, Nvidia, Alphabet, Microsoft, Tesla, Apple. I tried to come up with a clever acronym, but the best I could come up with was TANMAMA. Doesn't quite have the same ring to it as the FANG stocks – The TANMAMA stocks rip higher sounds like you're talking about a basket of stocks made up of tanning lotions and mojitos rather than cloud, EV (electric vehicle), AI (Artificial Intelligence) and AR (Augmented Reality) stocks.

As I write this, Apple is becoming the first company to breach a 3 trillion-dollar market cap. This makes it larger than the entire market cap of every company in the Russell 2000 (i.e., roughly 2000 small cap companies) and the entire stock markets of all but 5 countries.

Apple's current market cap implies that they will continue to stay one step ahead of the competition indefinitely, which they have managed to do so far. It also probably implies the success of several products that we haven't heard of yet. To Apple's credit, they have done an excellent job with new products – iPhone, iPad, iPod, Apple watch, AirPods, etc., but as they get larger the level of success to move the needle gets larger and larger as well. At some point they will almost certainly become a victim of their own success. We went along for much of the ride, but with our valuation discipline we exited the party a little too early.

Is this rational? Maybe, but it would truly mean that “Things are different this time”. Historically, there isn’t a ton of persistence in the S&P’s top 10 holdings. If the Fed has tamed the business cycle and there will be no more recessions (or if they do occur, they will be short and shallow) stocks can now trade at a permanently higher level (which implies lower returns going forward). Or possibly the huge push into passive investing has given the largest companies a permanent advantage via perpetual sponsorship (i.e., always owned) and cheap funding throughout the business cycle. Maybe capitalism doesn’t work as well as it used to and certain companies are able to generate above market margins forever, rather than eventually getting competed away.

Maybe AI is the society-evolving-technology that it is made out to be AND the current leaders will be able to maintain their leadership AND develop a profitable business. This is often the rub with being right about a new industry – it can be life changing and world altering, but picking the winners in the beginning is near impossible – think about automobiles, radio, television or more recently the internet, mobile phones or video conferencing. The early leaders have often ended up in the dustbin of history as also rans or never weres. Anyone remember the Duryea Motor Wagon Company? Or Farnsworth Television? Motorola and Nokia are memorable but now are simply also rans in the world of mobile phones. Netscape once had more than 90% market share of the browser market but had fallen to less than 1% by 2006. In the middle of the pandemic in 2020 Zoom was briefly more valuable than Exxon. This irrational exuberance (and pessimism in Exxon’s case) has since reversed, and Exxon now has a market cap over 20x that of Zoom. As Yogi Berra used to say – “It’s tough to make predictions, especially about the future.”

Microsoft has a 2.5T market cap. Alphabet (Google) is 1.5T. Amazon is 1.3T. Nvidia’s is now over 1T. Tesla and Meta both trade with market caps approaching a trillion (750B for Meta and 870B for TSLA). Just these six stocks surpass the market cap of the entire stock market of every other country in the world. For reference, China’s stock market is the 2<sup>nd</sup> largest in the world at 6.3T.

On one hand I get it – by focusing on the largest most profitable (at least in Apple, Google & Microsoft’s case), least leveraged companies, you can somewhat insulate yourself from the banking issue and rising interest rates, but you still can’t get away from the fact that starting valuation has a huge impact on subsequent returns. In the short term, valuation doesn’t matter much as the correlation between starting valuation and 1-year returns is near 0. Over the intermediate term, say 5 years, the relationship gets stronger around a -50% correlation (the relationship is inverse as the higher valuation you start with the lower subsequent returns you achieve and vice versa), but over a 10 to 15 year period (what I would consider an appropriate horizon for owning equities), the correlation is a very strong -80%.

Historically the market has done a great job of picking which companies will grow the fastest by anointing them with the highest valuation multiples. HOWEVER, these valuation multiples tend to be a great predictor of future performance – *in the wrong direction* – as the market has tended to overpay for the fast growers and underpay for the slow growers, which I would argue is happening to the extreme currently. This is the classic value effect. It hasn’t worked well in the near term as the market has been granting higher and higher multiples to the companies with the highest expected growth, but we believe that history will repeat itself and the market is currently either significantly overpaying for future growth or overestimating how much growth will occur.

Another factor to consider is the efficacy of buybacks declines as valuation increases. At 10x earnings a company can drive about 11.1% per year in earnings per share growth by using all their earnings to buy back stock (assuming no growth otherwise and no change in net income or market value). At 30x earnings a company can only drive about 3.5% in annual earnings per share by using all their earnings to buy back stock. Believe it or not, both juggernauts Apple and Microsoft, had periods where they traded at 10x earnings or less over the past 20

years and effectively used buybacks to drive earnings growth. That will be much more difficult from current valuation levels – especially since they have both spent down cash and added debt at the same time – they won't be able to do so as much going forward.

On the fixed income side bonds and cash equivalents now offer yields more attractive than they have been in over a decade. Short-term treasury bills are now paying north of 5%. A high-quality intermediate bond portfolio is yielding just shy of 5%. Bonds are now once again poised to do what they are supposed to do – provide income and diversification for stock portfolios all with low volatility. Rather than just being a risk reducer, they are now also a return generator. Bonds now once again yield more than stocks, which makes them an attractive alternative to stocks. They are much more robust than they have been with a well-constructed intermediate bond portfolio now able to still generate a positive return over a one-year horizon even if interest rates rise another 1%.

The current market's optimism persists despite rising interest rates, stimulus measures coming to an end, record levels of debt and deficits, geopolitical tensions, and weaknesses in the banking sector. While narratives and stories drive market sentiment, history suggests that overpaying for fast-growing companies can lead to suboptimal returns.

Going forward – bonds are more attractive than they have been in nearly 15 years based on yield to maturity. Outside of the top holdings in the S&P mentioned above the broader market valuations are reasonable. On top of a “reasonably” priced market TJIM's stock portfolios currently have one of the most significant discounts to the market we have seen in our near 40-year history and are trading near the lowest absolute valuations ever. We own a broadly diversified portfolio of high-quality companies that are consistently profitable. Bargains continue to abound in high-quality profitable companies with strong cash flows. While there is probably continued elevated volatility in the near term as the market bounces between euphoria and despondency, we believe that our portfolios continue to be as well positioned to generate both absolute and relative long-term returns as they have ever been.

As always TJIM appreciates the trust you place in us, and we will continue to be responsible stewards of your capital by building diversified portfolios of high-quality securities that we believe will provide attractive risk-adjusted performance going forward.

Sincerely  
TJIM Investment Team

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Footnote: This material has been prepared and approved for existing clients and financial consultants.