INVESTMENT PERSPECTIVE 4Q 2020

DÉJÀ VU?

Stock market bubbles don't grow out of thin air.
They have a solid basis in reality, but reality as distorted by a misconception.
-George Soros

The August 1929 edition of the *Ladies' Home Journal* [1] included an interview with John Jakob Raskob entitled "Everybody Ought to be Rich."[2] Raskob argued that the average American saver misperceived stocks as unduly speculative, preferring the paltry returns of savings accounts. Owning the stock of great American enterprises was far from gambling, he asserted. It was a way to participate in the growth of business, which he believed limitless. Raskob knew whereof he spoke. He was an executive of both DuPont and General Motors.[3] The 1920s had seen car registrations triple. Meanwhile DuPont was converting its profits in explosives into a revolutionary series of polymers and synthetic chemicals. So Raskob's worldview had been cultivated inside spectacular growth companies. As an example of the possibilities of share ownership, Raskob describes a plan he oversaw for GM executives that had returned 25x over the preceding five years. Let that sink in for a second – 25x. GM was, well, the Tesla of the 1920s. But Raskob's advice was particularly ill-timed. The Dow Jones Industrial Average peaked about a month after the article. By December 1929, stocks would be down about 30%. On the third anniversary of the publication in 1932, stocks had fallen 85%.

Recently two of my investing idols warned in the starkest of terms that we stand on the precipice of a market calamity. Seth Klarman compared current investors – desensitized to risk by the Federal Reserve's largesse – to frogs in a pot of water slowly approaching the boil.[4] Jeremy Grantham, founder of Boston's GMO, referred to investors' reliance on the Fed's moral hazard as a 'deal with the devil.'[5] Frankly, it did not take Klarman's observation to prompt the question of whether we are in a bubble. A lot of us who lived through the 2000 Internet bubble have been experiencing frequent episodes of déjà vu. Those sensations should not be lightly dismissed. Maybe it is a form of subconscious pattern recognition. That is important because I think bubbles are not fundamentally about valuation levels or even price changes. The defining feature of bubbles is the subtle aberrations of behaviors that become socialized.

Bubbles seem to initiate with the recognition of world re-defining technology. In the late 1990s that notion was the internet's potential to re-shape vast domains of entrenched business models. As a buy-side analyst at a momentum mutual fund in the 1990s, I had a front-row seat to the mania. For me there were early tells. Increasingly, you would meet people in social settings who had left professional jobs to day-trade. To trade for a living on a 20-something professional's accumulated wealth, you need a decent coterie of stocks making $15-30 daily moves. You cannot do it on the slow upward creep of a Microsoft or Facebook. You need Tesla-type swings. And there were plenty. The frenzy spread out from the internet pioneers like Yahoo, Netscape and (yes) AOL to carriers, networking equipment to the outlandish. The increasingly violent moves (always up) and rising valuations were the signals of unsated demand. So the investment banks obliged with a steady stream of IPOs. But those new issues would double or triple on the first day. It was like a whistle down the coal mines. And more supply was steadily carted out of the depths. One sure sign that public markets are over-valuing assets is that private market asset owners will manifest a sudden willingness to let the public 'share' in their upside. Soon 'old economy' companies were stumbling over themselves to glom onto the new, glossier world. A natural gas pipeline operator started trading 'bandwidth.' And the frenzy continued. Each new market high induced more supply. Until one day, an IPO failed to 'pop.' I was skiing in British Columbia when the bubble popped. I went in for lunch at mid-mountain and checked the markets on the Bloomberg. Of course, the mere fact that a ski resort had two Bloomberg terminals on the mountain should have told me it was all over.

After the implosion, an academic observed that the assumption of the total addressable market for internet traffic used in every business plan had been false. It turned out that Worldcom had conjured it from an outdated Department of Commerce study. Internet traffic had indeed doubled in ONE QUARTER in the mid-1990s. But it had slowed down considerably. But that article of faith – that face that launched a thousand ships – had been patently untrue. What is more, subsequently clear-eyed analysts discovered that the sum of the discounted market shares for all the networking providers was greater than even that counterfeit forecast of the total addressable market. A fallacy of composition, squared.

So what gives me déjà vu? Replace 'internet' with 'cloud computing' or 'artificial intelligence' or 'electric vehicles.' Replace 'day trader' with 'r/wallstreetbets' or 'ddtg.' Replace 'IPO mania' with 'SPAC Mania.' Substitute 'JDSU' with 'NVDA.' Substitute 'Janus 20 Fund' with 'ARKK.' In short, a lot of the foggy fragments of my 25-year memory are re-appearing with different names. But the real similarity is the zeitgeist of investing as a certainty. Raskob's advice to the readers of Ladies' Home Journal, the nonchalance of the 1990's day traders and the blandishments of David Portnoy today have a single common thread - the banalization of risk.

Of course, history does not repeat; it rhymes. Today's market is not a replay of 1999. Back then, the epicenter of irrationality was squarely in the middle of the U.S. capital markets. If you mention JDSU to anyone under 50, you will get a blank stare. In March 2000, JDSU was the 10th largest market cap company in the Nasdaq 100. The point is that hardware (Sun Microsystems, Cisco, Dell and Applied Materials all figured above JDSU) was dominant. The Achilles' heel of 1999's market's bellwethers was the dependence on non-recurring capital expenditures. Today, the NYSE FANG Index roughly occupies the 'center square' of the capital markets with $7 trillion in market capitalization. Those stocks trade on a 2022 Price/

Earnings Ratio of 31x. If those earnings materialize, those companies will have realized a 5-year compound earnings growth of 22%. To be certain, that is a little on the expensive side. But that does not strike me as crazy. More importantly, the benchmark business models are more recurring in nature. Facebook, Amazon, Netflix and Microsoft have a lot more in common with utilities than leaders of the Internet bubble. (Of course, their status as natural monopolies is not lost on policymakers.)

So, what about the epicenter of irrational behavior? Goldman Sachs has conveniently compiled an index of Unprofitable Technology Companies. Market capitalization? $1 trillion. Bitcoin? $750 billion. Tesla? $850 billion. The point is that global equities are $100 trillion. So when we think about the risk of possible bubbles, we have to bear in mind their proportion of total wealth. It seems like the focal point for lunacy is just not big enough to unleash a cascade of liquidations. Finally, it is important to think about the potential for collateral damage from mal-investment. Anybody in the 1990s driving around a major city was treated to the spectacle of roads being trenched and re-trenched to install fiber optic cable. The debt on the redundant 'dark fiber' would in turn need to be written off. The worst write-off from today's excesses will be my daughters' Roblox and the mountain of garage-sale Pelotons.

Jon Hirtle often says that judgment is nothing more or less than the sum total of our experience. That experience leads us to recognize recurring patterns in the fabric of markets and society. Yes, there are some troubling signs of excess. However, considering their magnitude, potential for contagion or fallout, the risks seem to be manageable. When we look at the broad equity market opportunity compared to fixed income – where yields are at historic lows – we believe our current full weight to global equities represents good reward relative to risk. Low rates not only make equities look more attractive on a relative basis, they support earnings by making it easier for companies to borrow to fund future growth. Our macroeconomic outlook is positive given the ongoing fiscal and monetary support and the Fed's commitment to keeping rates low for an extended period. Our view is further supported by the onset of a widespread, effective global vaccination campaign which should allow people and businesses to function more normally. Meanwhile, we are carefully monitoring the risks posed by pockets of excessive speculative behavior.

—T. Brad Conger, CFA
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[1] *Ladies' Home Journal regular circulation was two million in a country of 30 million households. Also, it skewed dramatically higher in income so that its advertising revenues were equal to the Saturday Evening Post.*

[2] *Raskob, John J. "Everybody Ought to Be Rich." https://www.joshuakennon.com/wp-content/uploads/2013/01/Everybody-Ought-to-Be-Rich.pdf.*

[3] *DuPont acquired 43% of General Motors in 1920.*

[4] *Aliaj , Ortenca and Eric Platt. "Baupost's Seth Klarman Compares Investors to 'Frogs in Boiling Water.' " Financial Times, 21 Jan. 2021, www.ft.com/content/9c3ecb09-c4bd-4066-a462-af496725105d.*

[5] *Grantham, Jeremy. "Waiting for the Last Dance." GMO. 5 Jan. 2021. https://www.gmo.com/americas/research-library/waiting-for-the-last-dance/*