JULY 28, 2020

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True Stories of Financial Euphoria Circa 1998-1999

Dear fellow investors,

When you are in a financial euphoria episode, like the one we are in currently, it is hard to visualize the impact it has when it breaks. Historically, it is the leading cause of stock market failure. We thought it would be helpful to discuss the secondary impact of the euphoria on common stocks. What do companies not in the center of the euphoria do when the fever breaks? How much portfolio adjustment do you need to do to protect yourself? What are the investment implications of owning common stocks whose prices have been inflated by mania, but are not in the center of the storm?

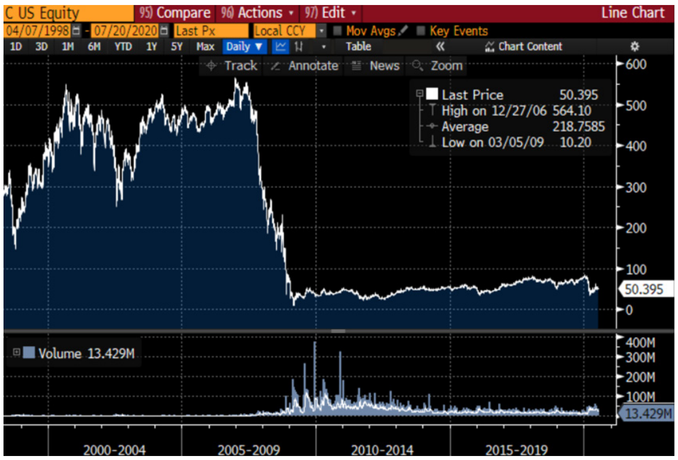
The 1990s were fabulous for common stock investors. At the time, I was working at Smith Barney and was running separate accounts for individuals. Sandy Weill and his right-hand man, Jamie Dimon, were building a financial behemoth through acquisition and excellent management. The pyramiding reached its pinnacle in the spring of 1998 when Weill merged Travelers Group with Citicorp. Both the acquirer and the acquired soared in price:

> *Much of Wall Street liked the deal, and Citicorp's stock shot up $35.625 to close at $178.50, while Travelers rose $11.3125 to close at $73. The announcement, which was made before the market opened, helped the Dow Jones industrial average move convincingly through the 9,000 level.*[1]

For non-tech companies (the average stock in the S&P 500 Index), the spring of 1998 was the top of the bull market which had started when the first Gulf War (January 15, 1991) began and ended with "Shock and Awe." Travelers was extremely popular in 1998 and Sandy Weill was considered the most successful person in financial services. Effectively, this transaction broke down the Glass-Steagall Act, which passed in the Great Depression of the 1930s to stop investment risk from infecting the banking system in the U.S.

In February of 1999, my wife and I decided to buy a vacation home in the high desert area of the far north end of Scottsdale, Arizona. Rather than finance the purchase, we chose to sell shares of the combined company, ultimately called Citigroup, to pay cash for the home. Those shares were valued around $53 per share, well down from the euphoria of the day the two companies merged. The financial world in 1999 hadn't been turned into the Wild West by slicing and dicing mortgages in a post-Glass Steagall world. Bank stocks became unpopular when tech stocks took over the entire stock market from June of 1998 to early March of 2000.

On July 20, 2020, those Citigroup shares trade for $50.14 per share. The problem is they were decimated in the financial crisis and had to reverse split the shares 1-for-10 on March 21, 2011. This means that the shares fell from $73 the day of the merger and $53 per share when we sold to $5 per share today. Our house cost us $40,000 in today's Citigroup stock.



Source: Bloomberg.

About the same time that Citigroup was created by the merger, we sold our shares of IBM and Hewlett Packard. These "old tech" companies had seen their share prices soar ten-fold from 1990 in Hewlett Packard's case and ten-fold from 1995 in IBM's case. Our theory was that if there is a hurricane in Miami, you should get the heck out of Palm Beach. Again, avoiding euphoria seeks to prevent stock market failure. We sold IBM shares around $125 per share in 1998 and look where they are today:

Source: Bloomberg.

The stock has only earned dividends for the last 21 years. Therefore, you can see that more than the most glamorous stocks are impacted by a period of financial euphoria.

Which sectors and companies are in the first line of risk when the current financial euphoria episode breaks? The FAANG stocks and all the new tech which are currently feasting on the stay-at-home movement are the "eye of the storm." Their momentum is the most egregious. For most professionals they are easy to deal with because of enormously high price-to-earnings ratios (P/E).

The second line of risk are the growth stocks which have drafted on the success of the first line stocks. These would be today's version of Citigroup and IBM. They are wonderful companies trading for 30-50 P/E multiples in a market with the kind of momentum we had back in 1998-1999. These mature growth companies are receiving capital from index, growth and momentum investors. They are not in Miami, but they are in Palm Beach.

Inflated P/E multiples among growth stocks like Visa, Mastercard, Costco, Coca Cola, Pepsi, Microsoft, Abbott Labs and PayPal (which we own a small piece of) could disappoint investors in one of two ways. First, the companies could hit a rough cycle for their business, see business return to normal post-pandemic or get hit by competition. Second, the P/E ratio for the most highly thought of mature growth companies is historically around 20. This would be a big comedown from the current 35-40 P/E multiples. In other words, they could end up with a chart that looks like the ones we showed above.

If you have never been through the unwinding of financial euphoria before, there are a few things to understand. The intoxicating euphoria can go on longer than most investors can resist. The Bible says, "Do not conform to this world," but these episodes cause value investors to become growth investors unknowingly.

Next, they break like "a thief in the night." Warren Buffett says it is like Cinderella's Ball and there are no clocks on the wall to tell you it is midnight. Remember, when it does hit midnight "everything turns to pumpkins and mice!" Buffett also says, "An orgy is the most exciting towards the end!" As of July 20, 2020, this tech stock party is extremely exciting.

If the year 2000 is any indication, investors and analysts who have pumped these high-flyers, growth stocks and the S&P 500 Index will recommend them all the way down. Every significant decline in price will seem like a great buying opportunity. The problem is your P/E dropping from 100 to 50 doesn't make your stock a buy, it just puts it closer to the 20-multiple that highly thought of and mature growth companies have historically traded for.

Therefore, we believe that the circumstances today are like early 2000, when the stock market started crushing growth stocks. About 30% of the money was transferred into the value side of the stock market upon sales made on the way down. The other 70% was destroyed as sellers raced for the exits from 2000-2003 (aka stock market failure). Will this time be any different?

Warm regards,

William Smead

[1]Source: *The New York Times*