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Today's Financial Euphoria

Dear fellow investors,

All major financial euphoria episodes hold aspects in common. Among our favorite books on investing is John Kenneth Galbraith's *A Short History of Financial Euphoria*. More than any other economist, we admire his understanding of the connection between the securities markets and the economy. Galbraith describes a speculative financial euphoria episode this way:[1]

> *Some artifact or some development, seemingly new and desirable captures the financial mind. The price of the object of speculation goes up. This increase and the prospect attract new buyers; the new buyers assure a further increase. Yet more are attracted; yet more buy; the increase continues. The speculation building on itself provides its own momentum.*

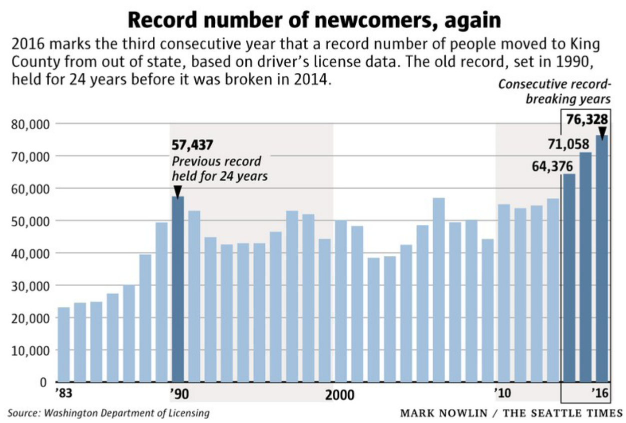
In Galbraith's view, the common denominators of speculative episodes are:

1. Extreme brevity of financial memory.
2. The specious association of money and intelligence.
3. Money as the measure of capital achievement. The acquisition of money is difficult. Accordingly, possession must be associated with some special genius.
4. Something new is in the world. In all speculative episodes, there is always an element of pride in discovering what is seemingly new and greatly rewarding.
5. Leverage gets attached to stocks and real estate.
6. They all crash. Galbraith explains: "This, invariably, will be a time of anger and recrimination."

Are we in a speculative episode?

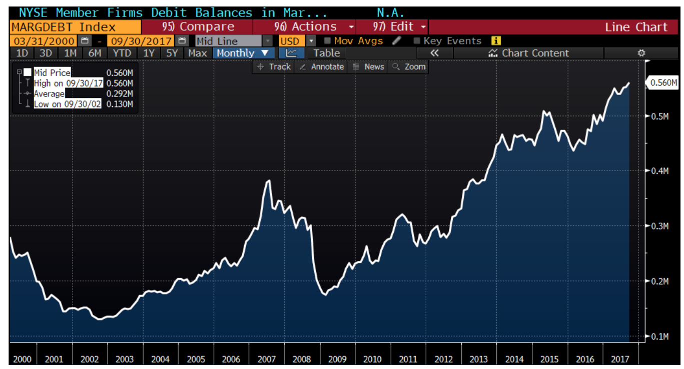
1. Investors have forgotten the technology stock crash of 2000-2003. Massive market capitalization is tied up in tech stocks, especially the FAANG stocks (Facebook, Amazon, Apple, Netflix and Google).
2. Mark Zuckerberg, Jeff Bezos, Tim Cook, Reed Hastings, and Larry Page are considered universally brilliant in the media and have blanketed magazine covers and daily TV coverage.
3. The high net worth of these executives is associated with genius.
4. Social media, online commerce, inventive electronic devices and algorithms applied to data mining are everywhere and look like a gold rush.
5. Commercial/residential property and building projects in tech heavy cities have been leveraged and look legendary. Seattle appears to be a center of this episode (thanks to Amazon) and our tech-based boom is exemplified by the following chart which chronicles the issuance of driver's licenses in King County:[2]

[1]Source: Galbraith, John Kenneth. *A Short History of Financial Euphoria*. USA: Penguin Books USA, Inc., 1994.
[2]Source: *The Seattle Times* "Florida newcomers surge: the latest on another year of record-breaking growth in Seattle area"



How does this episode rhyme with the past?

1. The faith invested in FAANG stocks looks like RCA in 1929, the Nifty-Fifty stocks of the early 1970's and the popular tech companies of the late 1990's.
2. Can any more adulation or prescribed brilliance be attached to today's most admired executives? Bill Gates, John Chambers and Andy Grove walked on water in 1999. Jeff Bezos must control 550,000 employees, two company headquarters and grow at a breakneck pace in revenues to perpetuate the metrics used by analysts fighting over each other to raise price targets on Amazon's shares.
3. Amazon's market cap grew by $64 billion dollars on Friday October 27, 2017. Back in 1999 on December 15th, Microsoft's stock went up 10% in one day ($50 billion) and added a gain the next day of $27 billion. Microsoft's share price peaked for 16 years on December 27, 1999.
4. Are social media, search-engine-optimization and delivering goods free relatively new? The answer is yes! Were Windows software, faster Intel chips and better Cisco routers relatively new in 1999? The answer is yes.
5. The most popular stocks rarely split their share price, which makes both individual and hedge fund investors very tempted to use leverage to buy the shares (see below[3]). To us it looks like arrogance!



The first responsibility of the value investor is to reduce or eliminate ownership of securities closely related to the mania. You must be early in avoiding these episodes and you must get out long before the "inevitable crash." In our view, speculative episodes go up on an escalator and come down on an elevator. History would remind us of the outcome of prior stock market euphoria episodes:

- *Crash of 1929:* The Dow Jones Industrial Average peaked in October of 1929 at $381 and bottomed in April of 1932 at $41. RCA peaked at around $110 per share and bottomed in the 1930s around $5 per share.
- *Nifty-Fifty Bear Market of 1973-1974:* The S&P 500 Index peaked at January 11, 1973 at $120 and bottomed on October 3, 1974 at $62. Coca Cola stock price peaked at $1.56 on January 4, 1973 and bottomed at $0.48 on October 4, 1974. Disney peaked at in January of 1973 at around $1.64 and bottomed in October of 1974 at $0.26.

[3]Source: Bloomberg.

- *Tech Bubble of 1999-2000:* Microsoft peaked at a share price of $59.56 on December 27, 1999 and bottomed at $20.75 on December 20, 2000. Cisco peaked on March 27, 2000 at $80.06 and bottomed on October 8, 2002 at $8.60.

All prior speculative episodes broke when you ran out of buyers at the top. We don't get to know when this episode will end because our job is to decide whether it will break—not when. We are reminded what Galbraith says about circumstances like today:

> *The circumstances that induce the recurrent lapses into financial dementia have not changed in any truly operative fashion since the Tulip Mania of 1636-37. Individuals and institutions are captured by the wondrous satisfaction from accruing wealth. The associated illusion of insight is protected, in turn, by the oft-noted public impression that intelligence, one's own and that of others, marches closely in step with the possession of money.*

We will let Galbraith conclude this discussion by coaching us on two final rules:

> *There is the possibility, even the likelihood, of self-approving and extravagantly error-prone behavior on the part of those closely associated with money.*

> *A further rule is that when a mood of excitement pervades a market or surrounds an investment prospect, when there is a claim of unique opportunity based on special foresight, all sensible people should circle the wagons: it is the time for caution.*

.Warm regards,

William Smead