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Smoked in 1999 or Vaped in 2018
What You Pay Buying Shares Matters

Dear fellow investors,

Have the purchase price be so attractive that even a mediocre sale gives good results.

—Warren Buffett

It is no secret that the U.S. stock market has been completely addicted to discounting the future success of the most popular technology stocks. Momentum-based growth investing has had many bouts of success in the past, but this is the first episode in an era where indexed mutual funds and exchange traded funds (ETFs) were the largest aggregate owners of the largest capitalization companies. In comparison, as recently as 20 years ago, individual and institutional investors were the biggest aggregate owners of the nation's largest companies through direct ownership. It is almost like the old-time owners of individual stocks were smoking cigarettes and today's owners are vaping.

We say vaping because a massive amount of market cap is perched on futuristic hopes tied to fast growing internet-based companies. Facebook's (FB) stock fell 19.6% from the close of trading on the 25th of July 2018 to the opening on July 26th. On July 27th of 2018, Twitter's (TWTR) stock opened 13.25% lower than where it closed on July 26th. There were no open market trades which occurred between those price levels. This means that a massive amount of capital was vaporized, disappearing into thin air.

Understanding the ramifications of this trading activity explains the risk being assumed by owners of expensive/popular securities, as well as index owners and exchange-traded fund investors. The Facebook re-pricing was the largest single market capitalization loss in the history of the S&P 500 Index and in U.S. stock market history. We should not confuse what happened here with looking at a stock having the same decline over many months. When a stock declines gradually, capital is being pulled out of it by existing investors, in many cases to go off to another portfolio holding. However, when a stock gets vaporized the capital just disappears.

This is important for three reasons. First, it is symptomatic of a stock market which has had near total disregard for risk-reward relationships. Since there has been almost no interruption in the run that the FAANG stocks have had, market participants have not had to consider risk for nearly five years. In this growth-momentum era there is no risk-reward relationship because there has only been rewards. The momentum has been completely addictive.

Second, it defies the long-term history of common stock investing and the historical advantage price conscious buyers have had. In his quote above, Buffett describes how closely tied a good purchase price and effective business analysis are to the future success of your stock selection. He is also famous for saying, "be greedy when others are fearful and fearful when others are greedy." The theory behind value investing, birthed by Buffett's mentor, Benjamin Graham, is that an equal amount of future success or luck will come out of 100 companies randomly. Therefore, what you pay to buy the future success determines your performance relative to the index by which you measure your results.

Third, it is estimated that as much as 50% of the money tied up in the large-cap sector of the U.S. stock market is owned via indexes and ETFs. Vanguard and Blackrock have been getting rich while luring more and more investors into indexes and ETFs, automatically deepening their involvement in popular securities. In effect, popular securities raise the nicotine level of the index. Counting Amazon (AMZN) and Netflix (NFLX), the S&P 500 owns over 29.45% of its assets in technology companies as of August 1, 2018 (Bloomberg). The only time the index ever got this committed to one sector (tech) was at the end of 1999, and we all know how that ended. The 80% decline in stocks like Intel, Cisco, Sun Microsystems and others with very large market caps in late 1999 proved cancerous to their investors and the S&P 500 Index.

This happened back when the Marlboro Man was still being used on billboards and in magazine advertisements. Stock-picking organizations like Fidelity, T. Rowe Price and Janus had star managers and they were owning the largest cap companies on behalf of American investors leading up to that financial euphoria episode. The Janus Twenty and other growth strategies were gorged with cash in 1999 as investors puffed up technology stock prices. It has done so poorly since then that the ashes got folded into another Janus strategy. This year, the First Trust Dow Jones Internet ETF was lit on fire and has received $2 billion in net inflows since the start of the year and now has $9 billion in total assets. It has made 23% so far this year, 37% last year and 20% compounded the last ten years.

In today's episode of financial euphoria, investors own the largest companies through indexes and ETFs, and the Marlboro Man has been replaced by star CEOs like Jeff Bezos, Reed Hastings, Elon Musk and Mark Zuckerberg. Will their glory get vaped at some point, the same way John Chambers, Bill Gates and Scott McNealy got burned in 2000-2002? It is not like the massive worldwide army of new software engineers and computer scientists aren't scheming right now to invent new technologies and businesses which will ultimately threaten today's star companies. We believe today's vaping companies will be invaded in the future just like the cigarette manufacturers and tobacco farmers were.

Notice that the only currently popular tech stocks which were part of the mania in late 1999 are Amazon and Microsoft. Amazon got vaped in 2000-2001 going from a high at $106.69 to a low of $5.97 per share. It didn't get back to $106.69 until late October of 2009 and Microsoft's recovery from its vaping of 65% took over 15 years. The risk-reward relationship always gets reestablished, just like nicotine's addictive power has its way. Don't kid yourself for one minute, very few investors make it through those vaping phases as ongoing owners.

Many charts have been out recently showing the big chasm between the pricing of value and growth securities making up the S&P 500 Index. Will the vaporization of Facebook and Twitter be a temporary blip in continued success for puffed-up tech momentum stocks? Is the largest single day decimation of capital a "warning shot across the bow" of a stock market which still has more people and more capital to addict before its ultimate top later in an extended cycle? Or, will the recent vaporization be the trigger of a major comeuppance for the market's largest and most popular securities? We don't have the answers, but we are very content to practice our stock picking discipline at prices which have worked in previous eras.

At Smead Capital Management, we believe common stock ownership always needs to be practiced within the confines of a healthy view of risk and reward. Those confines are being stretched in an unhealthy way via an addiction which over-confident buyers have for today's futuristic favorites. This financial euphoria episode could be opening the door to stock holders getting their capital vaporized, either directly or via indexes and ETFs. It has already happened for some Facebook shareholders.

Warm regards,

William Smead

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