When Is It Gambling?

Mae West once said, "I generally avoid temptation unless I can't resist it." Have you been tempted to invest in Tesla stock? It is soaring. You would have turned $10,000 into about $75,000 if you bought it at the beginning of the year. Wouldn't you like to have some of those profits? Is that a temptation you can't resist?

We did not recommend Tesla. Sure, in hindsight we wish that we had. But haven't we all witnessed or heard from a friend, colleague or relative who made a small fortune at the casino? When does an investment look more like a gamble than it does, well, an investment?

Tesla and a very small group of stocks called the FANG stocks have led the NASDAQ index to a gain of 40% this year, far outpacing the Dow Jones Industrial's return of 6%. The FANG acronym has been expanded to FAANMG, so the list includes Facebook, Apple, Amazon, Netflix, Microsoft and Google. Maybe we should call them the magnificent 7. With Tesla, the seven stocks, which are only 1.4% of the S&P 500 by count, represent almost a third of the value of the S&P 500, having outperformed now for the last five years, up 420% over that time.

There are other examples of greed-fueled stocks other than the magnificent 7, many of them IPOs (initial public offerings). Names include Airbnb, DoorDash, Rocket Companies and Palantir Technologies. Investors have made a lot of money in a hurry.

In the 1990s, stock market investors were attracted to a small group of stocks called the "dot com" stocks. That group returned 400% in the five years to 2000. Mae West might have said of the fun "too much of a good thing can be wonderful." Until it wasn't. In early March of 2000, those stocks crashed, erasing every bit of their profits from 1995 to 2000. Investors late to the party, who bought in early 2000, lost nearly 80% of their money. As a recent headline in Barron's recently put it, "It's feeling like 1999 all over again."

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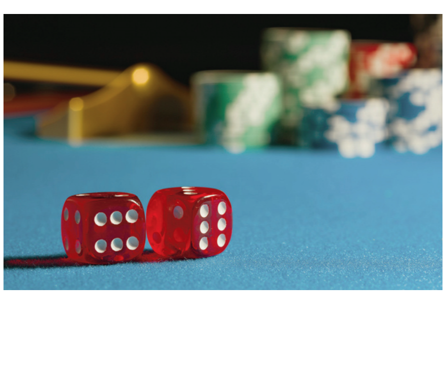

We think it is gambling when an investor is looking for quick gains; when an investor doesn't consider the investment as buying into a business that he or she wants to own long term. After all, buying a stock is buying part ownership in a company. That perspective requires discipline in determining a fair price. On average, when you buy the S&P 500 today, you are paying 2.5 times annual sales, or 30 times annual earnings. Those numbers are historically high; we try to find stocks that are cheaper than that.

Tesla has not yet turned a full-year profit, so we can't say what the multiple is on earnings. But it is selling at 21 times sales, or nearly 10 times what you would pay for the average stock in the S&P 500. That seems like gambling to us because the pursuit is seemingly all about temptation and not about properly valuing a business. Tesla is worth more than GM, Ford and Toyota combined.

As a group, the magnificent 7 trade at 8.8 times sales. Seems expensive, though not as expensive as Tesla. Most of our clients own Microsoft, many own Apple, and growth-oriented clients own Google. They have been fun to own. But we think now might not be the time to buy those stocks.

There was another group of high-priced stocks that preceded the dot com stocks, and they were called the Nifty Fifty. They led the market forward in the 1960s up until 1972. At the time, they were considered "one-decision" stocks. You bought them with the idea of never selling them. Familiar names included GE, Coca Cola and McDonald's, but also Polaroid and Sears. The group crashed in 1972, also losing almost 80% of their value. Some stocks like Polaroid never recovered. Polaroid's workers were recently bailed out by the Pension Benefit Guarantee Corporation, the quasi-government version of the FDIC, but for pensions, not banks. They were bailed out because Polaroid went out of business.

GE, Coca Cola and McDonald's lost a lot of value in 1972 but eventually recovered, and patient investors did just fine. Presumably some of the magnificent 7 and the IPO cousins will also work out in the long run, but we think things are already changing. Though Tesla is still moving up, the group is down since Labor Day by an average of 4% while the S&P 500 is up 5%. We think investors are now buying some of the cheaper, and often more profitable names.

We have stuck with our tried-and-true process throughout this volatile year. We prefer companies with good balance sheets that are more profitable than the S&P 500 (as measured especially by free cash flow). We look for growing sales. Most of the companies we favor pay dividends. We try to find the stocks with less risk. Not too many years ago, a study by Nardin Baker and Robert Haugen concluded that "Low Risk Stocks Outperform within All Observable Markets of the World." The paper was a follow-up on six other academic papers that concluded the same thing, that low risk stocks do not always outperform high risk stocks, but that they have outperformed on a consistent basis all the way back to 1926, the limits of their data.

You might call ours the tortoise approach. We believe strongly that over time, investors will be rewarded for taking on some risk and owning stocks. But we don't like to take more risk than is necessary. Paul Samuelson, the first American to win the Nobel Prize in Economics in 1970, once said, "Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas." We couldn't agree more.

Sincerely,

John B. Burke

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