Robotti
Value Investors

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Dear Client,

Tulips, Unicorns and Euphoria

Imagine you were a young Dutch man named Willem living in Rotterdam in 1633. You've inherited a few thousand guilders, and you're looking to invest for your future. Your neighbor proceeds to tell you how he sold a few of these small onion-like flower bulbs recently, and is buying himself a castle with the profits. Naturally, you want to mimic that outcome so you invest every last guilder you have in the promise that in much the same way those bulbs should become vibrantly colored tulips, your nest egg will grow into something beautiful once you sell them. At the height of the tulip mania bubble, many Willems (and Gertrudes) paid multiples of their annual salary for these rare, mystical bulbs. Fast forward to 1637, the tulip bubble burst, leaving the Willems and Gertrudes without a guilder to their name and a tough lesson on the difference between investing and speculating. In the end, speculators were wiped out and left with an exceptionally pretty plant that couldn't be sold for any amount of money. The pretty plant then withered and died.

Reading this story today, it seems obvious that investing your entire fortune in a few bulbs, as beautiful as their flowers may be, is an irresponsible way to invest. In fact, it isn't really investing at all. Before we rush to scold young Willem, remember that, at the time, it was considered irresponsible or even foolish *not* to buy every tulip bulb you could get your hands on. At the very same time tulip-mania gripped the Dutch Republic, the Dutch East India Company, the world's first formally listed public company, had just lost a major battle to the Chinese for the second time in ten years. As a result, Willem could have bought shares of what looked like a boring, out-of-favor business at a bargain price instead of spending his money on the wildly popular tulip bulbs. While it certainly would have been a much less sexy investment and was perceived to be even more risky (if not foolhardy), Willem would have actually been investing in a company that would maintain its dominance far past his (and his tulips') lifetime.

I'm not telling this story to disparage poor Willem, but to illustrate how stark the difference is between living in a bubble and thinking about past ones. Remember, all bubbles make sense … in the moment. This is the reason we continuously stress the importance of controlling emotions and remaining objective. The dot-com bubble of the late 1990's is a far more recent example giving us insight into how bubbles occur. Dot-com stocks were valued by "clicks and eyeballs" instead of asset value and cash flow. That may sound ridiculous in hindsight, but it is almost impossible not to get swept up in the exuberance when everyone, from the financial news to your taxi driver is boasting about the small fortune they made on the most recent dot-com IPO. Prudence quickly fades and it becomes foolish *not* to participate in such an easy way to get rich quick. Both of these events have become shining examples of what happens when speculation becomes confused with fundamental investing. It is also important to note that in prior periods of exuberance, and likely future bubbles too, there are early investors who do make huge sums of money, often very quickly. It's generally only the last people, the followers who join seeking hot trends, who generally lose their shirts.

Today's Tulips

Today, we believe there is a new, albeit just as colorful, bubble. Unicorns are private companies with a valuation over $1B. As of the beginning of the year, there were more than 300 unicorns in private markets. In 2018 alone, 26 of these unicorns IPO'd in the public markets. We would argue that many of these companies didn't want to go public but were forced to when there was no one left in the private markets to invest capital at ever higher multiples. While I've said countless times that public markets are not efficient, the fact remains that they often are far more efficient than private markets. Public stocks or funds that invest in public stocks mark their investments to market – so their current market value is readily calculable based on actual transactions. (Whether or not that represents their true valuation is a different story.) Private equity and other private market investors that do not have readily observable buy and sell transactions to turn to, mark their investments to model. Their investment valuation is based on model assumptions that do not necessarily reflect current business conditions.

I do not mean to imply that every unicorn IPO is poised to go the way of the tulip, but there are very real indicators that speculation is once again being confused for investing, especially when it comes to these "magical" companies. When I look into my toolbox to see how I can combat this, I see my favorite tool: valuations of future estimable cash flows. I'm very aware that value investing has been proclaimed dead everywhere from CNBC to Marketwatch and Seeking Alpha. There are two reasons for this proclamation, the first of which you and I are acutely aware of. Stocks grouped in the "value" bucket have underperformed, and the longer that continues the further in the grave pundits will bury the investment philosophy. We have seen this movie many times. I won't repeat our thoughts on that point other than to say underperformance leads to capital outflows and more underperformance until there is an inflection point (I'll come back to this). The second reason for value's apparent demise is that valuation is the clear enemy of the euphoria associated with many of the winners that have made lots of people lots of money.

Where do you find growth and not pay for it? Buried under "value"

Investors have become increasingly fearful about the obsolescence of boring industrial companies and as a result are giving very little value to anything other than the hope of optimistic future growth assumptions. As a result, markets have traded their fear in value stocks, and their optimism in growth and unicorns. Charlie Munger once quipped, "The whole concept of dividing it up into 'value' and 'growth' strikes me as twaddle." Warren Buffett goes on to explain, "The two approaches (growth and value) are joined at the hip: Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive." So we have a market where little to no value is given to growth inherent in many value-labeled stocks while investor exuberance in glamourous growth stocks has in many cases driven the "growth component in the calculation of value" well past most prudent measures. In other words, investors are potentially overpaying for stocks that have grown projecting continued growth and paying too much in their euphoria. In this type of environment, we have to keep returning to fundamentals. At the turn of the century after the dot-com bubble burst, we had five consecutive five-year periods of double digit annualized returns handily outperforming both the Russell and the S&P. I often quote Mark Twain who said, "history does not repeat but it often rhymes" and value is overdue for resuscitation.

Making Money Appeals to All Ages – but at What Cost?

I recently was shown an article from the Wall Street Journal that compared investors of the baby boomer generation with millennial investors. Fittingly, it was one of my millennial colleagues that shared it with me. The Wall Street Journal constructed two model portfolios. The first included stocks that should benefit from

the growing spending power of the millennial generation and included stocks such as Beyond Meat, Uber, Snap, Tesla and Netflix (none of which we own), among others. The second portfolio consisted of stocks that should capture the needs of the Baby Boomer generation who have entered or are entering retirement and included stocks like Pfizer, Royal Caribbean Cruises, Home Depot, and CVS (none of which we currently own). As I looked over the two portfolios, the first thing that immediately jumped out at me was the price to sales ratio for the millennial portfolio was a whopping 24.7x. Perhaps the impatience of the newest investing generation is driving them to project 25 years' worth of returns in the next five! But, far more shocking than the optimism of new investors was the ratio for the baby boomers portfolio, which stood at 3.65x. In fact, since 1998 the only time the price to sales ratio of 2.3x for S&P 500 was higher was at the peak of the dot-com bubble in early 2000. This compares to an average 1.7x since 1998, and our current composite's of less than 1.3x[1]. It's not hard to see how a new generation of investors could get swept up in promises of lab-grown meat, autonomous cars and colonies on mars, and to pay up for those prospects – but it seems that my generation is starting to pay up for future promises as well.

What we see is a dichotomy between physical and virtual. Physical assets are seen as old world economy, while the virtual world that is built on top of it is seen as the only part worth owning. What we would argue is missed in this split is that for every car used in a rideshare or movie streamed over the internet, there is a physical component to that being overlooked and undervalued. This is what we are seeing as the virtual vortex sucks capital out, continually discounting the cash flows of unsexy companies to continue feeding the glamorous promises of a virtual tomorrow. We believe that eventually speculation will cease to be confused with investing (at least for a time), and fundamentals will once again dictate valuations. When that happens, we are immensely well positioned.

Patience is fundamental to value investing because waiting for the market to understand what a company or industry is truly worth takes time. This holds especially true through cyclical trends, geo-political noise and other exogenous blurring factors and is why our time horizon has always been years if not decades. This particular cycle has been particularly long and enduring and I'm not turning a blind eye to changes that are happening. I do, however, question the myth vs. reality of all of these unicorns and the speed at which investors are assuming they will occur.

As we mentioned in our last letter, we have started to release short videos and thought pieces on our website, discussing different topics. I hope you will take a few moments to visit our website (advisors.robotti.com) and take a look. We are also on Twitter and LinkedIn. I would appreciate any feedback or suggestions you may have.

We look forward to continuing to work towards providing you with quality returns.

All the Best,

Bob Robotti

[1] Capital IQ and Robotti & Company Estimates

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