



SEPTEMBER 2017

THE FAANG STOCKS

In case you missed it, FAANG refers to the five wildly popular stocks that have been leading the market: Facebook, Amazon, Apple, Netflix and Google (renamed Alphabet). Of course being contrarians, we have an automatic revulsion to whatever is in vogue, and nothing could be more popular than the big five FAANG stocks that together represent the new economy and a huge percentage of the recent market advance.

FAANG stocks are obviously growing like crazy and can do no wrong. The problem is that what is obvious invariably becomes overpriced, and great companies become bad investments.

Here's a little history. In the mid-nineties, we avoided big cap growth stocks like GE, AIG, Enron and Tyco that were all the rage. Bad accounting and overly optimistic assumptions brought down these stocks, but that was followed by the dot-com and tech stock craze. We couldn't understand how the combined value of equipment suppliers could be valued more than all the telecom companies in the world. It turns out they weren't. During the financial crisis it became clear that it was worth having a healthy skepticism about the ability of big banks to manufacture straight line earnings. In every case, we were asked to suspend traditional measures of valuation and adopt a new reality, but the reality was that it ended badly.

With that background, let's look at the FAANG stocks and see why we are cautious. Amazon is a good place to start because it's a company we spent a lot of time looking at, would love to have owned, but didn't buy. The question now is should we reconsider? The answer is probably no because:

WAL-MART IS A BETTER INVESTMENT THAN AMAZON

That statement could only be made by someone who should have his brain studied for chronic trauma injury. Wal-Mart is an old, low end, big box retailer. It brings to mind stadium size parking lots full of pickup trucks and screaming kids, stocked with cheap Chinese goods and junk food. It's run by Doug McMillon, a guy you probably never heard of, from a non-descript building in Bentonville Arkansas. In short, it is the opposite of cool. Sales are growing by an anemic 5%, which explains why despite a dividend of almost 3% and a strong stock buyback program, only 41% of analysts give it a buy rating.

Amazon is the epitome of cool. It represents instant gratification of everything you could want with just a few clicks.

It's run by a Jeff Bezos from a revolutionary new office in trendy Seattle. Jeff, in addition to being a genius, is one of the richest men in the world, thanks to just a 17% ownership of the company. Amazon's growth is projected to slow from 27% a year for the past five years to a still sizzling 20%. If conquering the world of retail wasn't enough, Amazon is disrupting web hosting with its cloud computing offering and trying to do the same to entertainment with Amazon TV. Little wonder 86% of analysts have a buy rating on the stock. To suggest that Wal-Mart might be a better investment than Amazon is beyond being a contrarian. It's being suicidal! So, here goes.

First of all, we are not recommending Wal-Mart. We think there are more attractive opportunities in the sector. We are using it because it represents the base case for retail stocks. It is the largest retailer in the world by far, three times the sales of Amazon, with a history of rapid growth, but it's now stalled.

To be fair to Wal-Mart, when you have 2,300,000 employees and over 12,000 stores worldwide, it's hard to grow by double digits, much less 20% a year like Amazon. Still, they are trying. The online business is growing by 60% domestically and they are using some of their cash to buy their suppliers, which should improve margins. But, it's an elephant and it's hard to make it dance. So let's assume Wal-Mart just keeps plodding along for the next ten years with a 3% dividend and 5% earnings growth (3% due to growth in the economy and 2% inflation). A \$100 investment in Wal-Mart compounded at 8% for the next ten years will give you \$216. Much better than putting your money in the bank, but hardly spectacular. Surely Amazon will be better! Amazon has almost no earnings and no dividends, so Amazon investors value the company on cash flow, which is about \$12 billion versus Wal-Mart's \$23 billion.

Since the market is valuing all of Wal-Mart at \$245 billion and Amazon at \$480 billion, you are paying about 40 times cash flow for Amazon versus 10 times for Wal-Mart. That's the first sign Amazon might be overvalued.

Amazonians don't care about current multiples; to them it's all about growth. OK, let's assume Amazon reverses its downward trend in sales and can keep growing by 20% for the next ten years. That is a giant assumption because in addition to defying gravity, that would put sales at just under \$1 trillion, twice what Wal-Mart's are today. This would be a huge percentage of total domestic sales, which are about \$3 trillion today. If they don't get slammed by antitrust regulators. If they can capture about 20% of US retail sales. If their competition in online retailing and cloud computing can't gain traction. Then, they will have about \$1 trillion in sales in 2027.

So, now the question is, where will the stock be trading in ten years. For that we have to do a little math so bear with us. After twenty years of stratospheric growth, the law of large numbers will catch up to Amazon, and they will be lucky to see high single digit growth projections. Without the massive investments Amazon made in the past, they will bring most of their cash flow to the bottom line, so they will have earnings. That's good news, but with earnings come taxes, something they pay very little of today. At about a trillion dollars in sales, Amazon could at best have cash flow of 7% or \$70 billion. If they can bring 60% of that to the bottom line after taxes and other expenses, earnings will be about \$42 billion. Put an 18 multiple on that \$42 billion and you get total value of Amazon of \$756 billion ten years from now, versus \$480 billion today.

That works out to be a 4.6% annual return on your investment versus 8% for Wal-Mart, even if Amazon continues to walk on water and Wal-Mart does almost nothing right.

IS THERE A WORM IN APPLE?

On the face of it, Apple is by far the most reasonably priced of the FANG stocks. It is priced at about 18 times this year's expected earnings, has a ton of cash, is one of the strongest brands in the world, pays a 1.7% dividend and is projected to grow by 8-10% over the next five years. What's the problem?

Well, first of all, what do they make? Smartphones (64%), computers (12%), peripherals (11%) and software services (13%). The growth has been in phones, up from 45% of sales five years ago, and phones drive peripherals and services. Despite Apple TV, Watch, Pod, Pad, Tunes and Store, Apple is still a smartphone company. That's been a great place to be with worldwide smartphone sales increasing by 18-20% a year, but this year worldwide smartphone unit sales are slowing to 14% and are projected to go down to 6-7% over the next five years.

Average smartphone prices are declining almost as fast as unit sales are growing, making for a stagnant market unless Apple can either increase market share or increase prices.

Apple has generally been losing market share to lower priced phones in the key growth markets of India and China, so market share gains look unlikely. Apple has been successful to date in keeping revenue from slipping by increasing iPhone prices. The next iPhone 8 is rumored to be priced at about \$1,200 versus a similar iPhone 7 at \$800. Apple apparently needs that price to keep its amazing 21% profit margin in an industry that is lucky to get low single digit margins. It has to put enough new bells and whistles in your pocket to convince you to add \$15-20 to your monthly cellphone lease. It might work, but it won't increase market share and unit sales are already stagnant for Apple.

So where will Apple get the 8-10% annual growth rate it needs to support its current price? It's not obvious, but the risks are.

If revenue turns flat, and Apple is forced to cut its profit margins to something closer to the rest of the industry, the stock could get destroyed. Maybe growth will come from the \$1 billion they will invest in content, but talk about a crowded space! Without growth, and with declining profit margins, Apple's 4x sales ratio should decline towards the 1.5x for Samsung, 1x for LG or .5x for HP, Sony and Panasonic. That would leave investors with a bitter tasting worm in their mouths.

IS NETFLIX THE NEXT COMCAST?

We made a lot of money on Comcast, but we sold most of it when it became clear that traditional cable TV was being challenged by on-line offerings, the leader being Netflix. This was brought home when we noticed that teenagers never watch live TV. They stream it. Then the writing on the Wall came in 2013 when Comcast bought NBC/Universal. To us, this was an admission that Cable TV had become a slow growth business. The networks are dying and making hits is a risky business. Still, Comcast has continued to do well despite cord cutting and wireless broadband. Time will tell if we were wrong or just early.

But we didn't buy Netflix with the cash from the Comcast sales. Mistake number two? We couldn't believe that they would be able to sign up over half of the broadband households in the US, while keeping the content providers happy, and then emulate their US model overseas. The question now is do we buy it at roughly five times the price we could have gotten it for in 2013?

Here's a clue: Netflix is rapidly becoming a content company instead of just streaming old movies. A much more expensive and dangerous way to defend your franchise. Second clue: Netflix is now going head to head with Amazon.

Amazon has buried everyone who has stood in its path. If that wasn't bad enough, there is Hulu and HBO and Sling and ????. It's becoming a very crowded space with the only differentiation being original content. Cable at least has stickiness due to cancellation and reconnect fees along with triple play offerings. Cancelling Netflix once you've binge watched House of Cards is painless. The final clue that the tide is turning for Netflix may be Disney's recent decision to pull its content and become yet another direct competitor instead of a collaborator. Do I want to pay 50 times what the bullish analysts think next year's cash flow will be for a company potentially on the brink? We think there are better places to invest our Comcast winnings.

FACEBOOK VS (GOOGLE) ALPHABET

If you want to invest in on-line advertising, it's either Facebook or Alphabet, because together they control about 60% of the worldwide online advertising market. Nether stock is ridiculously priced; Facebook sells for ~43x cash flow, while Alphabet sells for ~22x. Future performance of both companies depends on growth, but obviously Facebook has a steeper hill to climb. Facebook will try to hold on to its social media franchise by, you guessed it, producing original content, and also monetizing it's Instagram, Messenger and WhatsApp platforms.

Facebook may be successful, but to meet expectations, it needs to keep growing by over 25% a year. Tough work for a social media company valued at \$450 billion.

In contrast, almost all of Alphabet's current valuation comes from its dominance in search advertising which shows no signs of obsolescence. Other than Baidu in China, Google has little competition and size has been an asset, not a liability. It's hard to imagine a business with a bigger moat against competition or a brighter future. Estimates are that the base search business grows sales and earnings annually by about 15% for a very long time

Then there is Alphabet's YouTube, Android, Maps, Chrome, Cloud and Home units. All have tremendous potential for growth and monetization. Add in their artificial intelligence and self-driving car technology and you have the potential to change the world. Facebook might be able to expand social media, but they aren't changing the way we drive or how we view the world. But wait, there is more! Google spends a good bit of its \$35 billion in cash flow on moonshot projects and venture capital. They have stakes in Uber, Airbnb and Glass Door. Even after that, they still have enough money to launch solar drones, air and fiber broadband plus various healthcare ventures.

When investing in companies like Facebook or Alphabet we think you have to minimize your risks and maximize your chances of something good happening to you.

We view Alphabet as one of the lowest risk companies we follow due to their market dominance in a fast growing industry. On top of that, it gives you the opportunity for a fantastic breakthrough in important new technologies and profitable businesses, AND YOU ARE NOT PAYING FOR IT!

BUY THE CAR, NOT THE STOCK

Tesla isn't officially a FAANG stock, but it's popular enough, and easily overpriced enough to be. Most importantly, it's just too easy to poke a hole in its valuation to pass up. We love the car. Elon Musk will probably go down in history as one of the great entrepreneurs of all time, but that doesn't make the stock a good investment.

Let's be extremely optimistic and say Tesla in ten years can match General Motor's sales today. It might happen; but that means sustaining a 30% annual growth rate that would double revenue every two and a half years! With an industry average 5% profit margin, on 2027 sales, they can earn \$8.5 billion from \$170 billion in sales. Put a 10x multiple 2027 earnings projections (almost twice what GM sells for today) and you've made a 1.7% annual return on your money for the next ten years.

But that is assuming that Tesla doesn't issue more shares, which would dilute those 2027 optimistic earnings projections. How else could Tesla fund that kind of growth in a highly capital intensive industry? The cash flow from the battery factories and solar panel business might kick in many years from now, after they cease to be a drain, but they too are highly competitive, capital intense businesses. To date, Mr. Musk has shown no shyness about funding growth any way he can. They just did a bond sale, but their credit rating is already junk. They can't issue a lot more debt without paying a much higher price, even if you assume interest rates remain low.

Without an insane growth assumption and no dilution of earnings, you lose money on Tesla!

THE DIFFERENCE BETWEEN TRADERS AND INVESTORS

We have tried to look at these stocks from the point of view of an investor, not a trader. The difference is that a trader couldn't care less about what will happen ten, five, even one year from today. He wants to get in a hot stock and get out with a profit. Traders love volatility because it makes for quick entry and exit points. In the short run, traders usually make money, because the current trend, even if it is based on nonsense, tends to perpetuate itself. Herds tend to stampede. But, in the long run, the profits from even a series of profitable trades can be wiped out quickly when the stampede turns into a rout.

FAANG stocks are perfect for trading.

Investors care more about what happens years from now than tomorrow or the next day because they plan to hold on to their positions for a very long time, generations if they can. They can suffer short term volatility caused by traders, but prefer not to, by selecting stocks with intrinsic value instead of popular appeal. Such investments exist, and we believe it is our job to find them, even if they happen to be a FAANG stock.

The point is, while we may miss a few revolutionary ideas, we won't get caught up in unrealistic expectations, and our clients will still be standing when reality sets in, as it always does!

ACCOUNTING 101

If anything we said doesn't make sense to you, or you just want to bone up on your accounting skills, here is a summary of the key words and assumptions we used. It's entirely voluntary, so here goes:

Sales and Revenue: We use these interchangeably to describe **total dollar income**, the top line of a profit-loss statement. It is an interesting way to compare a company's size and market share. It has limited usefulness as a measure of relative value because when you buy a business you are generally more concerned more about how much profit it generates than the value of the goods it sold.

Market Capitalization (Cap): This is what the market thinks the value of the whole company is worth. It's the number of common shares outstanding times their current price. It often leads to some interesting comparisons like: Tesla with sales of \$8 billion has a market cap of \$59 billion and GM with sales of \$160 billion has a market cap of \$50 billion. If you are an investor, you care about that.

Earnings per Share: EPS is the total earnings of a company divided by the number of shares. When you take the price and divide it by earnings, the ratio is known as **P/E**. It is the most commonly used measure of relative value of a company as in: Netflix sells at 170x earnings but Time –Warner sells for 16x earnings. Netflix is 10x more expensive.

Cash Flow: Cash flow, not earnings is often a better way to look at how profitable a company is. Cash flow adds back a lot of items companies include in their earnings, partially in an attempt to minimize taxes. Amazon had earnings last year of about \$2.3 billion, but cash flow of over \$10 billion. The difference is mostly from their ability to expense their investments in the business, which of course they want to do because it lowers their taxes. We generally prefer to value companies based on cash flow per share instead of earnings.

GROWTH: Growth is good! Investors are willing to pay a lot for it, but often they pay too much, and God forbid if growth should stall. When biotech company Amgen was growing sales and earnings by 30% a year back in 2000-2004 it sold for over 30x earnings, but when growth slowed to single digits from 2004-2010, the P/E got down to 10x. The stock did nothing for those six years.

10 Year Growth Projections: If you bought Amgen in 2006 for \$80 a share you clearly didn't think it would take five years before the stock saw that price again, but thanks to time and the resumption of growth in earnings, by 2016 you would have easily doubled your money. You would have tripled your money if you bought sleepy old Bristol-Myers instead, but such is the nature of projections, especially long ones. To justify the stratospheric valuations on some of today's growth stocks you have to assume they will grow for a very long time. Unfortunately, few companies have ever sustained a high growth rate for 10 years, but give them the benefit of the doubt and you can get some pretty outrageous results. Like Tesla selling as many cars as GM and Amazon capturing 20% of domestic retail sales.

VISIT OUR WEBSITE AT COMPASSAM.NET

COMPASS ASSET MANAGEMENT LLC • 10 Water St. Guilford, CT 06437 • (203) 453-7000

Compass Asset Management LLC is a SEC registered investment advisor, clearing transactions primarily through Pershing Advisor Solutions and Pershing LLC subsidiaries of Bank of New York Mellon Corp. This letter is written by Compass for the benefit of its clients and does not necessarily represent the opinions of its affiliated organizations. It is based on information believed to be reliable, but which is not guaranteed to be correct. Nothing herein shall be construed to be a solicitation to buy or sell securities, indicate that past performance is predictive of future returns, or recommend individual investments