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"Why do we believe things which are wrong?" Amazon's answer.

Everyone who writes gets the itch, now and then, to say something profound. It usually doesn't work out too well . . . but we'll go ahead and give it another try. Our subject is Amazon, which isn't very deep; but what's happened to Amazon lately points us straight at a pretty Big Question indeed: ***"Why do we believe things which are very wrong—catastrophically wrong, sometimes—when it's really obvious they're wrong?"***

The history of the investment world raises this question countless times; but at least the stakes in that world are merely our sacred fortunes. The history of the rest of the world raises this question again and again, as well: not "countless" times, but often enough and with such terrible consequences that the "How could we all have believed that?" question becomes profound, indeed. Let's glance at Amazon. It might shed a little light.

Purple is Amazon stock. Orange is the market's valuation of Amazon: its price/earnings ratio looking forward a year. Now, the professors among us—and there are a great many in the investment world—would jump up and down waving their arms at this point, offering a flood of nuances, criticisms and disqualifications about the faults and weaknesses of the "P/E ratio" as a fact to use when we think. They're absolutely right and completely wrong at the same time. The P/E ratio has all the weaknesses they name . . . but not one of them changes the fundamental meaning of that cliff-diving orange line.

It means this: Amazon has been "priced for perfection" by the market for a <u>long</u> time—but nothing should <u>ever</u> be priced for perfection. There is no such thing as perfection in our real world. That's why—when the market crowd acts as if there is such a thing—"priced for perfection" also means "doomed to a cliff-dive, eventually."

Amazon's price/earnings ratio has been stratospheric forever, seemingly: 70, 80 or 90 times earnings, which is the range the Dotcom Bubble made famous long ago. As we can see from that incredible, climbing purple line, "priced for perfection" didn't defuse Amazon's rocket ride, did it? "Why do we believe things that are very obviously wrong?" Let's glance at what was "obviously" wrong.

Amazon, of course, began as an internet shopping company. In General Forrest's words, "It got there the first, with the most." It spent galactic sums of money building a wonderful service which knocked half of Main Street's retailers out of business. A chunk of the galactic sums were spent on acres and acres of computers in giant warehouses, to keep track of Amazon's sales and deliveries. Then Amazon realized the acres of computers had acres of unused capacity (always true of computers) which could be used by every business in the world to "outsource" their own costly data processing work: doing it cheaper than they could do themselves. "Amazon Web Services" was born, and exploded with success. "AWS", of course, is in a completely different business than internet shopping.

Amazon Web Services is only 15% of Amazon's total sales. It is now more than 100% of Amazon's profits: "more," because the internet shopping business often either loses money or makes only a little. "Two Day Delivery" costs a ton of money—several tons, when inflation drives up the cost of gas, trucks, labor and electricity. None of that is nuanced or subtle. All of that has been "obvious" for years. Yet "priced for perfection" hung on, year after year, and the stock kept climbing—with the professors among us wisely citing the amazing growth of the company's "other business," Amazon Web Services, as justification.

Trees don't grow to the sky. They can be beautiful, strong and awe-inspiring . . . but they don't grow to the sky. It is indeed somewhat profound to ask, "How can so many investors ignore that piece of common sense for so long?" Of course that's the same Big Question we began with: "Why do we believe things which are very, obviously wrong?" Here's the answer, and Outlook's bit of philosophy for a Friday afternoon:

- **<u>Wishful thinking</u>**. When we want or fear something very much, we're tempted to stop thinking. "Wishful thinking," of course, isn't thinking: it's hoping. We're human beings, and that temptation is very strong.

- **<u>Uncertainty</u>**. When we're not sure about something important, we look around at what everyone else seems to be doing or thinking about it . . . and we're tempted to "let the crowd do our thinking for us."

- **<u>No time</u>**. Thinking clearly is work, and needs our time to dig up facts and look at all sides of the story. But we're all mostly busy with getting through each passing day and its chores.

So we're always tempted to "believe things which are wrong." Believing Amazon would explosively grow its Web Services business forever was one such thing—but a great many investors (and the usual mob of speculators) wished otherwise, or let themselves by kidded by the rest of the crowd—and especially by the astounding persistence of the stock's "priced for perfection"—into believing the Amazon tree would grow to the sky.

When the Dotcom Bubble finally burst 21 years ago, a very good company named Cisco saw its stock fall from $80 to $10. Today it's at $45. It's never gotten close to that $80, in the last 20 years; yet it's a strong company whose profits have grown 630% since 2001. Cisco is the poster child for "Priced for perfection = doomed, eventually." It's why Outlook hasn't touched Amazon, all these years, nor any of the other "Celebrity Tech" stocks which have added so much to many managers' performance . . . for a while. We cannot know when exactly "priced for perfection" will equal "doomed": only that it will, eventually.

Outlook Capital Management, LLC
125 S. Wilke Road, Suite 200E
Arlington Heights, IL 60005
847-797-0600

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