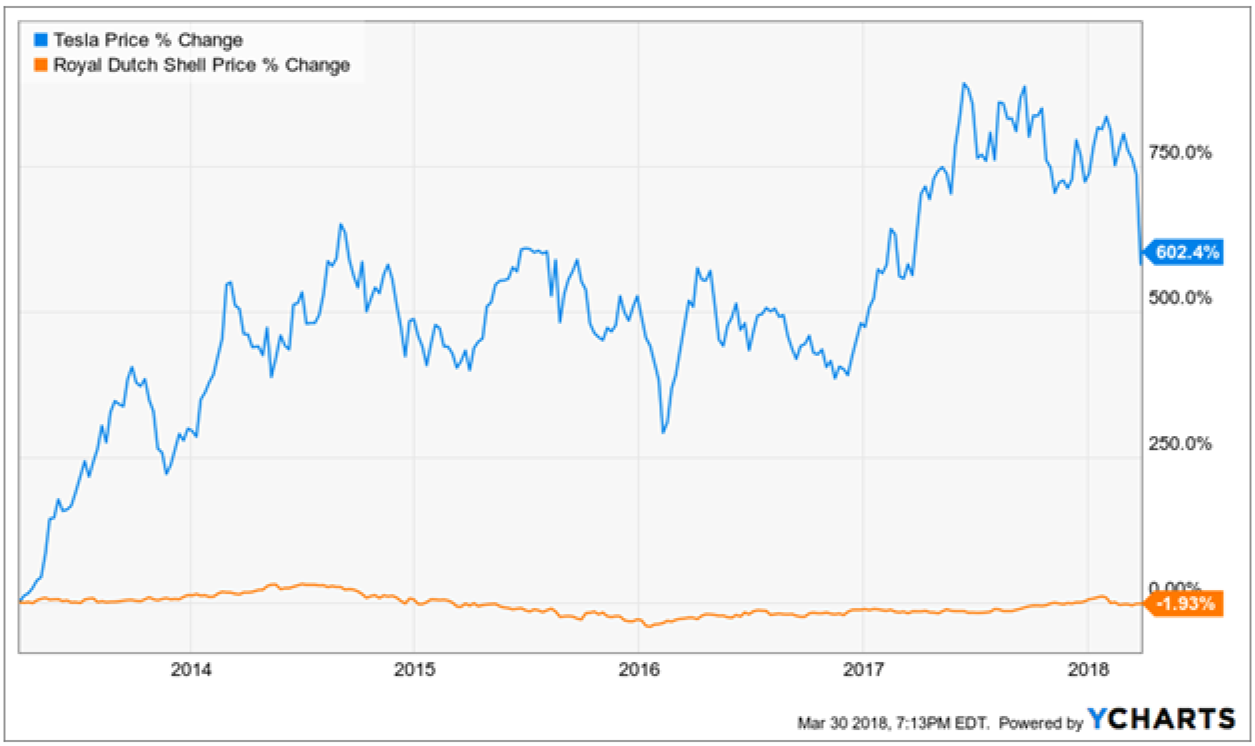
The Outlook: March 31, 2018

Tesla and Shell: danger for the market versus hope.

It's good to take every possible opportunity to understand the nature of the market. Since the market is a giant crowd of perfectly normal people, more or less, "understanding" it is somewhat like understanding any of us as individual people. Nope, not a trivial exercise. But the market's recent behavior sheds some light.

After a cheerful January, a jaw-dropping down and up in February, and finally a jaw-dropping up and down in March, the market ended down 1%, roughly, for the first quarter—the first "down" quarter in a good while. As Outlook noted a few days ago, the blame for this result has been handed, loudly, to a handful of big high-fliers which have done wonderfully for years—"leading" the market—hence whose staggering recent action has created plenty of jitters in the investment world. Earlier this week we used one of that club, Facebook, to shine light on the nature of the market. Let's use another, Tesla, for the same purpose today.



Here's Tesla's 5-year performance, in blue above. (The dismally flat orange line is Royal Dutch Shell—but we'll come to that later.) A few months ago Tesla was up nearly 800%, until the damage of the past 3 weeks. When we consider the tremendously big valuation of Tesla as an entire company, we can understand the investment world's fear that if such multi-year leaders are going to stagger and fall, the game's up for everyone.

We can understand it . . . but it's wrong.

A simple way to understand why it's wrong is to look, now, at the orange line: Royal Dutch Shell's total return to investors over 5 years. Dismal indeed. And if Shell's orange line will be staying flat for the next couple of years, while Tesla's blue line continues its downward plunge (fairly likely, in Outlook's opinion), then we might fear that the market's fear is well-grounded. That sort of future picture would mean that this bull market had lost its high-flying "leaders," and nobody had stepped up to take their place.

That's very unlikely. To understand why, let's look a bit deeper at these two businesses: Tesla the "rocket;" and Shell the "lame plowhorse."

> ***"As a reality check, Tesla is worth twice as much as Ford, yet Ford made 6 million cars last year at a $7.6 billion profit while Tesla made 100,000 cars at a $2 billion loss. Further, Ford has $12 billion in cash held for "a rainy day" while Tesla will likely run out of money in the next 3 months. I have never seen anything so absurd in my career."***

That was a hedge fund manager speaking a couple of days ago. He isn't worth quoting because he is a hedge fund manager—but because of what he said. Of all the hundred million words or so written about Tesla over these 5 "rocket years," we've seldom seen so few words express so clearly what any investor most needs to understand about the company and its stock.

Now let us flip back to Royal Dutch Shell. We can see the blue plunge from 2014 to 2016, as oil itself dropped like a rock. We can see the plunging "operating cash flow" (orange) which told Shell's management: "fix it or die," more or less. And we can see what they did. They fixed it: cutting costs, selling non-crucial assets, paying off debt. 2017's cash flow rose 80%, and its continued rise is as close to a fact of life as the business world ever provides.

"Operating efficiency has led to strong cash flow generation by the company. Over the last year, Shell delivered $39 billion in cash flow from operations, excluding working capital, and that is in a $55 oil price environment. The level of cash flow generation is <u>60% higher than in 2015</u>, when the oil price was also at $55. The level of cash flow is also close to the 2014 number when the oil price was at <u>$99</u> per barrel. These strong results illustrate the cash-generating capabilities of Shell's lines of business, all focused on operational excellence but also activities with high profit margins."

That's an analyst simply quoting Shell itself, as the company recently explained its progress and strategy. There are a great many facts and statistics which we might scrutinize to illustrate Shell's outstanding response to its crisis. But this one fact captures the story: <u>Shell now makes as much cash flow as it did when oil prices were twice as high.</u>

What is in the nature of the market, that it can fall so deeply in love with a stock like Tesla, not for a few quarters but for <u>five years</u>; while spending much of the same five years intensely doubting Shell (and Micron, Caterpillar, Cummins, Freeport, Schlumberger, Conoco and a great many others <u>not</u> owned by Outlook), despite the jaw-dropping difference in what's actually been going on inside these companies, compared to Tesla?

Outlook's answer is "human nature." We are inclined to assume the best about winners, overlooking flaws and weaknesses which seem obvious later on; and assume the worst about "losers" or companies in trouble—overlooking strengths and achievements which would be obvious to us, if we bothered to take a hard look. The market's speculating crowd, which is vast like the stars in the sky, makes its living from its understanding of our inclinations. That vast crowd staggers and falls when it thinks such inclinations matter more than solid business achievements. In Tesla's case, the solid business achievements have been thin on the ground: dangerously thin relative to the market's joyful treatment of its stock. In Shell's case, the achievements are all over the place, ranking somewhere between "impressive" and "astonishing." And so Shell's orange line will not keep bumping along down in that dismal valley. It will be rising sharply like so many of the market's "other" companies, which have been doing the same kind of hard, effective work to build improving business performance. That's why we own them, and it's why we're not inclined to share the market's recent fears.

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