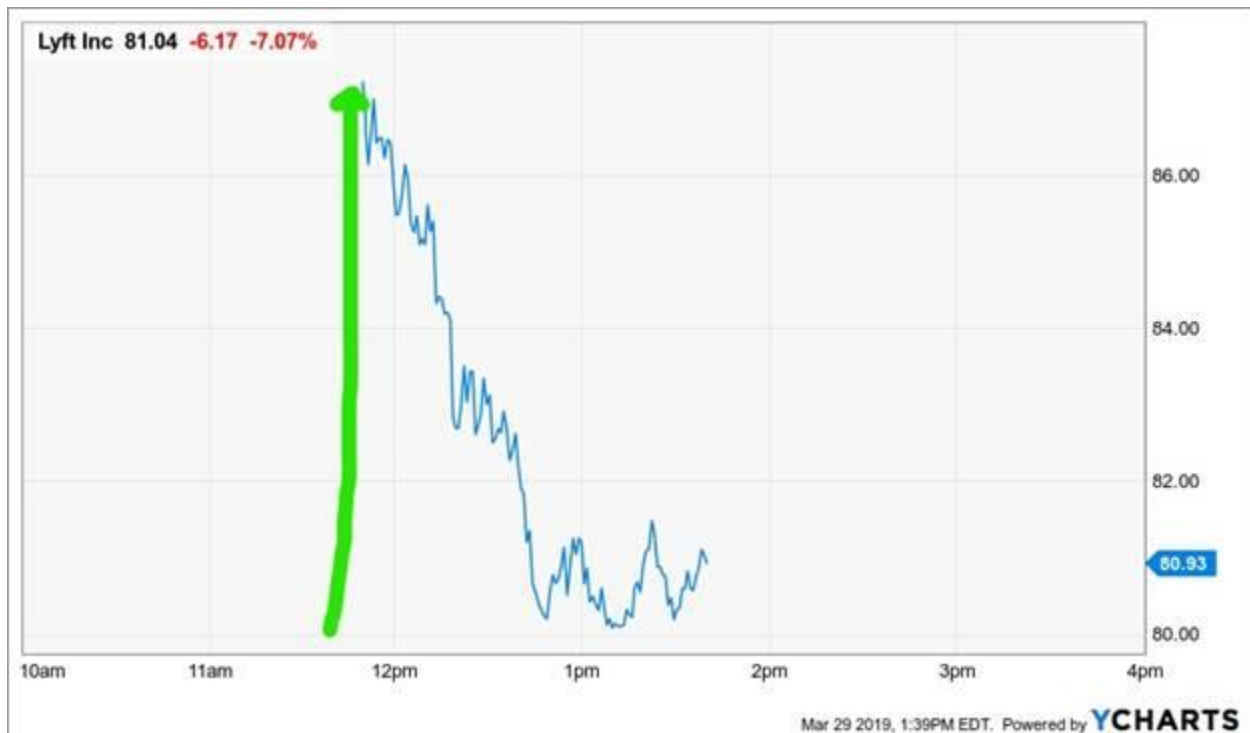


The Outlook: March 29, 2019

The market's nature: zombie valuations vs. everlasting life valuations

We talk a lot about “the nature of the market,” don’t we? Pardon in advance for doing it again, today. It deserves the recurring attention, in Outlook’s opinion, because so many investors are uncertain about the market’s nature—or downright wrong, often enough. That’s no wonder, given the absolute flood of daily messages washing around the investment world, which suggest the market is something other than what it actually is.

Let us contemplate Lyft, today. The ride-sharing company (and Uber competitor) is in the headlines today because it just “went public,” meaning it sold shares in the publicly-available stock market for the first time. We’ve been informed, all week, that Lyft’s IPO was “hotly anticipated,” which is code for “If you’re in the know and got some shares, you’ll make a killing this morning.” Here’s how the killing looked.



Lyft sold its shares “ahead of time,” so to speak, at \$72, and the moment they began trading they rocketed up 21% or so, to around \$87. Nice work if you can get it . . . and this afternoon’s market is surely filled with speculators gnashing their teeth because they didn’t manage to get any. Of course, they would have had to be quick to keep the 21% return falling out of the sky, as we can see above. Lyft trades around \$81 at this particular moment, a couple of hours before the market closes—a 7% loss for anyone buying when Lyft’s bell rang, and so slow or so optimistic as to have held, for an hour or two.

Now straight to the point. Lyft, of course, has done nothing but lose money as a private company, so far. Its profit margins stand at minus-44%, coming into today. That number is stunning, almost like a wonder of nature worth our awe-struck gazes . . . but no time for that. Yesterday Mr. David Trainer, a

Main Street-type analyst, summed up Lyft this way. All the company has to do, to justify today's market valuation, is:

- Become profitable immediately, replacing the 44% negative margin with a 4% positive margin; and
- Grow sales 25% per year for 10 years;

Yes, only 2 things to do. If it does, remarked Mr. Trainer, the company might reasonably be worth 1.6 billion dollars after the 10 years. The slight problem is that this afternoon's valuation, at \$87, was 30 billion dollars. So if Lyft gives us 10 years of spectacular success following an instantaneous reversal of today's operating losses . . . it could be worth about 5% of what the market says it's worth, at this moment on Friday afternoon.

Let's seemingly change the subject, just for a moment.

Cisco: 15 Years After the Top



That is Cisco, peaking at \$80/share at the end of the Dotcom Bubble in March, 2000. Cisco then, unlike Lyft today, was solidly profitable and rock-solid financially. But its 2000 earnings were around 36 cents per share, for a price/earnings multiple of 220 or so.

Following the red arrow, we see that 15 years later, Cisco traded at \$25, which was 70% less than its peak, having spent most of the 15 years at that \$25, or lower. Of course, now we're going to make disrespectful remarks about "the nature of the market," but first, one last thing: unlike Lyft, Cisco was then, and has remained ever since, an extraordinarily solid company financially. Profits have endured their challenges, but beaten them, growing admirably throughout. Cisco's operating business—centering on global

computer networks—has adapted to its challenges. The company was the global networking leader in 2000, and still is today.

No matter: down 70% anyway, and stayed down. Why?

Because the market, in fact, is so far from a coolly-calculating, always-rational, fine-tuning judge of operating businesses and their relative cash values that the only people in the investment world who can't see the joke are the most highly-educated among us: the professors from the most distinguished halls of academia who thunk up the “efficient market theory” which makes all those claims about the market’s nature. They did this decades ago, and they still believe it. (That might point us toward the topic of “the nature of intellectual thought,” but we’ll stick with what we know.)

Mr. Trainer’s nice work ended with his own opinion about why the market does things like Lyft, today; and Cisco, yesterday. He looked at professional fund managers—most of whom purposely own what most of their competitors own, rather than what they don’t own. They do this because clients’ money leaves fast when a fund noticeably “underperforms” its peers or its relevant index. Client money doesn’t leave when they do about what everyone else is doing. Client money flows in when they spectacularly “outperform,” but that’s a dicey proposition, as far as most of them are concerned. Above all, they wish to avoid the worst pain, which is that loss of client money.

So, if “everyone is buying Lyft,” everyone must buy Lyft—regardless of a galactically-silly valuation. If Lyft pops 21% the day it opens, great. If Lyft then plummets 40% in the next week or two . . . too bad, but really not so bad as long as “everyone else” is taking the same pain. That may sound more like a herd of lemmings rushing over the cliff together, than a collection of sharp-minded independent thinkers. Indeed.

The nature of the market is troubling, isn’t it? Yet as we remarked just yesterday, we are saved by the fact that Wall Street is not Main Street. Main Street creates things, sometimes with flashes of genius; and builds things, usually with admirable determination and persistence over many years. If you are 2019 Lyft or 2000 Cisco, the market always eventually faces the fact that what you are building might be good, but it’s not a cure for cancer or the secret of everlasting life implied by the market’s silly value. If you are 2019 Micron, Caterpillar, Freeport, Cummins, Conoco and the rest, the market always eventually faces the fact that what you are building is not only quite good, but very far beyond the zombie valuation awarded by a doubting market.

It is much safer to own those zombie valuations, knowing their Main Street successes always wake the market up in the end; rather than owning those “everlasting life” valuations—which never defeat gravity, in the end. We’ll keep doing that.

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

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