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Not a Mystery

Summary: Stock prices may be disconnected from media negativity and risks related to a still-untamed coronavirus pandemic, but this can be understood and is normal, in our opinion. In this newsletter we argue that uncertainty and possibly scary valuations do not mean you should run away from equities. Our view is unchanged. We remain bullish regarding the long-term outlook and prospects for *exceptional companies* to create value.

Wall Street & Media Focus on the Economy and Valuation is Not Helping You

Reorient your investment thinking. A great quantity of investing advice and focus found on Wall Street and the financial media is centered on 1) discussing the outlook for the economy and 2) evaluating whether the market is attractively priced relative to the outlook. This seems reasonable right? On the contrary, we argue that you should spend no time thinking about either. First, it is nearly impossible to have special insight into the future of the overall economy. Individual components of economic activity can be forecasted. However, the challenge with getting the future of "the economy" right is that *there are too many inputs*. It is just too hard to construct a forecasting model that will capture and appropriately weight all the relevant factors. Coronavirus is a case-in-point. No one had the risk of Covid19 built into their economic outlook.

If you accept this, you're half-way to understanding why discussions of "market" valuation are unhelpful. For starters, if the economic outlook is highly uncertain then it becomes very difficult to evaluate *with conviction* whether stock prices (in general) are too high or too low. But we think there is a deeper issue. It has two parts.

The first part is that valuation measures are typically relativized to the past. That is, when Wall Street or the media comment on valuation, today's prices are normally compared to past measures. But why? Today's large companies have different business models, different levels of profitability, different tools to grow, much greater access to global markets and operate with different accounting and tax rates and regulatory regimes relative to the past, not to mention a completely different interest rate environment, among other variances. Comparing the valuation of today's companies with a group of businesses from the 1960s is not going to tell you anything useful. Ignore this. In place, what you'd really like to know is how today's valuation for equities will compare to their future valuation. But that is unknowable. The second part is that "the market" is *too wide a lens*. Within the market, there will always be some companies that are fantastically underpriced relative to their prospects and others that are massively overvalued. Reflecting on whether the market overall is too expensive is not going to help you find great investments and avoid duds.

Stock Prices and the Economy are Decoupled, Deal with It

We propose: a more useful investment thinking framework is to start with the assumption that equity values are *more often than not* trading on factors that have little to do with long-term earnings and cash flows. We read an article, published yesterday, written by famed economist Robert Shiller, which goes to great length to explain the "mystery" of the divergent direction of stock prices and economic news. Here's an excerpt: "The more economic fundamentals and market outcomes diverge, the

SEE DISCLOSURES ON PAGE 4-5

deeper the mystery becomes, until one considers… [that] stock-market movements are driven largely by investors' assessments of other investors' evolving reaction to the news, rather than the news itself." We have immense respect for Prof. Shiller and can never hope to be as esteemed or to contribute as much as he has. He has the Nobel Prize! Nevertheless, we have to this call like we see it. It's bullshit. There *is no mystery* surrounding the decoupling of the market overall and the economic outlook, just as there is frequently no mystery when an individual stock price bears little connection to the underlying company's fundamentals. It is happening all the time. The trouble is that our brains are wired to seek coherence and explanatory narrative in our understanding of the world, and thus, we are frustrated when the world does not cooperate.

In this case, the problem stems from the false premise that prices for stocks and the market are set via a process of rational evaluation of investors (whether human or computer) regarding the outlook and taking into account all relevant information. This is just not true. Based on our experience, stocks and the market frequently make movements that have nothing whatsoever to do with fundamental outlooks. We'd go so far as to say that *most stock price movements are decoupled from expectations* for future earnings and cash flows. Why would we say this? Recall our earlier discussion. The future is difficult to predict, and changes in long-term outlooks normally happen very slowly, so it follows that jittery daily or weekly stock price or market movements are normally unrelated to the fundamental outlook. Once you replace and reframe the false narrative that stock prices are tied to individual company fundamental outlooks with an understanding that this is seldom the case, you won't need to conjure up a convoluted explanation for what's happening. The mystery disappears. (BTW, here is the link to the rest of Prof. Shiller's article.) Judge for yourself.

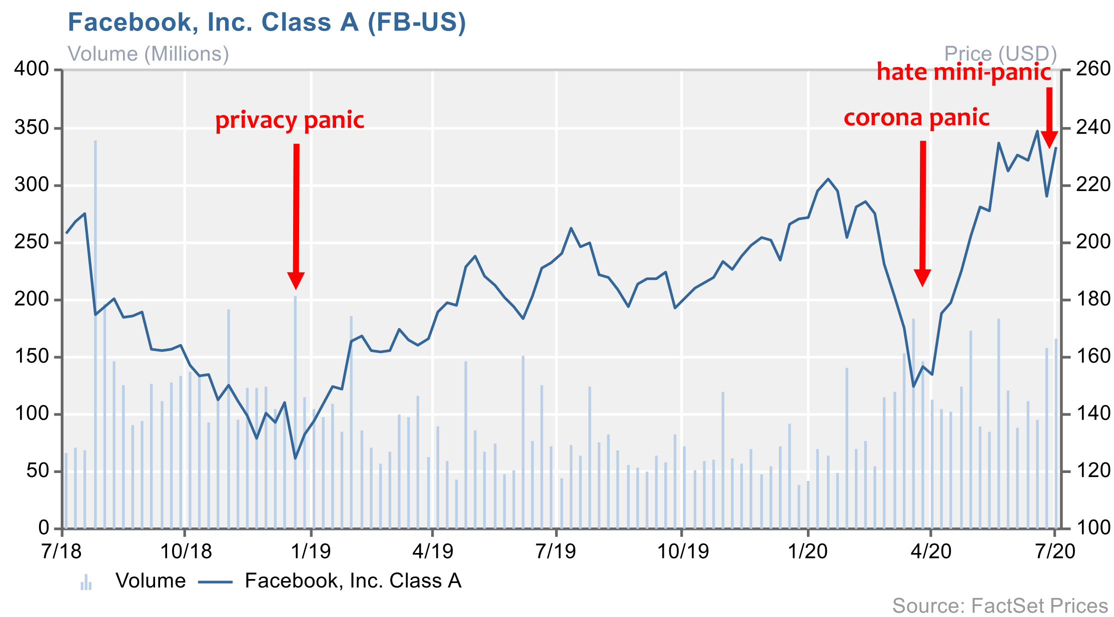
Uncertainty does not mean Do Not Act

Get an edge by focusing on factors that can be predicted. We have argued in earlier letters that Wall Street has one focus which is driving transactions and the financial media (not all journalists, just the industry taken as a whole) is a noise machine. Together, these work in a symbiotic relationship, constantly triggering investors, corporate management teams, and governments to act, and profiting from the volatility that ensues. The good news is that this creates an environment that lends itself to investment opportunities. We have argued here that some very important aspects of the future are unknowable or unpredictable. So put all your savings into gold? No, we accept this and in turn use it as a foundational component of our approach to stock selection and risk management.

How We are Managing Client Money: Facebook (FB)

Know how to identify noise. We wrote about Facebook in April when the stock was trading between $150 and $160. (You can read that write-up here.) At that time, the shares were swept up in a general market selling program related to fear of Coronavirus. We argued then that Coronavirus had actually made FB more valuable, regardless of near-term advertising revenue, as isolation and stay-at-home orders drove more traffic to the company's platforms. This further provided a proof-point of the company's main use-case as a mechanism for people to connect. Regardless of whether we were "right" FB shares have since more than recovered, hitting a new high above $240 this week. More recently, FB shares dipped as social unrest generated a debate on whether FB should do more to remove "hateful speech" from the platform, spurring a number of companies to pull or pause advertising. However, the damage to the share price has been limited. Why? Investors have generally ignored the risk posed that FB advertisers revolting could snowball into a bigger backlash. It's simple, in our view. FB has more than two billion active users. The company has extensive knowledge about these individuals. There is no other equivalent and effective platform for advertisers to reach this group, most of whom are not even in the U.S., which is the locus of the current political tension. The brouhaha about hate speech is noise. Yes, Facebook remains a favorite punching-bag for the media. It makes an easy target, precisely because it is everywhere, and its model is so powerful. Our focus as investors in the stock remains on the long-term potential to monetize its user base across its platforms (Facebook, Instagram, WhatsApp). We continue to believe it is very early and the shares are not expensive relative to this long-term potential.

Figure 1. Love > hate. FB shares are up 19% YTD and 23% over the past year.



Still no business travel but taking advantage of the situation to hit some of the best Greek islands: I am based in Paris and normally I return to the States a minimum of every other month to visit companies, meet with clients, and walk retail. I try also to get to London and China at least one time per year. It is not looking like this program is going to happen in 2020. First, I had to spend seven weeks in a farm village in the French countryside to avoid the government-imposed *confinement* in our small Paris apartment which is notably lacking in outside space. I did get back to Paris for a bit, but then returned to the countryside, where I'm writing this today. I usually try to avoid locations known to attract giant mobs of tourists at high season but given that Americans are personae non gratae, other travelers can't come and cruise ships are left in dry dock it seemed this was the year to go to Greek islands. To prepare, I am bushing up on my more-or-less nonexistent Greek via a language learning app where you can schedule 1x1 video instruction for at very attractive prices. Φαυταστικόσ!

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Mr. Zolidis started his career in finance in 1996 following degree studies in Philosophy at Kenyon College and the University of Oxford. He has followed U.S. consumer companies as a senior analyst since 1999, mostly on the sell-side, writing research for institutional investor clients. He also managed money in a buy-side role at a long-short equity fund over 2013-2014. He was named in the Wall Street Journal's Best on the Street list in 2005. Mr. Zolidis founded Quo Vadis Capital, Inc., a Registered Investment Advisor (RIA) and research consultancy, in 2017 and works from New York and Paris, France.

Smells nice too. Here's a field of lavender off one of my usual MTB routes down here in the French countryside. Usually the flowers are covered by a din of white butterflies and bees. Eventually the farmers come through, chop off all the flowers and then stuff them into little *sachets* (bags) and sell them at the local *marché* (market) where can buy 'em. Makes the powder room smell like your grandma just visited.

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The analyst who is the author of this report has a long position in shares of Facebook (FB). Quo Vadis prohibits analysts from trading in a way that is inconsistent with opinions expressed in reports [subject to exceptions for unanticipated significant changes in the personal financial circumstances of the analyst].

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