June 2021

How the Meme Movie Ends

Two Speculations Debunked

All-time highs on Memorial Day. The S&P 500 is up 12% YTD, enjoying an ongoing stimulus- and reopening-fueled rally. We remain bullish on the prospects for select companies but see speculation in alternative assets, percolating inflation, and the coming inflection in interest rates and taxes as risks.

What can action in speculative assets tell us?

The attractiveness of speculation is inversely related to fear of losing money. What has the investing public learned from the corona-panic and the financial crisis before that? We suggest that the lesson has been: the Feds don't want you to lose money, and the government likes a stock market that goes up. After all, when things seemed most scary, such during the corona-panic, Uncle Sam got to work behind the scenes to tweak the mechanics of the market to stabilize prices and shift the narrative to recovery from fear.

What distinguishes speculation from investing? The way we see it, investing involves buying an asset, be it a stock, piece of real estate or a business when there is some reasonable basis for believing the asset will have a greater value in the future than the price paid. Speculation is similar but accepts a much wider range of outcomes (including more downside risk) for the asset and does not require a reasonable basis to believe the asset will be worth more in the future. An example of speculation, according to finance books, is raw land. Raw land does not generate income and its future value is probably determined by factors exogenous to the property.

Where are the biggest areas of speculation right now? This may anger some people but we're going to call out three categories. The first are so-called special-acquisition-companies or SPACs, the second are digital currencies (Bitcoin, Ethereum, Dogecoin and the like) and the third are meme-stocks (Gamestop, AMC, Express, etc.). We'll leave discussion of SPACs for another newsletter (or maybe we'll spare you).

Take digital currencies for starters (we don't say crypto, there's nothing cryptic about them, in our opinion). There is no *fundamental basis* for the value of these digital "tokens". And this is exactly what makes them awesome – for speculation. Let me explain with an analogy to the world of philosophy. In symbolic logic, if one accepts a logical contradiction (e.g. A and not A) as true then *any statement* can be proven. Similarly, if digital currencies have no fundamental basis for their value, then *any value* can be justified.

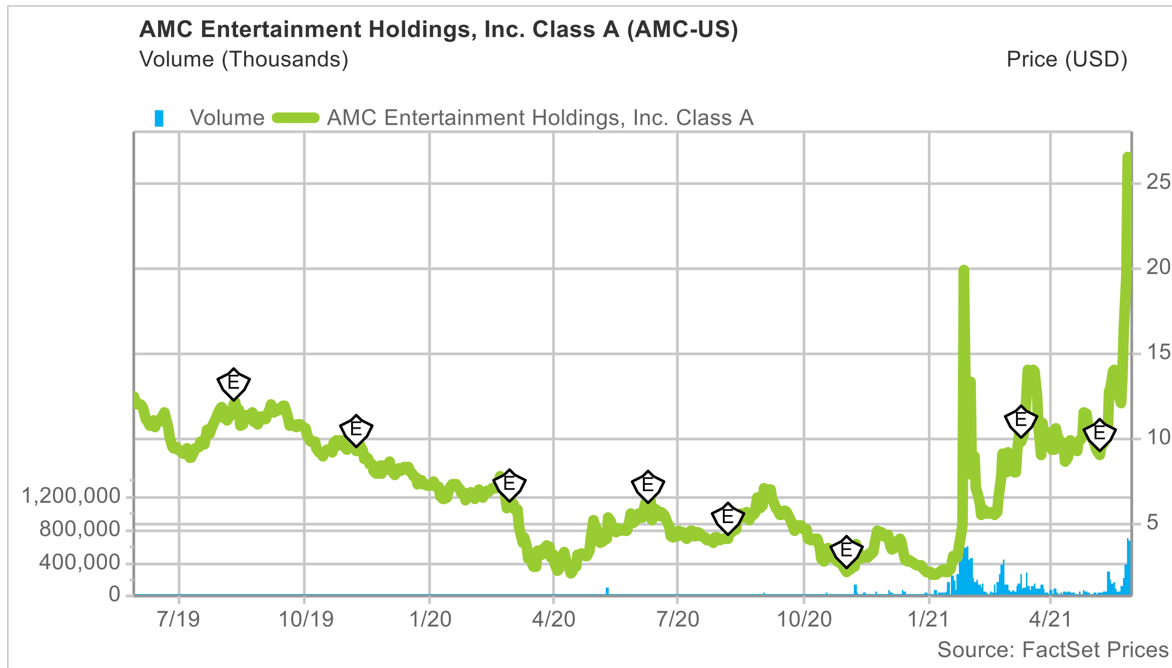
What about meme-stocks? In this case, there are real companies behind the mob-based price action. However, the activity of buying and selling GME or AMC shares appears *purposely detached* from any relevant fundamentals (future earnings, cash flow, unique assets and liabilities). Unlike Ethereum, it is possible to analyze the value of AMC. Let's do something the meme-followers aren't and take a look:

AMC Entertainment Holdings, Inc. (AMC) is the largest operator of movie theaters in the world with about 1,000 theatres, 60% of which are in the U.S. How can we determine value of its stock, which jumped 116% last week and over 1,000% YTD to close at $26 on Friday? One way is to start with the company's best performance in the past five years, which was 2018, when AMC generated cash flow from operations (we'll use EBITDA as a shortcut) of $812M on revenues of $5.5B. The company should have just over $5B in debt net of cash at the end of the second quarter and now has apx. 462M shares outstanding. If AMC can return to 2018 levels of profitability and trades at 5-10x (using enterprise value (debt + equity) to EBITDA), then the business is worth $4B to $8B. When

we subtract the $5B in debt, the equity (stock) is worth between zero and $3B. At the high end of the range, each share would be worth $6.50 vs. Friday's $26 price. Of course, this assumes AMC could get back to peak results. In fact, the company lost money in three of the five past years and is forecasted to lose money in each of the next five.

We'd wish the Dogecoin and meme-speculators good luck but it's probably not necessary. After all, the Fed's got your back, right?

Figure 1: AMC was valued at $17B at Friday's close despite an indebted balance sheet and little chance for near-term profits.



The Fed is Increasingly Conflicted and Knows It

The Federal Reserve has used monetary policy (lowering interest rates and bond purchases) to reduce the cost of financing and doing business. The government is using fiscal policy (increased spending and direct payments to individuals) to directly stimulate spending and drive economic activity. It's working. However, there are consequences, both intended and otherwise. In the case of monetary policy actions, the promise of ultra-low interest rates for an indefinite period has contributed to a higher stock market. The government fiscal policy actions have an intended social dimension, which is to provide help to families on the lower part of the income spectrum.

Both sets of actions are generating cost inflation. Ease of financing is creating higher equity and real estate values. Direct payments to individuals are driving price-insensitive demand, which is being met with, you guessed it, fewer discounts and incentives from retailers and service businesses. Labor costs are rising as a rush to rehire workers is clashing with a disincentive to work created by enhanced unemployment payments. Supply chain disruptions still rippling from Covid restrictions are contributing to shortages in certain items, causing prices to rise, as well as higher distribution and transportation expenses.

The bottom-line, in our opinion, is that the economy is no longer in need of intubation. The stimulus and spending actions have served their purpose. A multi-trillion-dollar spending and redistribution program is probably not necessary from an economic perspective, in our view. Meanwhile, the nearing inflection in monetary policy (we anticipate fewer bond purchases and rising interest rates) combined with the negative effects of proposed tax hikes (no amount spin can make these positive for economic activity) will together surely be negative equity prices. We won't even address what it might mean for fake digital currencies or stocks trading on thermal vents.

How we Approach Risk Management

Let's be honest. Managing investments in a stimulus-driven bull market that goes up every month should not be too difficult. This may change with the coming backdrop of rising interest rates and taxes. Of course, the timing and magnitude of these headwinds are unknown. The hope would be that the economy's exit velocity from stimulus will allow it to overcome less central bank support and continue to grow. One day, the economy perhaps might even generate a surplus for the government and allow it to reduce debt. Actually, no one thinks that will happen.

Among risks, one is the Federal Reserve acting too slowly to pull back on stimulus, thus sparking significant inflation which require even higher interest rates down the road. Alternatively, the rate and tax hike combination could retard economic growth, leading to lower valuations for the stock market. These are in addition to the normal risks and the unknown risks (remember the pandemic contingency planning everyone had in place ahead of Covid19? Right.)

Some investors address risk to investments by balancing exposure to equities (stocks), with bonds, cash and sometimes commodities. Others use hedging strategies including options and/ or short-selling. Still others advocate diversification, channeling grandma's "don't put all your eggs in the same basket" wisdom. Some market timers try to predict (that is, guess) when the market trend will reverse and advocate increasing or decreasing cash as a percentage of your portfolio to take advantage of anticipated entry and exit points. *We have a different approach.*

Our view is that it is not possible to anticipate the outcome, on a macro level, of the combination of known and unknown risks and effectiveness of the policy response, which is itself a risk. Accordingly, we believe market timers are fooling themselves while creating unnecessary trading costs and tax liabilities. We also see the low returns of bonds in the current environment as mostly a waste of time. Lastly, the main result of wide diversification, in our opinion, is that you own some great companies and some lousy companies in equal measure. Why is that wonderful?

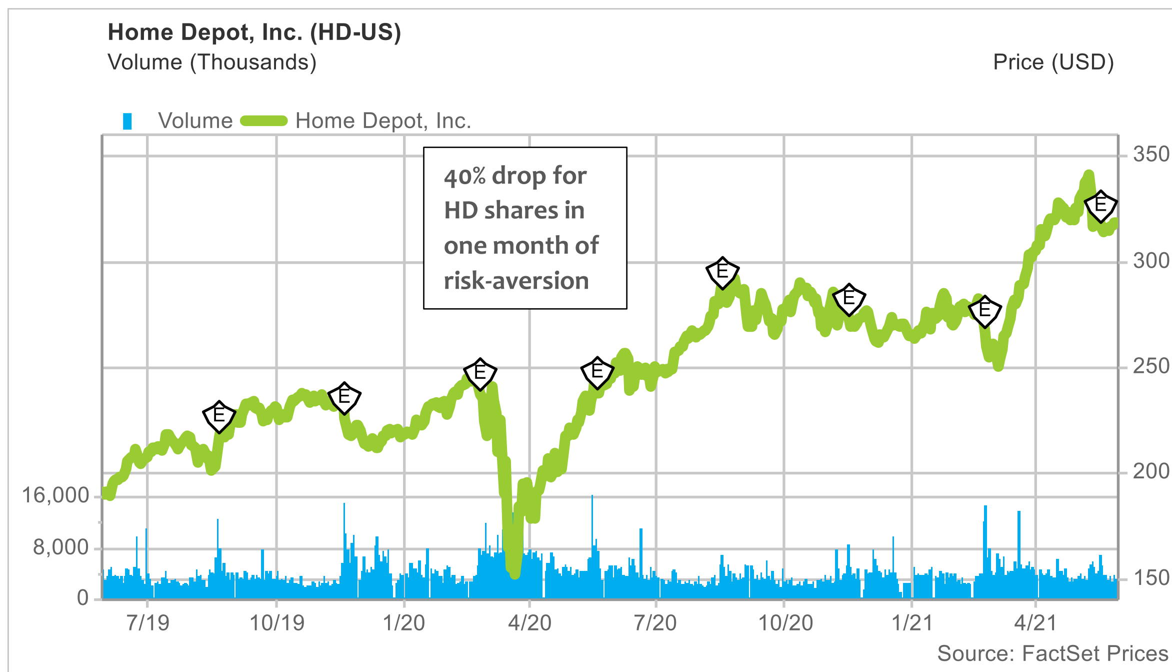
Instead, our risk management approach is the following: *We hand over the response to known and unknown risk to the management teams of the companies in which we invest*. We know that the management teams of the best companies have the greatest resources, the best systems, strong brands, and ability to adapt to change. Rather than spend time trying to forecast the unknowable future, we focus our energy analyzing business models and management strategies and *leave the hard stuff up to them.*

As an example, consider Home Depot (HD), the largest and best home improvement retailer. We have followed the company for about 15 years. In our view, the company's exceptional performance is due to a combination of its real estate (the company was the first big-box home improvement retailer to open in most markets and it occupies the best locations which serves it as a long-term structural advantage), its retail and merchandising strategy, a decade of underbuilding of U.S. homes since the financial crisis (which has increased long-term demand for home improvement-related spending) and the company's excellent management team. We believe these factors are well understood by professional investors. Yet, during the corona-panic, HD shares plummeted

about $100 per share to around $145, losing 40% of their value in just one month! We didn't know what was about to transpire, but *we felt confident handing over the response to the crisis to the HD team* and held our positions. We should add that our approach also reflects a lesson learned during the 2009 financial crisis when we missed an incredible opportunity to recommend HD shares when it got as low as $20. DOH! Regardless, with the shares having now rebounded to $320, we continue to feel good about HD's ability to react to whatever comes next and continue to like the stock.

A side benefit of our approach to risk management, which also includes concentration rather than diversification, is that we spend close to zero time considering whether the market is overvalued or not, which is a constant preoccupation of the financial media and financial advisors elsewhere. The valuation of stocks in general is simply not relevant to the long-term prospects of the small number of great businesses that we own.

Figure 2: Home Depot (HD) two-year chart. Did the market timers get out at the start of 2020? And then get back in at just the right moment?



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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.

Outdoor seating is open again in Paris. France has lagged the U.S. in vaccinations but simultaneously also benefits from a much-stronger social safety net for the unemployed, which includes access to health care. Accordingly, the country has kept stricter lockdowns place longer relative to what has been happening in the U.S. Last week, the *terraces*, that is to say, outdoor dining, were finally reopened. I took the shot below from the balcony of Printemps, a monstrous Paris department store, which operates a food-hall type assortment of small resto-boutiques on the 7th and 8th floors. The building you can see jutting out above the rooftops is the top of the Paris Opera house.

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