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Stranger Things

Near the end of last quarter's essay on Bitcoin, we wrote, "our view is that this conversation would not be happening were it not for the monetary experiment that global central banks have undertaken. When the cost of speculation is zero, people will speculate." Recently Andy Kessler wrote a column in the Wall Street Journal that highlighted many examples of current excesses and put them into historical context. Kessler, a businessman, investor, and author of several books, started his career as a chip designer and programmer with Bell Labs. He then transitioned to Wall Street, where he was an analyst first with Paine Webber and then with Morgan Stanley covering the semiconductor industry during the internet bubble. He currently resides in California and is focused on venture capital investing. With his permission, we are reprinting his piece:

The Market Fails a Breathalyzer

Joby Aviation, which plans to begin an electric air tax service in 2024 is worth more than Lufthansa, EasyJet, or JetBlue. Does that seem right? In this market, why not? Heck, earlier this year Tesla was worth more than the next nine car manufacturers combined, though now only the next six. Beyond Meat, made with pea protein, is worth more than the entire market for peas eaten globally—like the bumper sticker says: Imagine whirled peas. Do fundamentals even matter?

I can go on. Used-car sales platform Carvana is worth more than Volvo, Honda, Ford, or Hyundai. Airbnb is worth more than Marriott and Hilton combined. Crypto-exchange Coinbase is worth more than the Nasdaq. I live at the intersection of innovation and disruption, but when companies are worth more than any possible reality, watch out.

How about those meme stocks still getting hyped on Reddit's WallStreetBets? Those who bid GameStop shares into the stratosphere waved at Virgin Galactic Holdings as they soared by. A year ago, the stock was $6 and it now $190—some dupes paid $483, game over. Short sellers Melvin Capital, Point 72 and D1 Capital focused on fundamentals and got their assets handed to them. Shorts lost more than $9 billion between January and June.

New Chairman Ryan Cohen, who is driving change at GameStop, may be a retail genius for turning around Chewy, but Redditors may want to put in a call to hedge-fund manager Eddie Lampert, who bought Kmart and merged it with Sears in 2005,as a highly touted "integrated retail" play, combining stores and online sales, eerily similar to the argument for investing in GameStop today. The stock peaked at $135 in 2007. It is now at $0.30 as the company languishes in bankruptcy. A 1970's Sears Johnny Miller leisure suit is worth more.

AMC Entertainment's stock was scraping $2 at the end of 2020. It is now $50 thanks in part to Robinhood speculators, and the company has smartly raised cash. But what about the fundamentals? Theaters are still sparse, and Disney and others are willingly putting blockbusters directly onto their streaming services—ask Scarlett Johansson about Black Widow's ticket sales. Theaters are the new roller rinks.

Venture capital is cuckoo. After investing $120 billion in the 2000 dot-com frenzy and just $16 billion in 2002, U.S. venture capital invested $130 billion in 2020 and then $140 billion in the first half of 2021. Startups these days raise money as "the Uber of gardening" or "Space as a service." Oh wait, the latter was WeWork's pitch, whose founder Adam Neumann declared in 2017, "our valuation and size today are much more based on our energy and spirituality than it is on a multiple of revenue." Is "spirituality" the S in SPAC?

And check this out: In June, an Italian artist auctioned an invisible statue for $18,000—in reality it was an empty box the artist claimed was a "space full of energy." WeWork energy? Yeah, maybe fundamentals are a quaint relic of a bygone era.

The Federal Reserve deserves most of the blame. Near-zero interest rates means the market has no true north to help compare stock valuations with reality. We are navigating turbulent seas with a spinning compass. Former Fed Chairman William McChesney Martin once explained that the Fed's job was "to take away the punch bowl just as the party gets going." From the looks of it, the entire market would blow about a 0.35 (as in Dow 35000) on a breathalyzer test.

So no, fundamentals don't matter—well, until they do. In 1989 Tokyo real estate sold for as much as $139,000 a square foot—350 times the value in Manhatten. At that price, Tokyo's Imperial Palace was worth more than all the real estate in California. Not anymore after Japan's triptych of lost decades.

Yahoo was once worth $125 billion and AOL $200 billion during the dot-com bubble. Both are worth 99% less today. Tesla CEO Elon Musk recently tweeted, "I thought 1999 was peak insanity, but 2021 is 1000% more insane!" Remember, when the selling starts, fear of missing out turns into fear of losing everything as speculators jump like rats off a sinking ship.

Today's negative real yields don't reflect reality. The Fed has warned it plans on tapering bond and mortgage purchases later this year. Someone is at least reaching for the punch bowl. The compass may stop spinning soon. Until then and always, stick with fundamentals.

We continue to believe that fundamentals and, more importantly, the price you pay for future cash flows will matter again. As a result, we own many quality businesses in our portfolio that trade at enormous discounts to the broader stock market because their cash flow streams are somewhat variable. This variability works in both directions, and our belief remains that the actual economy will continue to strengthen over the coming quarters allowing our companies' earnings and cash flow to grow significantly faster than the broader market. In the fixed income arena, we can still find reasonable values but continue to hold a large portion of our assets in very short duration instruments providing ample opportunities to reinvest at higher rates over the coming years.

As always, if you have any questions or want to catch up, please give us a call.