

It's All About the Fundies

A common mistake we see everywhere is when people justify the current value of company X,Y, or Z based on where Amazon, Google, Apple, or some other game-changing winner was at a similar stage. This extreme sample-bias is surely comforting for those that have fallen in love with a stock or theme, but not every sexy earlier-stage company out there is going to end up being a FAMANG, in fact, it is extremely likely that not a single one of them will.

All that being said, we'd like to talk about one of these winners – because diagnosing and understanding *why* they became winners can be an extremely illuminating exercise.

And as it turns out, multiple expansion or contagious narrative spreading had very little to do with the long-term performance of these stocks. This post is about what did matter. This post is about what actually determines share prices, even for one of a handful of globally-dominating winners.

We've already touched on this in [Secular Winners and Value Investing](#), where we noted an interesting disconnect between expectations and fundamental reality for another one of the FAMANGs. But today, it's a different security. A company that in the mid-2000s we thought might be a *short*.

I was thumbing some our internal research, and found a piece from days gone by. It's on Apple. And it's written on January 11, 2007; two days after Steve Jobs introduced the first iPhone in a keynote or the Macworld Conference in San Francisco.

The “iPhone 2G” wouldn't be released in the US until late June of that year, but it wasn't hard to realize in real-time, during that keynote, that the state-of-play, as we knew it, would be thereafter changed. In our analysis, we observed:

“Apple changed the game with the iPhone unveiling which blew us away (and our short position which we quickly flipped into a long). While the Mr. Market tries to figure out how many \$499 (expensive?) handsets can sell, he will once again miss the landscape change and its magnitude.”

But we also anchored ourselves. We didn't define the market size as all the phones Nokia, Blackberry, and Motorola were selling, we instead compared it to the market size of the iPod. We didn't consider the economics of an app ecosystem. We even worried about “iPod cannibalization.” I mean, how quaint.

With the benefit of 14 years of hindsight, I can see where we were desperately trying to temper our own enthusiasm throughout our note.

Consequently, our vision was cloudy.

And with that, we didn't see what really mattered.

What we *did* see was the stock on an expensive 35x forward earnings, and we thought that was a bit high. So we didn't buy as much as we might have normally. That forward multiple today has collapsed to 26x. So we were “right” on that count.



But the multiple isn't what really mattered. And it wasn't passive flows that mattered. It wasn't interest rates that mattered. It wasn't an ever-expanding infectious narrative that mattered.

Very simply, it was only the fundamentals that mattered.

Using earnings as a proxy for those fundamentals, way back in January of 2007, the consensus sell-side analyst was looking for a (split-adjusted) fiscal 2007 EPS of \$0.10.

Today, in March of 2021, the consensus sell-side analyst is looking for fiscal 2021 EPS of \$4.43.

In their wildest dreams, no analyst on the buy or sell side came remotely close to imagining this kind of improvement in the fundamentals of the company. It was all about underestimating the market size, Apple's market share, and their profitability. It was about better income statement modelling. It was about better, clearer, analysis. It was all about the fundies.

The night we published that internal note, Apple closed at a (again, split-adjusted) \$3.45 per share. It closed Friday night at \$120. Back on that day in 2007, the market cap of Apple was \$82 billion. It is now over \$2 trillion.

And it isn't like Apple forgot to return any capital to shareholders in the interim. With the share buybacks and dividends the total returns since we "called" the recently introduced iPhone a landscape-altering game-changer, the stock has returned over 4,000%.

Over 14 years, these 41 bags of price appreciation were all carried by changes in expectations for the fundamentals of the company, not by an ever-widening forward multiple (which actually contracted).

Now, for those of you that know us, you also know that this by no means is a suggestion to go out and buy anything simply because you think the market is underestimating the TAM.

As we wrote in [Was Value Just a Hot Hand Thing?](#):

"...the growth investor has to be careful using individual winners (like Amazon, Google, or Apple) to justify ownership of names they believe to be tomorrow's winners."

And in [The Times that Try Stock-Pickers' Souls](#):

"It's very convenient to draw parallels between past winners and newer companies as if it is a foregone conclusion they too will win in similar fashion. Not everyone can be Amazon, in fact, no one else may ever be Amazon."

However, a mea culpa is certainly due, and this Apple episode has certainly been a lesson for us, and hopefully instructional for other value investors out there. If you get the fundamentals right, you don't need multiple expansion to make big money – and don't overdo the "be objective" thing, it can actually bias you.

Moreover, and finally, for the very rarest of companies, severe, sustainable beats are markedly more possible than you ever could have imagined.ⁱ

ⁱ Full disclosure, I took my own advice and went out 15 years to try to imagine the most bullish possible scenario for Tesla, and couldn't get there. I honestly did try though. <https://www.marketwatch.com/story/ive-pulled-out-all-the-stops-for-tesla-but-cant-find-the-upside-on-the-stock-11610117368>

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