TEMPLETON & PHILLIPS
CAPITAL MANAGEMENT, LLC
A BETTER VALUE

VALUATION STILL MATTERS

When I entered the industry back in 1998, it was "the new economy" that drove the markets as the internet and the companies seeking to capitalize on it transfixed investor's imaginations into a mindless stream of buy orders. Of course, "value was dead" and people like Warren Buffett, "didn't get it."

John Templeton had already sold his mutual fund business, and while retired, was still very engaged managing his fortune on behalf of his philanthropies. I recall visiting with him in the Bahamas shortly after I entered the industry and making the regrettable mistake of asking, "what tech stocks are you buying?" Always polite, he shared with me a story from his childhood when he and my grandfather gathered as young boys along with many other neighbors and onlookers at dusk one night outside of a house near town square. They waited in great anticipation as a man walked out of his front door and waved to the crowd, then briefly stepped back inside and flipping a switch, lights suddenly came on, and the crowd cheered. It was the spread of electricity. It changed the world forever. However, Sir John said that he had studied electricity stocks, and the time to have gotten out was "three years prior." He then walked me through similar investment manias that had unfolded in radios, automobiles, air travel, and televisions. From there, it was easy to see he believed a similar fate awaited dotcom stocks trading at well over 100x earnings, if there were any earnings at all. I learned a year later, not long before I began managing a fund he seeded, that he had sold short approximately $400 million worth of tech stocks approximately 11 days prior to their IPO lockup expirations. It was reported in the press and other associates that he made nearly 90% on that strategy. For those interested, this strategy is described in Investing the Templeton Way: The Market Beating Strategies of Wall Street's Legendary Bargain Hunter, Sir John Templeton.

Sitting here today, I can easily see that the electric vehicle maker Tesla trades at 157x earnings, and 13x estimate sales. Now, and in all fairness, it is correct to say that Tesla is revolutionizing the automobile industry. You could take it a step further and argue that Tesla should not be compared with many of the dotcom era busts. Fair enough. Because the real lesson lies within a dotcom success story that also revolutionized technology in the go-go 90's and has been a smashing success ever since. Let's take a quick look at Microsoft. First introduced in 1985, Microsoft Windows has maintained its desktop software prowess ever since with a formidable 77% market share (as of December 2020). From a 1990s tech bull's perspective, Microsoft has been living the dream. The company still dominates the market it created decades ago, as evidenced by its over 1 billion users. Far from a one-trick pony, in the last twenty years, Microsoft successfully tackled the gaming market and not to mention fought off Google during its transition into the cloud-based desktop with Office 365. (We do not own MSFT for disclosure purposes).

Despite its myriad successes during the past thirty years or so, investors that bought the shares at the height of the dotcom mania in the late 1990s had to wait 17 years to generate a positive return—yes, 17 years. In hindsight, it is relatively easy to see that back in 1998 Microsoft's Price to Sales ratio of 21.9x and its P/E of 61.0x had already accounted for almost two decades of success that would follow. In 2021, we count no less than 718 stocks in the U.S. trading at more than 20x sales; what are the chances these 718 companies will be at least as successful as Microsoft?

It is worthwhile and even amusing to review the stock market darlings of the 1990s. Gadzoox Networks, Inc. is a great example. The company produced hardware and software for network area storage and went public in July 1999. Initially priced at $21, the share price soared on the initial day of trading to more than $87 and giving the firm a market capitalization of $1.97 billion. It was a brief 15 minutes of fame as the company filed for bankruptcy in 2002 and then sold to Broadcom for $5.8 million. It strikes as a reasonable question; how many other Gadzoox are hiding in plain sight?

Scott McNealy of Sun Microsystems really put it all into perspective in a Bloomberg interview from 2002. Recall that at the peak of the dotcom mania, Sun Microsystems traded at 10x revenue.

At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?

Based on our research through Bloomberg, we found that near the height of the dotcom mania in December 2000 there were 203 stocks trading at or above 20x sales. As we mentioned earlier, in the present day we see 718 stocks in the US trading at or above 20x sales. It appears that investors have either forgotten or were not around to gather the lessons of the late nineties. On that last note, it reminded me of a wonderful quote by John Kenneth Galbraith from *A Short History of Financial Euphoria*.

"This is normally the time it takes for the recollection of one disaster to be erased and for some variant on previous dementia to come forward to capture the financial mind. It is also the time generally required for a new generation to come on the scene, impressed, as had been its predecessors, with its own innovative genius."

In conclusion valuations matter, and this time is not different! In July 2020, we launched the Templeton and Phillips Partners Fund which is available to accredited investors. The fund maintains a focus on concentrated global value while also seeking to add protection against the

risks created through inflated valuations and increasingly risky corporate balance sheets. If you would like to learn more, please reach out to me directly at LTempleton@LTFunds.com.

Happy Bargain Hunting,

Lauren C. Templeton