# A DOG NAMED CISCO

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In the late 1990's I was introduced to a prospective client. I cannot recall all the details or our conversation but I do remember that she mentioned her dog's name was Cisco. Since she was my age, I asked her if she had named her dog after a popular TV series in the 1950's, The Cisco Kid. She said no, that she had named her dog after the Cisco company stock, because it had been so good to her. At that time Cisco had posted a dazzling 10-year performance record. She concluded that we could not perform as well as Cisco so she did not hire us.

A historical review of Cisco's stock since that fateful conversation offers a wonderful learning opportunity. Present market conditions show signs of something I call the *great company/lousy stock* syndrome.

In 2000, by every reasonable measure Cisco's stock was extremely overvalued; in March of 2000 the stock peaked at a price slightly more than $80 per share. The stock remained lofty until August of that year, still selling at around $70. Then it proceeded to collapse along with other technology stocks, bottoming under $10 per share in September of 2002. We included the rise and fall of Cisco's stock in an investment article we published[1] in March of 2001.

PRESENT MARKET CONDITIONS SHOW SIGNS OF SOMETHING I CALL THE GREAT COMPANY/LOUSY STOCK SYNDROME.

Here is the important part of the Cisco story. In 2000 Cisco was a great company, with a dominant market share in the buildout of the web. The company continued to remain extremely successful. Since 2000 the company's earnings have increased 4.5 times, a compound annual growth rate of nearly 9%. The company has a strong balance sheet, generates excellent free cash flow, and began issuing regular dividends in 2011.

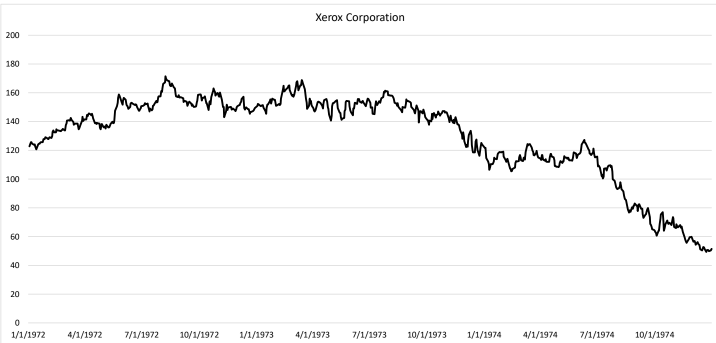
If you bought Cisco stock in August of 2000, were you rewarded for the success of the company? *Hardly.* The stock of Cisco has not approached $70 since 2000 and today trades around $46. Even after adding back dividends you have lost money.

Investors who purchased and/or owned Cisco in 2000 succumbed to the *great company/lousy stock* syndrome. This syndrome occurs infrequently but happens when an investor becomes enamored with a company and decides to ignore the price/value relationship. This is a perilous mistake for investors, because it ignores the fundamental truth about investing-*price is what you pay, value is what you get.* Once an investor loses this fundamental mooring, he or she is left with only the stock price as a decision guide. This is why extremely overvalued stocks keep rising until they don't, sometimes referred to as the "greater fools" theory. When the stock begins to decline, the game is up. The stock will decline (often painfully far) until disciplined investors can find value as buyers.

The rise and fall of Cisco and other technology companies was the second time I had observed *great company/lousy stock* syndrome. In 1973 I started my investment career as an analyst for the trust department of a Minneapolis bank, the precursor to Wells Fargo. In 1973 the Nifty Fifty were the current mania among investors. They were called "one decision stocks" to be purchased and never sold. They were in general very good companies; their stocks were selling at grossly inflated valuations.

My employer was heavily invested in some of these companies. I vividly remember two – Xerox and MGIC (Mortgage Insurance Company). In August of 1973 Xerox traded at $158 per share and was expected to earn $2.35 per share. This means the stock traded at 67 times the expected earnings. My bank's Xerox analyst picked up clear data that their business was slowing. The stock declined from $158 to $49 per share at the end of 1974. Xerox remained a viable company thereafter; the stock, however, did not exceed its August 1973 price until May of 1996, 23 years later. MGIC was selling at $100 per share, 50 times its estimated earnings of $2.00 per share. When its stock dropped to $50, the analyst said it was time to buy and the bank's portfolio managers piled in. The stock bottomed at $6 per share in 1974.

[1] http://dginv.com/view/insights




*Source: CRSP*

The experience of the Nifty Fifty burned into my brain the central importance of price-value relationships. This singular focus helped guide us through the financial crisis of 2008. On October 31, 2008 we published an article titled, "A Once-in-a-Generation Opportunity". We asserted unequivocally that our financial system had suffered major damage, but stocks were so inexpensive they should be purchased anyway. We have remained steadfastly bullish ever since. During this period, we have not let presidential elections, budget deficits, rising/falling interest rates, Brexit, Hong Kong, or the Coronavirus change our investment stance.

Forty years after the Nifty Fifty and twenty years after the rise and fall of Cisco, the stock market is once again in the grip of the *great company/lousy stock* syndrome. The list of extremely overpriced stocks includes many small companies but also includes the five largest companies in the US by market capitalization – Microsoft, Apple, Google, Amazon, and Facebook.

These five companies have achieved extraordinary success. Arguably they are the most successful companies in U.S. economic history. At first blush these are different businesses, but there is a common thread to their success. Each has successfully exploited the centralization of the web, known more broadly as the "cloud".

Their success is widely recognized by investors. These five companies have a combined market value over $5.5 trillion representing nearly 20% of the S&P 500's entire value.

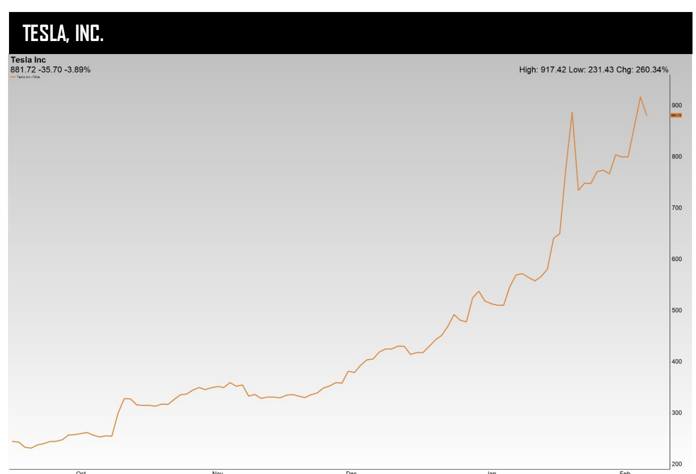
The recent price increases in these stocks have been dramatic, rising nearly 29% (on average) since October and adding $1.3 trillion to their combined stock market value, roughly equal to the entire value of Walmart three times over.

We put together a spreadsheet analyzing the investment value of these five companies at today's stock prices to compute a likely return current investors can expect over the next ten years. We gave them credit for a future annual growth rate of 6% per year, a rate higher than GDP and generous considering their already enormous size. Our analysis assumes that in ten years each company's stock price will reflect an appropriate value of the company. Our analysis suggests investors will likely lose about 3% per year over the next decade before dividends, a fate similar to buyers of the Nifty Fifty in 1973 or Cisco in 2000. *Great company, lousy stock.*

There are a number of other stocks selling today at mind-boggling valuations – Tesla, ServiceNow, and Shopify exemplify the breed. These stocks have also risen significantly since last October. Tesla is the most spectacular example, increasing by over 400%. ServiceNow is up more than 62% and Shopify, 71%.

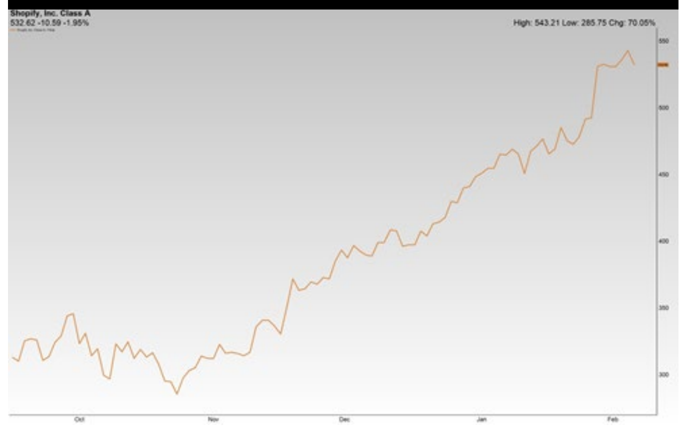
OVER MANY MARKET CYCLES WE HAVE OBSERVED THAT INDIVIDUAL STOCKS OR GROUPS OF STOCKS CAN REMAIN AT EXTREME VALUATION LEVELS LONG ENOUGH TO CAUSE DISCIPLINED INVESTORS TO DOUBT THEIR OWN CONVICTION.

To illustrate how swiftly these stocks have risen, we have included price charts for each of these companies since October of last year.



SERVICENOW, INC.


SHOPIFY, INC.




These stocks are now dangerously overvalued. We cannot predict how long this mania will last. Over many market cycles we have observed that individual stocks or groups of stocks can remain at extreme valuation levels long enough to cause disciplined investors to doubt their own conviction. We have observed that peak market prices typically occur after an extreme price "melt-up" and the ensuing decline may begin with no particular economic news – or an unplanned event like the Coronavirus. At that moment selling begets selling and the declines can be severe. This boom-bust stock price action is specific to the stock market and may not correlate to the overall economy.

As with every prior period of excessive valuation, the laws of financial gravity will ultimately prevail. *The question is not "if" but "when".*

There is a clear path to sustainable investment performance even during these market conditions. The disciplined investor must honor the financial laws of gravity and reduce or sell those companies with extreme overvaluations. The disciplined investor must ignore the discomfort and anxiety that comes from lagging relative performance; an inevitable outcome from avoiding or selling the stocks that are driving the market. The disciplined investor must also mentally prepare for the collateral effect of downward price pressure on their own stocks as the market in general deals with the natural process of finding the right price for overvalued stocks. The payoff for the disciplined investor is that their own stocks are unlikely to experience a severe and permanent decline in prices.

THE DISCIPLINED INVESTOR MUST HONOR THE FINANCIAL LAWS OF GRAVITY AND REDUCE OR SELL THOSE COMPANIES WITH EXTREME OVERVALUATIONS.

These stocks of obvious danger also have been focal points for capital and mindshare, thus leaving many stocks underanalyzed. Current market conditions offer disciplined investors opportunities to find many fine growth companies today whose stocks are selling at value levels attractive to the patient investor.