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RESEARCH

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INVESTOR INSIGHTS – SECOND QUARTER 2024

Party Like It Is 1999!

This was the chorus of the lead song on a 1982 album by Prince. It also became the mantra for investors in 1999, suggesting the long bull market from 1982 to 1999 was going to continue in full swing. It did continue for one quarter, but the bear market started at the beginning of the second quarter of 2000 and continued down through 2001 and 2002, losing over 50% of its value from peak to trough. This is not what the optimists of 1999 thought they were expecting.

The decades of the 1980s and 1990s saw dramatic rises in stock values with the S&P 500 rising 17.5% in the 1980s and 18.2% in the 1990s. When we analyzed the stock market in 1998, we discovered that the top 11 stocks provided all of the return of the S&P 500 which was up 28.6%. Quite certain this trend could not continue, we told clients this could never happen again. Were we ever wrong! In 1999, the S&P 500 was up 21.0% and the top 6 stocks provided the entire return. These 6 stocks were part of the 11 from 1998. Even more astonishing was that these 6 stocks provided all of the return of the index for the 2 years ending in 1999.

The market movement was all based on the optimism of new technology: the internet and the cell phone. Analysts thought these technologies would revolutionize our lives, and they did. Like many households in this country, my wife and I no longer have a home phone, we just have our cell phones. This was not conventional wisdom in 1999, no one imagined we would give up home phones. A home phone was the essential form of communication in our personal lives, while our business line was the same for our business life. To think that we would have one phone we carried in our pocket that would serve both purposes was not in the thinking of most of us in 1999. It was, however, in the thinking of those companies building cell phones and what we now call the iPhone. The companies building cell phones, the iPhones and developing strategies using the internet were publishing research papers projecting a world where instant communication via phone or the internet would revolutionize our lives, and it did. I had a personal experience last year that dramatized how far we have come. Every fall I go to Europe, Ireland and England to visit our managers there. Last year I had a particularly short and compact trip, so I just carried just my cell phone. I did not bring a computer or an iPad. What I found was it all worked fine, exactly what was suggested to us in the early 2000s.

While it is true that all of the predictions of analysts and businesses suggested would come to reality did come to reality, there were two problems with this analysis. First, the suggestion that this would happen quickly turned out to be too optimistic. Perhaps more importantly, the value investors put on these companies was enormous. Many investors and analysts used the most dangerous words ever used in the investing lexicon: “This time it will be different!” If you study history, you know this time is never different. The euphoria for change only pushes stock prices to levels that are insane. This was true with railroad companies in their day, it was true of technology companies in their day, and it is true for AI today.

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The AI Revolution is Real! The Problem is the Stock Prices are Insane!

There is a story I have heard over the years that is a reflection on many investors today and it goes like this. Two old friends went to the theater to see a cowboy movie, and as they always did, they talked throughout the entire movie. They loved to bet with each other, and when they got to one scene one of them bet the other that one of the cowboys would not pull his gun and be killed in the next scene. His friend accepts the bet and sure enough the cowboy does not pull his gun and is killed. After the movie the one who lost the bet is taking out money to pay his friend, but his friend confesses, he has seen the movie before and cannot accept the money. The one trying to give the money says to his friend, "I have seen it as well, I just did not think he would be so stupid the second time."

This story has always reminded me of investors. It would not surprise us to find out that all of our clients have been asked by one of their clients if they should own NVIDIA, after it has risen 150% this year. Our other guess is none of our clients had a question about NVIDIA before it rose. The fear of missing out is real and powerful, and even though a stock that rose from roughly $49 to $123 a share in 6 months should be a sign to investors that they did miss out on that opportunity, for many investors it does not. What FOMO investors never get is that, "this time is never different!"

NVIDIA has an interesting history. We first discussed NVIDIA when we discovered it in the ARK portfolios. ARK bought NVIDIA at 50 cents and they sold it at $19.50 earlier this year. These prices are adjusted for the 10 for 1 split NVIDIA had this year. During the time they owned it, NVIDIA was close to bankruptcy twice. It never did file for bankruptcy, and as I am writing this, it trades at $123, more than 6 times what ARK sold it for. Now there have been many stories about what a mistake it was for ARK to sell at what seems like such a low price. The reason ARK sells all stocks, including NVIDIA, is that they cannot see how they will get a 15% compounded, annualized return over the next 5 years. Now ARK can be and has been wrong on that analysis, and it looks like they will be wrong on NVIDIA. The price of NVIDIA has risen this year from $49 to $123 a share, and this is just 6 months of the year. That is a return of 151%. While it is true that AI looks like it will help our lives in amazing ways and NVIDIA will be the beneficiary of that, it also is dramatic how extreme this rise in stock value has been. We have looked at how analysts are predicting the future price of NVIDIA and many are suggesting no change over the next year. If there was no change in the price of NVIDIA over the next 4.5 years, the compounded, annualized return for NVIDIA over the first 6 months of this year and the next 4.5 years would be over 20% per year. That is a 20% return over 5 years for a company that has yet to show a profit.

While the believers may turn out to be right, we are not in their camp. We have seen this movie before, and it usually ends with long periods of no return or losses. Amazon experienced three periods of over an 80% decline, and we wonder why NVIDIA will not have the same experience. The experience of those 6 stocks that accounted for the return of the index in 1998 and 1999 is helpful to review. The poster child of those stocks is Microsoft. It peaked at the beginning of 2000 and then declined by half. It took 15 years and 9 months to get back to breakeven. Since 2015, the stock has risen 9 times its 2015 value and is the stock that has the highest market cap in America. The compounded annualized return since January 1, 2000 is 10.2%. All you needed to do to get that return was accept a loss for over 15 years and then live through dramatic appreciation over the last 7 years and 9 months. The compounded annualized return since July 1, 2015 has been over 30%.

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1998, 1999 or a New Era?

So where are we today? Have we experienced all of the 1998 and 1999 phenomenon? No one knows the answer to those questions, yet it is on all of our minds. We think this plays out in one of two ways. First, we are wrong about the overpriced nature of NVIDIA and AI, and AI turns out to be the one new development that does not go through a long period of no or low returns after having a dramatic rise in stock price. The second possibility is that we are right to be concerned, and the stock prices in both the indices and stocks like NVIDIA fall and go through a long period of no or low returns. Obviously, we are in the second camp. The difficulty with this opinion is that we have no idea how long we will be wrong before we are right. We do, however, have some thoughts.

1. Timing the market has never worked, so those investors whose plan is to sell before NVIDIA drops or as it is dropping will not work.
2. Investors get enamored with stocks that have risen, even if they did not invest at the bottom.
3. NVIDIA has been the largest cap stock in our country and is vacillating among the top 3. So, the likelihood of it doubling from here is incredibly small.
4. The “this time it is different” crowd look exactly like those who came before them, in 1999 and 1929.
5. Dividend stocks will always be needed by some investors, and growing dividend stocks will always have a purpose for many investors.

For the 5 years ending 2023, our dividend strategy outperformed the S&P 493 and did so by declining 2% when the index went down 19%. This is what will happen again at some point, and that is what investors will be discussing!