## Avoiding the limelight

In the mid-1990's, while in university a professor assigned a paper due the following week from a reading by famed economist John Maynard Keynes. I knew a little about Keynes; he was an economic genius, he wrote a lot of books, and he died in 1946. There was only one place this reading was available: in a single book on reserve at the university library. This meant the entire class of 100 students were jockeying for access to the same book, at the same time. A logistical disaster ensued; lineups at the help desk, arguments at the photocopier and panic all around. This chaotic scene was the 1990's version of Google: standing around waiting at the library photocopier.

I'm not sure my kids will ever believe this story; they have grown up in a world were everything is connected, and information is ubiquitous all because of the internet. Electronic connections have changed everything about how we all work, play, and live.

Imagine if you had perfect foresight and knew way back in the 1990's how important the internet was going to be for the future of our world. Wouldn't you want to invest alongside the companies that would be responsible for the growth and acceleration of this paradigm shift? In the beginning stages of the electronic revolution, there were a handful of organizations that foresaw the future better than most. One of those companies was Cisco Systems.

Founded in 1984 by two Stanford computer scientists, Cisco created many of the technologies responsible for the commercialization of the internet. From its inception, Cisco grew at an incredible pace, creating new and exciting internet capabilities no one had ever seen before. Cisco invented new revenue streams by discerning how the internet would be used in the future. No other company was able to match Cisco's ingenuity. It added to its dominance by acquiring hundreds of its competitors and integrating their complementary technologies. By 2000, Cisco had become the worlds most valuable company, worth more than $500 billion.

The internet is among the most important commercial inventions of all time, right up there with the wheel and the lightbulb. Modern day technology giants like Amazon and Google would not exist if not for Cisco. Financially, Cisco has been a consistent revenue generator. Figure 1 below shows Cisco's annual revenues since I was fighting with my classmates at the photocopier back in the mid-1990's. It's hard to imagine more consistent revenue growth over a 25-year period. Figure 2 shows the number people employed at Cisco since the mid-1990's which has similarly increased almost every year.

**Figure 1. Cisco's annual revenue growth**

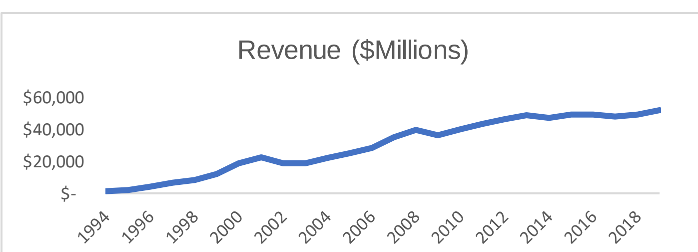
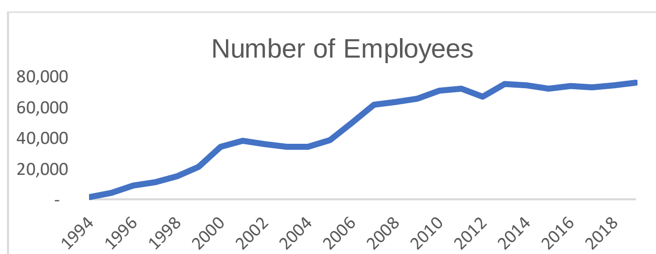



**Figure 2. Cisco' employee growth**




Cisco today continues to be a behemoth. It's still the largest company in the networking and communication devices industry and maintains a dominant share of the technologies that underpin the internet. Today, more than 80% of the world's web traffic travels across Cisco connections. In addition, Cisco regularly ranks as one of the best places to work and consistently scores highly on its environmental, social and governance programs. It's longest serving CEO won multiple awards including Time Magazine's 'Most Influential People' and Harvard's '100 Best Performing CEOs'. Cisco has operated a highly successful business for decades in every way measurable.

Given these facts, how would you feel about an investment in this company? Is Cisco a "buy"?

While you think about that question, consider this proposition; what if you could travel back in time, and were given the opportunity to invest in Cisco in the year it became the largest company in the world, the year 2000. Given what you now know about Cisco's future from 2000 to today, would you have invested in its prospects as it was just hitting its stride? How many shares would you have bought? As a time-traveller you would know that for the next 20 years Cisco would dominate in a rapidly expanding industry, increase its revenue almost every quarter, hire lots of talented people and be an all-around successful company. In 2000, Cisco had all the characteristics of an ideal investment.

The result of an investment in Cisco in the year 2000; after 20 years, a $1 investment would be worth 96 cents at the end of September 2020. Unbelievably, after 20 years you would have less investment than when you started. This is hard to reconcile. How can an investment in a business as successful as Cisco, which has experienced consistent growth in revenue and market share, lose money over two decades? The business has not faltered in any way, why has its stock failed to increase along with its other attributes? The reason: Cisco had become a *celebrity* organization.

In 2000, investors were in love with Cisco. It was an exciting company in an exciting sector. That is a good thing. The trouble started when this 'exciting' company began to be viewed as infallible. Believing a company can't make mistakes is inviting hubris. Even the best companies are made up of flawed humans; infallibility is a myth. Typically, *celebrity* organizations are led by charismatic CEO's who offers a clear and innovative vision of the future. These captivating leaders attract corporate enthusiasts and together they create aggressive ambitions for the future. Investors become admirers of senior management in the same way rock stars have fans. Vulnerability arises when *celebrity* companies lose their ability to objectively assess weaknesses and threats. When investors fall prey to their adoration, they will buy into the business at any price. Eventually, the price being asked for a share of future gains becomes entirely divorced from reality.

One way to measure the *celebrity* status of a company is to look at how much investors are being asked to pay today for $1 of future profit (that is, how much must you pay now to receive $1 annually as long as you hold the stock). This ratio of 'cost today' (stock price) for 'profit tomorrow' (earnings) can be compared to similar companies to gauge whether a *celebrity* premium exists. Generally, the lower an amount asked today to receive $1 of future earnings, the better. For example, in 1994 you were required to pay $20 for $1 of Cisco's future earnings. On its own this metric doesn't mean a whole lot, so we should compare it to other companies' ratios; in 1994, the price demanded for $1 of an average large US company's future profit was $21, which is close to the long-term historical average.

By 2000, the amount demanded for $1 of future earnings of Cisco had risen to $195. That is *celebrity* company level. Fast growing companies often have higher prices demanded for future profit but amounts above $35 tend to be excessive and often prove unprofitable. So why did Cisco stock lose value over two decades even though its business grew and succeeded? It lost its *celebrity* status. The market woke up to the fact that Cisco's future earnings were not worth $195 and so the stock price stopped climbing. It has taken two decades to reach an appropriate equilibrium. Today it cost $30 for $1 of future earnings. It is still expensive compared to its 1994 ratio.

| **Company** | **Cost today for $1 of future profit** |
|---|---|
| Tesla | $771 |
| Zoom | $619 |
| Shopify | $573 |
| Broadcom | $460 |
| Amazon | $121 |
| Starbucks | $110 |
| Salesforce | $100 |
| PayPal | $86 |
| Netflix | $85 |
| Lululemon | $78 |

The market always contains *celebrity* companies. Social media has allowed for even more of them. Listed to the left are some popular modern-day *celebrity* companies and their current prices today for $1 of future earnings. To be sure, these companies operate incredible businesses, but the prices demanded for a share of their future profits is expensive. That doesn't mean these company's stock prices will follow the same path of Cisco, but if history is a guide, the probability is high that some of them will suffer a similar fate. Investors would be wise to be aware of the prices they are paying.

Companies valued as though they are infallible are fragile in a way that is not often considered. They are subject to significant volatility should their future be anything but perfection. On the other end of the spectrum are companies which are viewed as being incapable of future success. These companies offer significant upside should they achieve even modest profits. Listed to the right are current examples of quality businesses that are being offered at more reasonable prices. They may not be as exciting, but that should not be the goal. We are only interested in paying a reasonable price for profits.

The value of any investment is the sum of future income streams received. The less we can pay now for a solid business, the better our chances of finding investing success. The overall market today is demanding higher than normal prices for all investments due to the Covid crisis and low interest rates. Waiting patiently and avoiding celebrities makes for a good strategy, even if our investments never get to centre stage.

| **Company** | **Cost today for $1 of future profit** |
|---|---|
| Proctor & Gamble | $26 |
| Home Depot | $24 |
| Pfizer | $23 |
| Loblaws | $22 |
| Berkshire Hathaway | $22 |
| Telus | $20 |
| Molson Coors | $13 |
| Royal Bank | $12 |
| Intel | $9 |
| Citigroup | $8 |

Your *looking forward to the day when Covid is a forgotten name* investment advisor,

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