HILBERRY GROUP
WEALTH MANAGEMENT

May 28, 2021

Thou Shall Not Overpay

I had an email exchange with a Gen-Xer client this week on the difference between a great company and a great investment. We were discussing the returns his friends have made (so far) owning cryptocurrencies, the FAANG stocks and Tesla. All have been popular and depending on one's entry point, show extraordinary gains.

Cryptocurrency sites say Bitcoin was worth $1 in Feb/2011. Bitcoin $USD values began being tracked by major data sites like Bloomberg and Refinitiv in July/2014. According to Refinitiv, Bitcoin closed July/2014 at $583.85 $USD. The New York Stock Exchange (NYSE) began offering its **NYSE Bitcoin Index (NYXBT)** in May/2015 at $237. A curiosity driven speculator with $1,200 to risk in May/2015 could have acquired 5 Bitcoins. At one point in April/2021 Bitcoin is recorded by the exchange to have traded at $63,247 X 5 Bitcoins = $316,285. If that same speculator had acquired 1,200 Bitcoins at $1 in Feb/2011 their April peak value would have been $75.89 million US dollars. Little wonder my Gen-X client has investment envy. I wish his friends good luck. I suspect they'll need it.

Have Markets Gone Up To Much….

Watch Anna's latest video here

https://www.youtube.com/watch?v=7xulqr2ntoQ

NATIONAL BANK FINANCIAL
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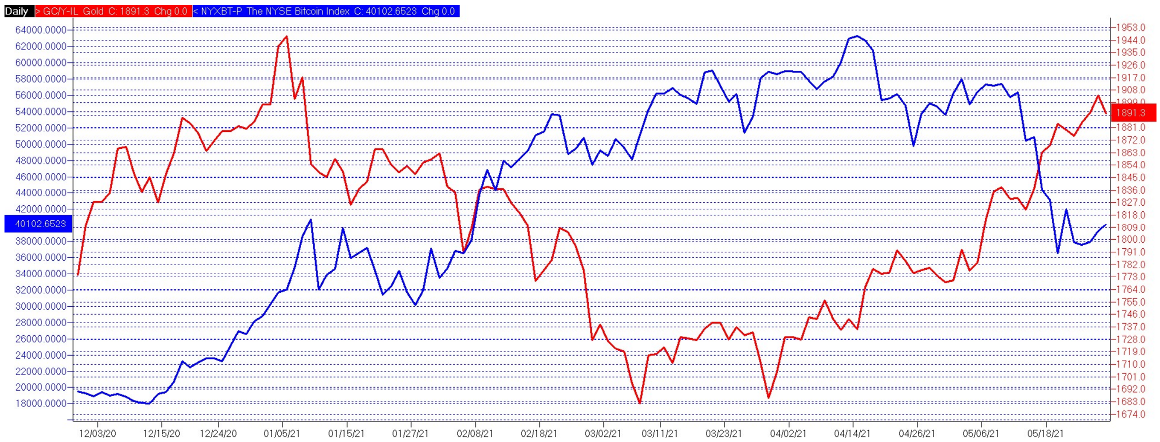
Before we get into my commentary on valuations. I'll address an argument in favor of cryptocurrencies that the US dollar is about to collapse under a pile of US debt and rampant inflation. This idea says Bitcoin's rise in price confirms the risk is approaching. As Bitcoin's price increases are hardly a secret, if the risk was near, we should also see the same price increase pattern in the price of gold. I decided to pair the price of 1 troy oz Gold in US dollars with the price of Bitcoin in in USD. If this risk was increasing, one would expect to see both moving together in a flight of capital out of US dollars. The nearer the risk the more rapid the increase should be.

Gold USD (red) vs NYSE Bitcoin Index USD (blue) daily ranges – 6 months May 28, 2021



(source: Data Refinitive, Chart - Steve Hilberry)

Gold and Bitcoin have ended up roughly where they began the year. The two patterns are <u>inversely</u> correlated. The chart tells me blocks of money have been moving out of one and into the other. That spike in the blue line is mid-April/2021 with Bitcoin around $63,000. The first week in May/2021 Bitcoin was still around $55,000. The second week in May the Chinese Govt announced they were clamping down on cryptocurrencies. Funny how the price had already begun to slide. Gee whiz, I wonder if insiders in China with friends in high places got the news prior to the announcement? From the 3rd week in May onwards, Bitcoin has crashed while Gold has jumped. This chart is indeed confirming a flight of capital, I suspect out of China and <u>into</u> US dollars.

This chart disputes the notion Bitcoin's rise signals the end of US dollars (and the end of banking and finance as we know it but that's another topic). It confirms Bitcoin is probably very popular with those attempting to move and hide money from authorities. If one shows up on a Monday with a Billion dollars equivalent in Yuan to buy Bitcoin, unless there are a billion dollars worth of sellers ready to exchange with you, you'll have to pay up. When you then go to sell it Tuesday on the other side of the move, again you face price risk. If you want to hide money from the authorities, it's because if they catch you, you'll lose all your money and may end up in prison (you may already be there). Risking some of your dosh to Bitcoin's market value over a short period of time in and back out, to end with US dollars could be a risk worth taking. An 'exchange' that connects you to others willing to take the other side of your trade could make a lot of money. You will see punters and promoters making all kinds of claims. If on the other hand you're attempting to compound wealth over the next 10 years, Bitcoin, if it survives, is an inappropriate vehicle. This tells me Bitcoin is not, repeat not a currency. It has been recently seen as an alternative medium of exchange to gold and silver.

Now to my discussion of value, leading off from a comment on the rise of Tesla and the FAANG stocks also owned by his cryptocurrency loving friends, that have also proved extraordinarily profitable.

Steve's reply May 27, 2021

From my perspective I've seen so many of these kinds of stories end so very badly. The current rage feels so much like the late 1990's period. It's worth noting that similar fortunes (on paper) were made during that period. Let's take a darling from that period that went on to even greater things.

Microsoft (MSFT-$251.06)

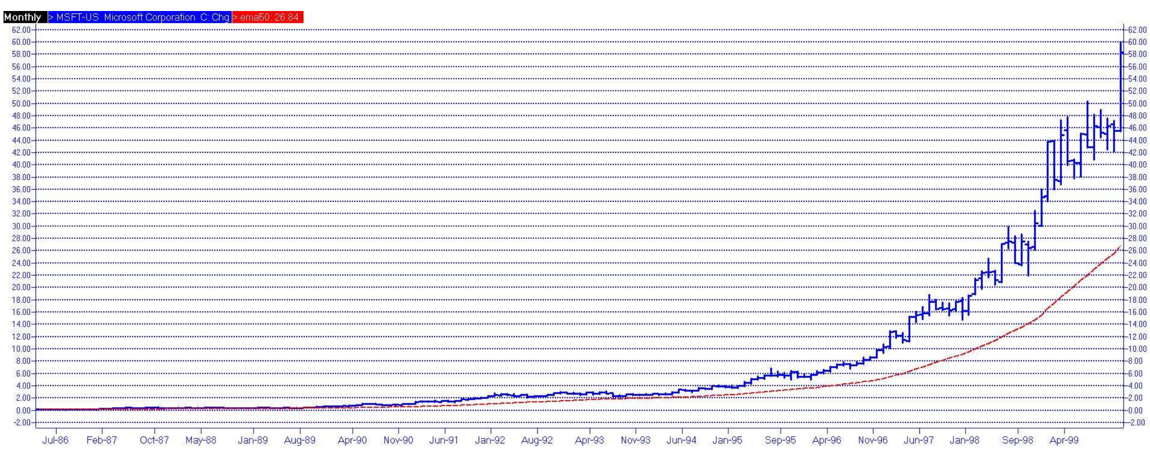
No one can argue that Microsoft hasn't been a fantastic investment. The first chart plots Microsoft over the past 10 years. The chart goes from May/2011 at $25.01 to May/2021 $251 for an easy 10 X return (!!)

The next chart plots Microsoft from their original IPO back in April 1986 at a split-adjusted price of 11 cents (yes 11 cents) to date ending at $251. It's been amazing investment depending on when you bought it.

See the initial explosion in price 1986 to 1999 (1), the period from 1999 to Mar/2009 (2) and Mar/2009 to Oct/2016 (3). The red line reflects the long walk to break-even from 1999 to 2016.

Here is what the Apr/1986 to Dec/1999 period looked like to investors at that time (the chart is adjusted for stock splits). Starting price is 11 cents, ending is $58.38. Extraordinary! Note the parabolic chart pattern.

Microsoft (MSFT) April/1986 to Dec/1999 – monthly ranges



Jun/1986 Microsoft began showing net profits per share of 1 cent. By Dec/1999 Microsoft was generating annual profits of 70 cents. The exponential growth had investors predicting even higher rates. The parabolic curve at the end of the chart was a sign of excess enthusiasm, *Fear Of Missing Out (*FOMO) tossing caution to the winds.

With the stock around $58 it was trading at 83 X earnings. Zero dividend. It was a great company trading at a lousy (expensive) price.

Here is what happened next.

Microsoft Dec/1999 to Oct/2016 Start is $58.38. End is $59.32.

Over the next 16 years Microsoft's top line revenue continued to grow. From 70 cents profit in 1999 Microsoft generated $2.79 in 2016. Earnings grew 4-fold. It really is an amazing company. The stock went down for 9 years bottoming in the Great Recession in March/09 at $14.87, then ground higher to the Dec/1999 price by Oct/2016. Eventually, Microsoft's earnings power caught up with the price. It took 16 years.

What if you missed out on the early stages of Microsoft's growth (they were just an idea in 1986) but then jumped on it after the price started to accelerate in the late 1990's? IE momentum buying. Recall this implies one buys and DOES NOT SELL on any subsequent collapse. That would have been extremely painful to do for an investor believing in the momentum idea.

With that caveat in mind, to feel good about holding Microsoft for the first decade of this century IE: "The stock price is down but I'm still in the black" the very latest date one could have acquired Microsoft at or below the subsequent 2009 lows was in June 1997 monthly range around $14.00. You would have then watched the stock quadruple then collapse and lay there for 16 years being ½ the typical working career span. We were not buyers in 1997, 2000 or for the following first decade.

Microsoft initiated a dividend in Sept/2002 at 8 cents per share. That dividend has grown strongly. By late 2012 with the stock price still languishing around $27, sales per share were $8.80, cash flow was $3.12, earnings were $2.72 and dividend per share was up to $0.80 per share, a 10-fold increase. In Nov/2012 the shares traded at 10X earnings. The dividend represented a 3% yield on market price vs 0% back in 1999. It was a great company at a fair price. History showed that fair price proved to be a steal.

In Nov/Dec 2012 we thought the stock was cheap enough, with a high enough dividend yield and we started buying Microsoft around the $27 mark roughly 50% cheaper than it was in Dec/1999. Cashflow and earnings per share had climbed each year since the IPO in 1986. Unlike Tesla, Microsoft has had no annual earnings losses, has shown increased annual earnings each year since 1986 and with one exception being the 2001-2002 year post Dotcom bust where cash flow declined 1.8%, has grown operating revenue each year. In 2012 Microsoft was paying out 25% of the company's cash flow as dividends. Today Microsoft is paying out roughly the same 25% ratio of cash flow, leaving 75% to grow the business. Solid stuff.

After we bought Microsoft in 2012 the stock price jumped. By Oct 2018 the stock price was over $110. While the dividend had doubled from 80 cents to $1.68 the stock price had nearly quadrupled. In Oct/2018 the dividend yield was down to 1.4%. The dividend yield was unappealing. We sold all of it. We sold too soon. Today Microsoft trades around $251 explaining why Mr. Gates remains a 1%'er despite his recent divorce. There's nothing untoward about how he earned his money. There isn't an inequality problem either. All of us could have owned Microsoft along with Bill.

If we'd held on, our current dividend per share would be $2.24. Compared to the $27 price paid in 2012 we'd now be receiving close to 8.3% dividend yield on our original cost. Never mind the potential for dividend reinvestment over the past 9 years. Ouch.

Since 2012…

- 2021 sales per share are projected to be $22.05 a gain of +2.5X over 2012.
- 2021 cash flow per share is projected to come in around $9.25 – roughly 3X 2012.
- The dividend is now $2.24 or 2.8 X 2012. The rate of growth in the dividend has slowed from the mid-teens per year to a still respectable 8-10%.

So…Sales per share are up 2.5X, Cash Flow per share is 3X, the Dividend is 2.9X. Looks like the relationship of the dividend to sales and cash flow makes sense. One would expect the stock price to gained about the same for nice 3X. The stock has gained 10X.

Yipes!!!

At today's prices Microsoft trades around 32X earnings and 27X cash flow per share. Including the heady days of the late 1990's Microsoft's long-term average price-to-cash flow-ratio has been around 23X. For today's buyer, the dividend yield is down to 0.89%. In 2012 the going 5-year bond yield was 0.72%. Current yields are 0.81% so we can't explain away the dividend yield difference on the alternatives. Clearly, by any measure Microsoft investors are paying up for the future. It's not nearly as expensive as Tesla but it's clearly not cheap.

In hindsight, back in 2012 I knew Microsoft was a great company at fair price and should have kept a portion of it. It is indeed painful to have sold it.

Here are the lessons I learned.

- When I see a parabolic price chart, no matter how compelling the story, stay away. I should be very, very reluctant to buy.
- When I see a great company do the Icarus death spin then get rolled into the gutter, get interested. No hurry. The groaning will go on for a while.

- When I see a great company fall from favor yet see a growing cash flow, earnings and dividends, if the dividend yield is attractive, it's a chance to grab future cash income.
- Once I've bought, after trimming to reduce my original purchase risk, I should be very, very reluctant to sell.
- I will look like a fool at some point.
- Recognize extremes.

With these lessons in mind what do we see in Bitcoin/Tesla?

Bitcoin has no cash flow, is not a profit generating entity so I can only dismiss this as pure gambling. Maybe it works. I wish your friend all the luck in the world. I suspect they'll need it. He is of course pleased. As I don't have access to all his other curiosity failures, I don't know the truth of his entire situation. I also don't know what he's done about those gains. Greed is a nasty thing.

Tesla is at least selling something, seems to be selling more somethings than in the past and MAYBE will prove to be a sustainable profit generator. The market price certainly implies this. I've noted the parabolic price pattern on the stock previous Weekend Readings. That parabola is not a good sign.

My bet is Tesla – if it succeeds - will require the same kind of patience as Microsoft did in 1999. Unlike Microsoft, Tesla's cash flow has been very spotty. Earnings have been dominated by subsidized revenues, carbon credits, electric vehicle subsidies, local government and Federal tax incentives, etc. Unlike Microsoft, Tesla is competing against incumbents, with a lot more cash flow and infrastructure. Tesla's CEO is a drama story. Imagine Tesla without Elon Musk? How does Tesla compare to Microsoft's 1999 peak values? What about the other FAANG stocks P/Es?

- **F**acebook $330.: 28X.
- **A**pple $125: 28X
- **A**mazon $3,225: 61X
- **N**etflix $506: 61X
- **G**oogle $2,418 (Alphabet): 32X
- Nvidia $646: 76X
- Twitter $58.30 (fwd): 74X
- Tesla $630: 138X projected forward earnings and 629X trailing posted

Facebook pays no dividend. Apple pays a dividend, is priced to yield 0.7%, Amazon, Neflix and Google, Twitter and Tesla pay $0 dividends. Nvidia pays a dividend and priced to yield 0.10%. Facebook, Apple and Alphabet (Google) are not cheap. The rest are very expensive.

History has repeatedly taught me to be cautious of these kinds of ratios. **Thou Shalt Not Over Pay**.

***'Times Of Fraud, Mania & Chicanery'* – Jamie Catherwood – May 23, 2021**

https://investoramnesia.com/2021/05/23/times-of-fraud-mania-chicanery

***'How a Lack of Fear Upends Markets'* – Novel Investor – May 21, 2021**

https://novelinvestor.com/how-a-lack-of-fear-upends-markets/

***'The Optimal Amount of Hassle'* – Morgan Housel May 19, 2021**

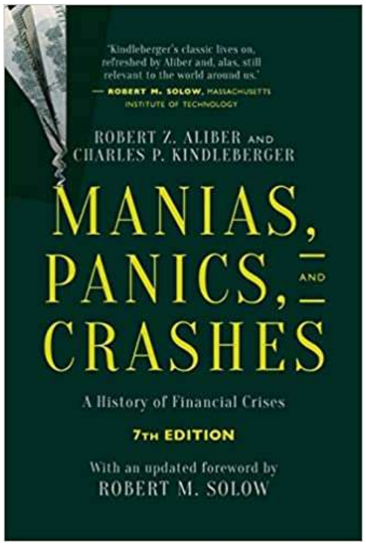
https://www.collaborativefund.com/blog/the-optimal-amount-of-hassle/

***'Why Investing Feels Like Astrology'* – Moontower May 19, 2021**

https://moontowermeta.com/why-investing-feels-like-astrology/

The above comments and story links are cautionary. This doesn't mean I'm hiding under a rock in cash waiting for the world to end. We're largely invested for growth and dividends. We are playing a bit more defensive of late and remain tilted toward dividend income. I believe the business cycle is in early stages and there are many good things to come.

Monday will see the US markets closed for the Memorial Day long weekend. We expect things to be very quiet over the weekend. This may be a good time to re-read Manias, Panics and Crashes by Robert Z. Aliber.



https://www.amazon.ca/Manias-Panics-Crashes-History-Financial/dp/1137525754

May 28, 2021

Steve & Anna Hilberry

Have a Great Weekend!

FOR THE RECORD May 28, 2021

DOW INDUSTRIALS:	34,578
S&P 500:	4,213
S&P/TSX COMP:	19,895
WTI:	$66.98
LOONIE IN $USD:	$0.8280 $US

Sent by

Montreal office
National Bank Financial
Wealth Management
1155 Metcalfe 5th Floor
Montreal, Quebec H3B 4S9
Phone: 514 879-2222

Toronto office
National Bank Financial
Wealth Management
130 King Street West Suite 3200
Toronto, Ontario M5X 1J9
Phone: 416 869-3707

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