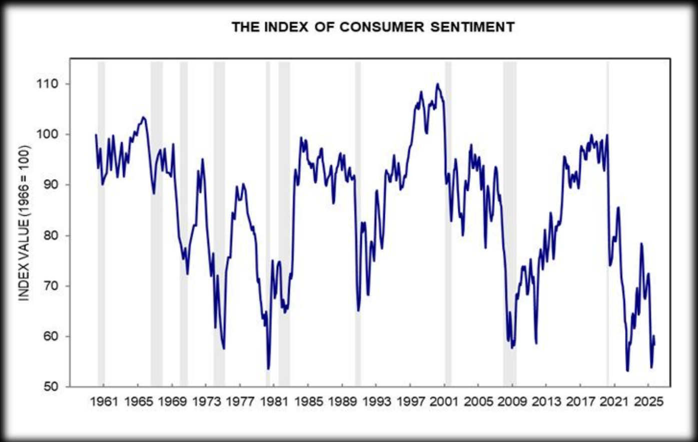
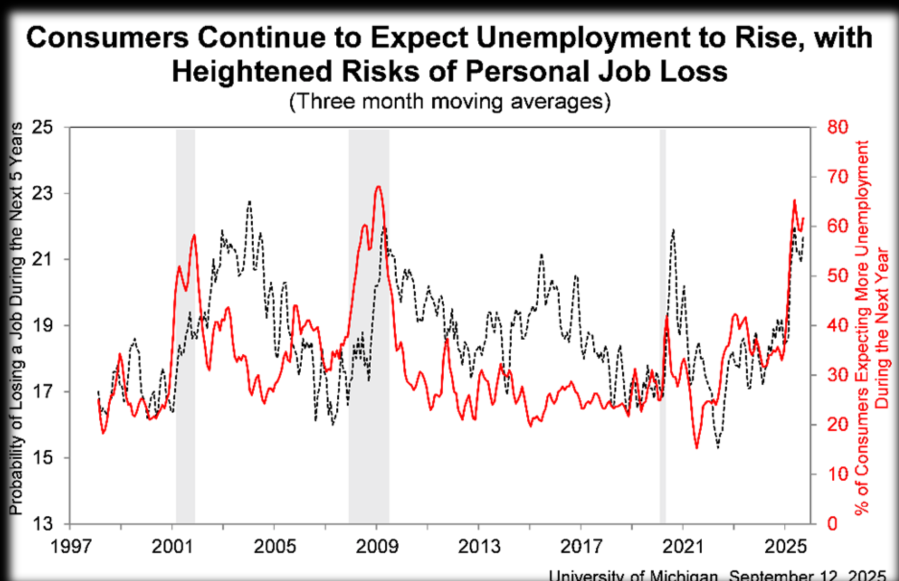
Facts Revisited
More Things That Didn't Make The News



When we established G2 Rampart we knew clients needed good intel and a solid defense. Part of that mission entails not only reviewing things that are in the news but sharing things that go under the radar for most investors. For example, the news, so aflutter at present with AI, has failed to highlight the fact that consumer sentiment, now at about 55, is in the bottom one percentile since inception of the measure in the 1960s. Also, not seemingly highlighted is the fact that readings below 60 have either signaled or been coincident with recessions. Interestingly, we also recently had the employment numbers restated to eliminate about a million jobs which were actually not created during 2024, confirming our distrust of the published jobs numbers that we shared with readers in recent years. We are also hearing that consumers expect to lose their jobs at about the same rate that they did in 2008 or 2000. Meanwhile, consumer debt is piling up with student loans coming due and sub-prime auto loan delinquencies near all-time highs. This month, in fact, a top three sub-prime lender in TX and CA filed bankruptcy under allegations that it had used the same collateral on multiple loan agreements. This is seemingly the kind of news that one would expect those opposed to the current administration to be shouting from the rooftops, despite the fact that cycles are rarely purely within the immediate control of an administration.

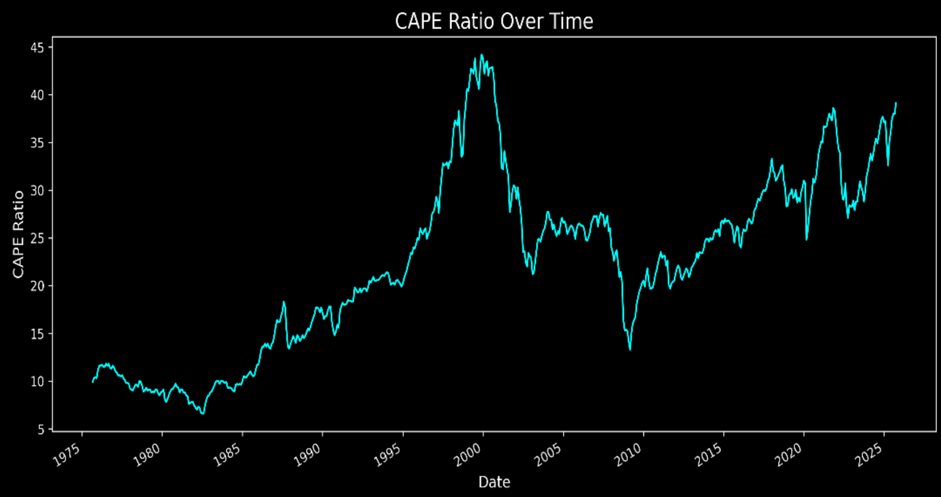
We do love a good story and get excited by the prospects of strong revenue and earnings growth. Problems arise sometimes when investors let stories drive investment decisioning. Some recent stories around things like AI or rare earths are interesting and exciting and present hopeful promises for the future. Stories and perspectives can be bound to math, valuations and other factors to make good investments at times. In good markets, in bull markets, investors, hearing those hopeful stories, tend to think less critically about the attributes for long term investment success. When thinking of a hopeful stock that you either own or wish to own, ask yourself, “In a most awful market, would I buy it in size?” Often positions are undertaken because the momentum of the market is rewarding and reinforcing investors. In such times, facts that run counter to the story, risks like those mentioned above and many others, are minimized. One notable story that came to light in recent weeks was the incredulous story of a tech company that, after reporting a 12% earnings increase, went on to project future earnings gains on the order of 100% per annum. The market, duly impressed, rewarded the company with no less than a forty percent pre-market move. These are heady days when a company once favored as the darling of the 1990s tech riot which only recovered to its 2000 highs around 2016 was once again dancing upon the stage.



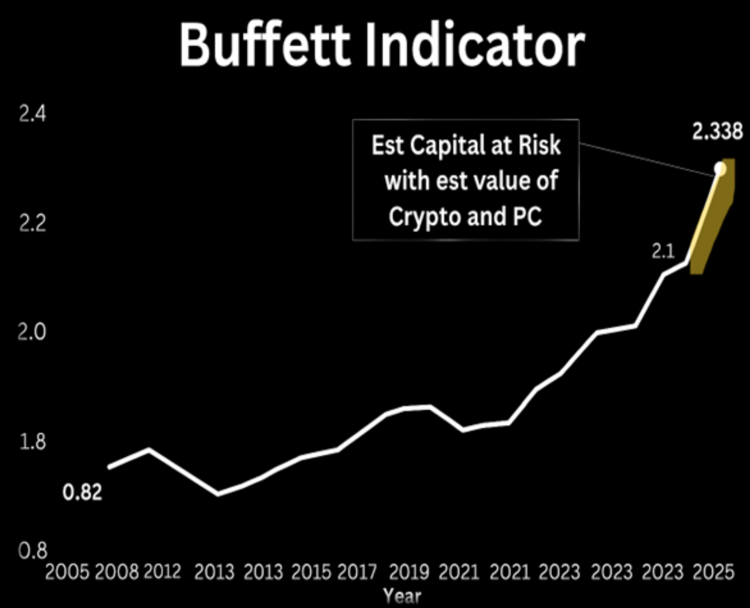
For some reason, the news made me think of many of the companies of the 2000s and the Shakespeare line about, ‘a poor player who struts and frets his hour upon the stage and then is heard no more.’ One such darling of the 2000 tech riot which ultimately acquired one of my own very successful holdings at the time was JDS Uniphase. JDS was a meteor that screamed skyward posting upwards of 60% margins amid flaming hot revenue growth. It was the time of the titans in optical networking, companies that could blaze into the hundreds of millions and billions in market cap. JDS, like companies today, saw its revenues, earnings and market cap streak higher. Today, many like to delude themselves by suggesting that the difference between today’s tech market and that of the 2000s was that companies *back then* were not real, viable companies. Oh, contraire. These optical networking companies were not the Superbowl ad sock puppet type of internet companies. It was a revolution in the making and the one upon which all of our current telecom, computing and communications rides. In short order, JDSU stock price quickly doubled over and over. The story ended with the stock losing about 99% of its value. Why? Attendant with the growth, the stock valuation ballooned into the many hundreds of times earnings. In contrast, a company which I had acquired and, ultimately, sold before it was acquired by JDS was bought at about 10X earnings. These were companies which shared many similarities with the current poster children of the AI/chip revolution.

Today's AI space showcases companies that trade hands for 500X earnings and a full 70X sales. For fun this weekend, imagine if your business was worth 500X its earnings (i.e., your business earning $2MM being priced at $1B). A company with that kind of valuation should also promise some kind of religious experience. To be fair, that is actually an example of a software company which usually trades at higher multiples (ex. 30-60X EPS) than chip companies because they have high margins requiring less capital investment. It may surprise some to realize that PE ratios for chip manufacturers have historically traded at the very low end of double digits, being regarded as highly capital intensive, cyclical stocks. The idea that semiconductor companies can persistently trade at very high multiples is not completely consistent with history, even for those who are leading innovation. Today, preeminent companies in the software space can command PEs in the 50s and 60s. Following not long after the 40% daily move in an AI stock we got an announcement of a $100B investment in an AI company by a chip manufacturer. This highlights two often overlooked developments. One: Software companies believe that they must make huge capital investments to stay competitive, which begs the question as to how much, how long and what is the ongoing margin/financial impact? And, two: An AI company using newly injected capital to purchase the products of the investor seems somewhat circular. We also received word of another tie up or two from the very same company with a nod toward collaboration. All of the foregoing, however, is very common as growth slows. Acquisitions, partnerships, even questionable ones, follow rapid growth. The collaborations and acquisitions are also likely a not completely irrational means of defending the moat. Partners and/or portfolio companies are less apt to become customers of competitors or competitors themselves. And, long range agreements draw out the cycle, if only a bit. This is not to say that the industry is in contraction, rather to suggest that management is wary that the incredible high margins and growth rates are at-risk and is moving to secure them.

In a capitalization weighted, largely passive and fan-driven stock market, it is well documented that assets and values are concentrated in a relatively small number of companies. Given the vast weight these companies have in the indices, it is fair to evaluate how they are valued relative to earnings over time. We can discern a trend in CAPE ratios of the seven largest companies in the market in 2005, 2015 and 2025. The methodology and data sources can produce somewhat different ratios. The fact is, however, that the ratio is now multiples of the multiple in prior years. The CAPE ratio, as a reminder, is the ratio of the market cap to ten-year inflation adjusted earnings, as such it reduces the weight of outlier earnings years. One can easily dismiss such an analysis by countering that it defines different sector leadership at different times or does not take into account the scaling abilities of tech or the higher inherent margins. Yes, those are worthy considerations. They also highlight the erosion of other sectors of the economy. For example, companies like GE, Citigroup and WalMart would factor in earlier years before being replaced by a heavily tech-slanted cohort in 2025. In the early years, companies like META or Alphabet did not even have ten year earning histories as public companies. All things taken together, however, we do not have examples of extraordinarily highly valued companies persisting over long horizons. If one were to assume a normal distribution, one could expect that there is something like a 3.8% chance of a CAPE valuation higher than today's, based on the last fifty years of data.



Today, we are also seeing rampant speculation in crypto and gold in addition to anything happening within equity markets. Before dismissing the two as unrelated to equity markets, it is worth considering things like liquidity, transparency, the wealth effect and speculative appetites. Consider that today there is $4T in crypto. In years past, we might simply use the total market cap of stocks divided by GDP to assess valuations. What if, however, there are dollars pouring into other, new pockets of risk capital beyond equity. If we loosely assume $57.5T in US equity holdings, $4T in crypto is not an insignificant sum. In fact, considering that there is limited visibility, high volatility, an unknown derivatives value, low liquidity in some instances, a new asset class and unknown value of pledged assets, the additional $4T is quite meaningful. While individuals in a tame market do not associate equity and crypto risk, a less than tame market can cause seemingly unconnected assets to converge. Consider an investor facing a collateral call who must try to liquidate his crypto as it careens lower. Pricing might be obscured on some derivative obligations held or the market might function in unanticipated ways. These things happen quickly and can equally quickly sap one's risk appetite, optimism and investing enthusiasm. At times like these, both professionals and individuals may be said to back away from the market, exacerbating the problem. Given the unknowable nature of so much crypto, as well as the lack of historical data and transparency, it is uncertain what kind of splash $4T can have. One may assume that the impact is not near zero and could very well be astronomically greater, even disproportionally so. Remember, this $4T was an entirely non-existent market until very recently.



In the midst of all the talk of economics, crypto, AI, we really have to mention private credit. In the wake of the financial crisis of 2008, banks were pushed back from certain types of lending. Into the breach leapt what are now called loosely private credit funds. Unlike bank lending or funds raised in offerings of rated debt, these loans are largely negotiated and placed privately. They are neither rated nor highly liquid. They do, however, have some size as the market has grown dramatically. Much of this debt is tied to private equity sponsor funds, real estate, technology and even crypto. It is not reflected on the balance sheets of the big financial institutions which are regarded as too big to fail. The market is estimated to be somewhere between just over $1.5T to somewhere on the order of $3T. The degree of error in the estimates is telling in its own right. So, it is either $1.5T or 100% more than that. That is like saying, I own one car or maybe two. It truly highlights the lack of transparency and ambiguity in an asset class that will be alarmingly difficult to manage in a credit situation. Further, harkening back to our discussion of the Buffett ratio, if we were to naively stack the aggregate value of crypto and private credit onto equity capitalization, we would see that the sum is more than 2.3X GDP. This it nearly three times the ratio in 2005.

And, if one were to believe someone like Howard Marks of Oaktree, virtually all crises start in credit. Now, we have a newly built, unseasoned, opaque, illiquid, unrated, largely unregulated pool of credit that is built largely around things like technology, AI, crypto and companies who are either unable or find it more attractive to raise capital outside of banks and the public market than within it. Fortunately, some, perhaps many, of these managers will perform well and exercise prudence. Notably, however, as I have discussed with clients many times, bids for such assets can be gappy at crucial times when one would most wish they were not. A bid at 97 can become a 53 bid, for example, before the market closes. Further, whereas the US Treasury has become quite cute with regard to what assets it buys in times of crises, unrated, private debt of small, perhaps, unprofitable companies has, as of yet, been something in which they have expressed an interest. There is a first time for everything, but one should be aware of the circumstances. Notably, at the moment, arrangements are being made for Joe-six-pack to invest his 401K assets in private and alternative investments that were previously the sole domain of the wealthy, sophisticated and institutions. This as the current Shiller PE hovers at about 39 and the PE at about 29. The more one studies, considers these aspects of the current markets, the more convinced one becomes that hindsight will reveal how obvious the excesses have all become. One has to wonder if many of the *experts* are now resigned to 'aping unreason proleptically' as John Maynard Keynes referred to it and simply going along with valuations, assuming rationality is lost and they are better served anticipating and imitating irrational behaviors themselves.

Sidebar:

Keynes is said to have, ultimately, died rich using an investment strategy that did not 'ape unreason, but emphasized: contrarian, bottoms up, value, dividend-paying, out-of-favor.

Tesla, the genius inventor, ironically died broke.