



INVESTMENT WHIPLASH: BETTER TO BE LUCKY THAN GOOD?

Closure on Apple & Amazon Short Sales

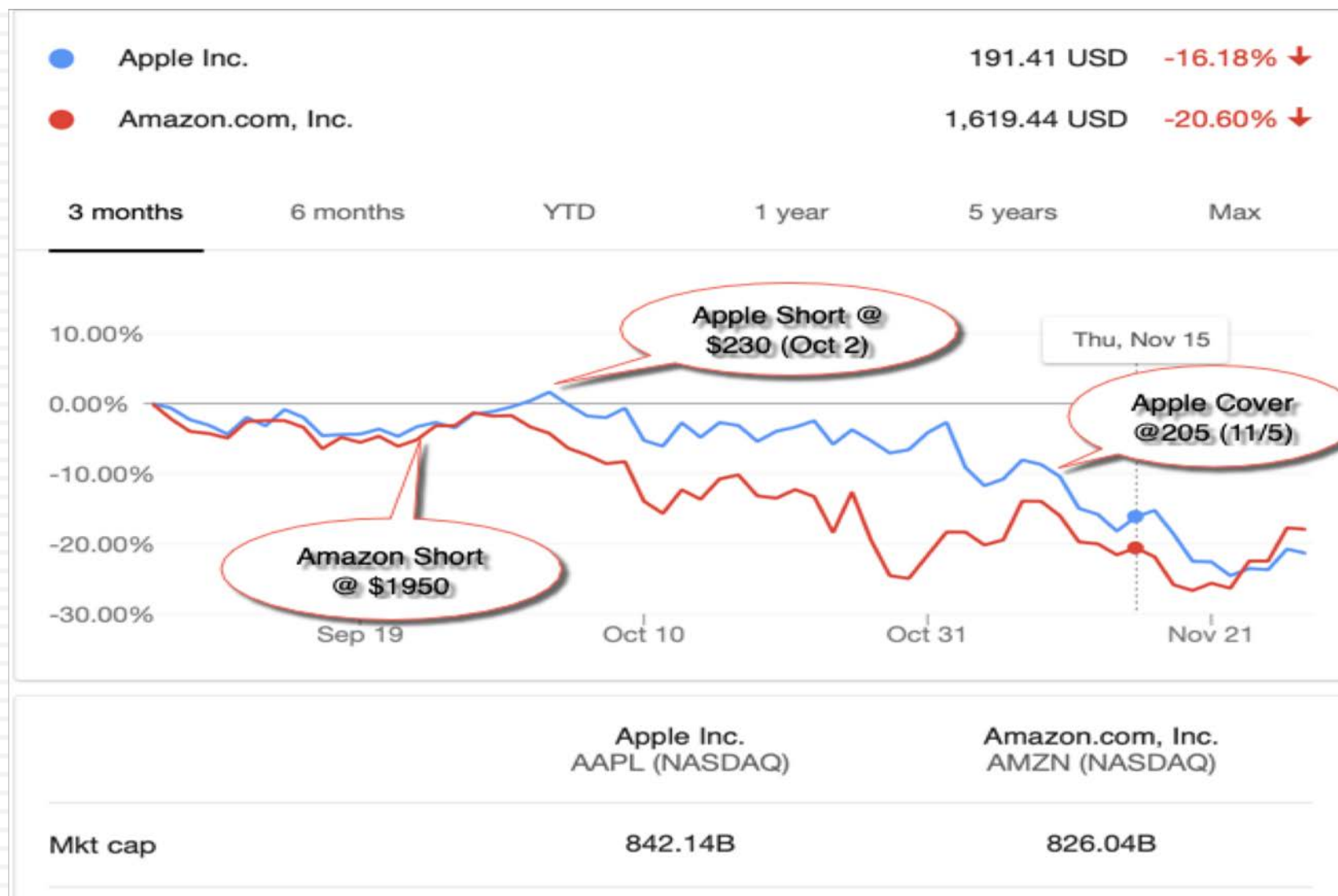
The Lead In

- In September, I concluded that Apple & Amazon were over valued and I was selling short on both stocks, Amazon for the first time in 22 years of tracking the company and Apple at a limit price of \$230.
- Two months later, both stocks have taken serious hits in the market, down almost 25% apiece, and my short sales have been covered
- It is always nice to have happy endings to my investment stories, but rather than use this as vindication of my valuation skills, I will argue that I just got lucky in terms of timing.

My September Valuations

	Apple	Amazon
	<i>Base Case Summary</i>	
Stock Price (9/20/18)	\$ 220.00	\$ 1,950.00
Base Case Value Estimate	\$ 200.00	\$ 1,255.00
% Over or (under) valued	10.00%	55.38%
	<i>Simulation</i>	
10th Percentile	\$ 176.00	\$ 705.00
Median	\$ 200.00	\$ 1,242.00
90th Percentile	\$ 229.00	\$ 2,152.00
Skewness	0.2810 (Mild positive skew)	0.6596 (Strong positive skew, with greater chance of big positive than big negative outliers.)
	<i>Gap Catalyst Assessment</i>	
Earnings Reports	Unlikely. Both companies have strongly scripted earnings reports, where expectations are managed well and results hue to the expectations. With Apple, the focus is on iPhone growth and levels of margins, and with Amazon, it is on revenue growth, with changes in margins.	
Corporate Actions/News	More likely with Apple, where the iPhone new model cycle and the big announcement settings can be price catalysts, than with Amazon that tends to introduce new products in more understated way.	
Management Dynamics	Unlikely with both companies. They have disciplined and long-standing top managers, and neither has a CEO who will make unforced errors.	
Macro/External Factors	With Apple, it is low, though the US trade war with China could cause a rethinking of future growth, but with Amazon, it has become higher, as regulatory authorities and anti-trust enforcers turn attention towards company.	
Investment Judgment	Sell current Apple holding. Sell short if stock >\$230.	Sell short at current price.

A Happy Ending?



Investment Judgments

- My Apple short sale which was initiated on October 2 was closed out on November 5 while Amazon got tantalizingly close to my trigger price of \$1412 (with a low of \$1420 on November 20, before rebounding.
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Intrinsic Value Lesson 1: Auto Pilot Rules to fight behavioral biases!

- I put in limit orders on both my Apple short sale and my covering trades on both stocks because I know my weaknesses and left to my own devices, the havoc that they can wreak on my investment actions. I have never hidden the fact that I love Apple as a company and I was worried that if I did not put in my limit order at \$230, and the stock rose to that level, I would find a way to justify not selling short.
- For the limit buys to cover my short sales, I used the 60th percentile of the value distribution, because my trigger for buying a stock is that it be at least at the 40th percentile of its value distribution and to be consistent, my trigger for selling is set at the 60th percentile.

Intrinsic Value Lesson 2: Intrinsic value changes over time

- Among some value investors, there is this misplaced belief that intrinsic value is a timeless constant and that it is the market that is subject to wild swings, driven by changes in mood and momentum.
- That is not true, since not only do the determinants of value (cash flows, growth and risk) change over time, but so does the price of risk in the market.
 - The former occurs every time a company has a financial disclosure or a major news story (acquisition, divestiture, new CEO)
 - The latter is driven by macro forces.

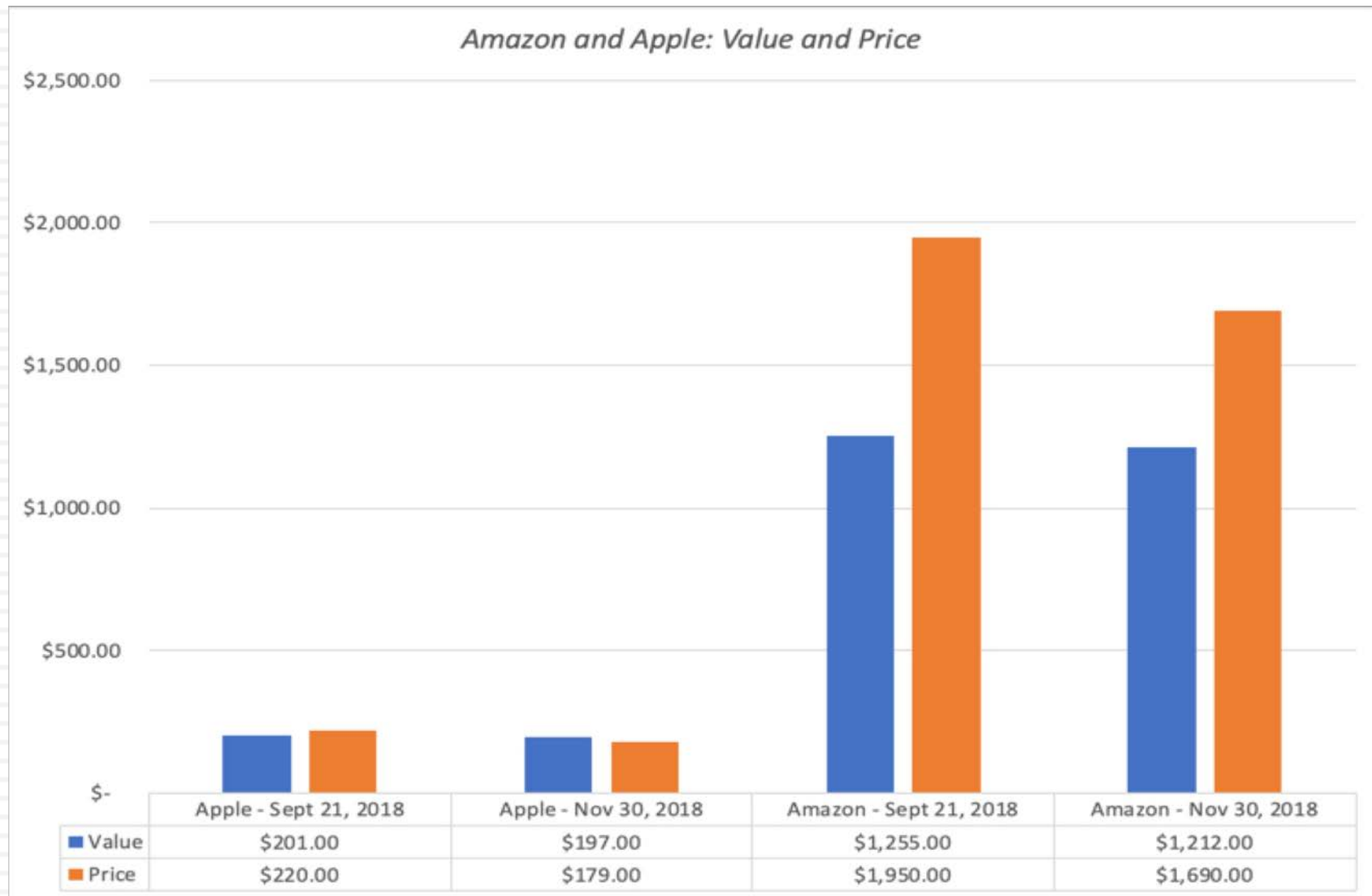
Apple and Amazon

- Since my September valuations , there have been a [few news stories](#) and we can argue about their consequentiality for future cash flows and growth, but the big change has been in the market.
- Since September 21, the date of my valuation, equity markets have been in turmoil, with the S&P 500 dropping about 5.5% (through November 30) and the US 10-year treasury bond rate have dropped slightly from 3.07% to 3.01%, over the same period. If you are wondering why this should affect terminal value, it is worth remembering that the price of risk (risk premium) is set by the market, and the mechanism it has for doing so is the level of stock prices, with a higher equity risk premium leading to lower stock prices.

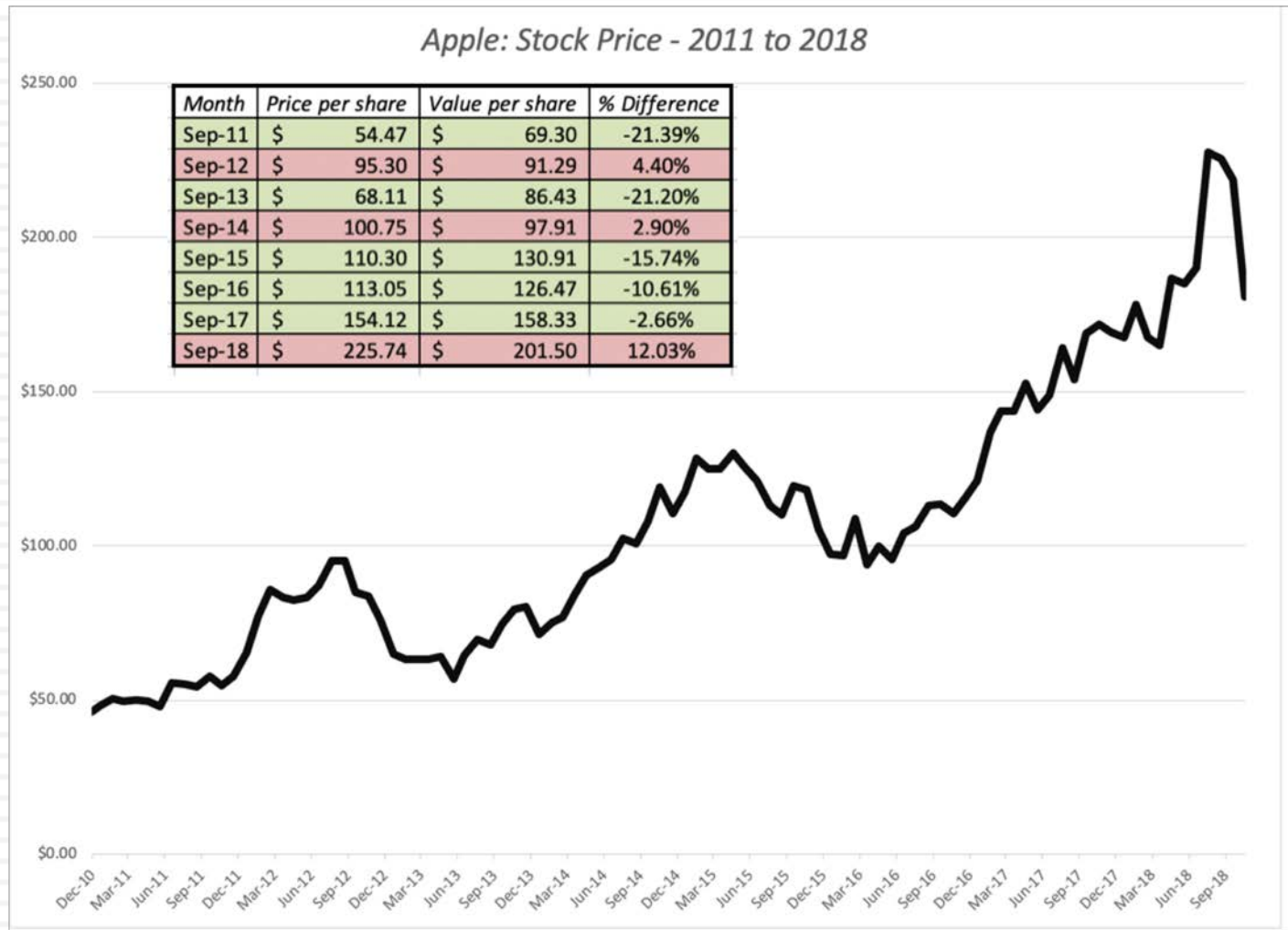
ERP Changed!

<i>End of Day</i>	<i>US 10-yr T.Bond</i>	<i>S&P 500</i>	<i>Implied ERP</i>
8/31/18	1/0/00	2901.52	5.04%
9/30/18	3.06%	2913.98	5.38%
10/1/18	3.09%	2924.59	5.36%
10/2/18	3.05%	2923.43	5.36%
10/3/18	3.15%	2925.51	5.35%
10/4/18	3.19%	2901.61	5.39%
10/5/18	3.23%	2885.57	5.41%
10/8/18	3.22%	2884.43	5.42%
10/9/18	3.21%	2880.34	5.43%
10/10/18	3.22%	2785.68	5.61%
10/11/18	3.14%	2728.37	5.73%
10/12/18	3.15%	2767.13	5.65%
10/15/18	3.16%	2750.79	5.68%
10/16/18	3.16%	2809.92	5.57%
10/17/18	3.19%	2809.21	5.56%
10/18/18	3.17%	2768.78	5.65%
10/19/18	3.20%	2767.78	5.64%
10/22/18	3.20%	2755.88	5.67%
10/23/18	3.17%	2740.69	5.70%
10/24/18	3.10%	2656.10	5.89%
10/25/18	3.14%	2705.57	5.78%
10/26/18	3.08%	2658.69	5.89%
10/29/18	3.08%	2641.25	5.92%
10/30/18	3.12%	2682.63	5.83%
10/31/18	3.16%	2711.74	5.76%
11/30/18	2.99%	2760.17	5.68%

Intrinsic Value Lesson 3: But price changes even more



Apple: A Longer History of Price and Value



Intrinsic Value Lesson 4: A long time horizon is necessary, but not always required

- Buy and hold (forever): One widely quoted precept in value investing is that you should buy good companies and hold them for eternity. While buy and hold is not a bad strategy, since it minimizes transactions costs, taxes and impulsive actions, I hope that my Apple analysis leads you to at least rethink its wisdom.
- Long time horizon, if needed: My short sale on Apple was predicated on value, but it lasted only a month and four days, before being unwound. In fact, earlier this week, I bought Apple at \$175, because I believe that it under valued today, relative to value, giving me a serious case of investing whiplash. I am willing to wait a long time for Apple's price to adjust to value, but if the price adjusts quickly to value and then moves upwards, I have to be willing to sell.

Intrinsic Value Lesson 5: To thine own philosophy, be true!

- I did cover my short sale, by buying back Apple at \$205, but the stock continued to slide, dropping below \$175. I almost covered my Amazon position at \$1412, but since the price did not hit that level, I held on and the stock price is back up to almost \$1700.
- I am not regretful about missing my chances, because you have to be true to your investment philosophy, even if it means that you leave profits on the table sometimes, and lose more money at other times. I have faith in value, and that faith requires me to act consistently.

Bottom Line

- As investors, we are often quick to claim credit for our successes but equally quick to blame others for our failures, and I am no exception.
- I am sorely tempted to view what has happened at Apple and Amazon as vindication of my value judgments, I know better. I got incredibly lucky in terms of timing, catching a market correction and one targeted at tech stocks, and I am inclined to believe that luck is the main reason for why my Apple and Amazon positions have made me money in the last two months.
- I will bank my profits, even if they are entirely fortuitous, but I will not delude myself into believing that I have somehow developed timing skills.