2019 3rd Quarter Stock Market Commentary

RETURN OF THE LIVING DEAD

"The main purpose of the stock market is to
make fools of as many men as possible."
– Bernard Baruch

In 1975 a little-known high school dropout named John Travolta received a call from his agent to audition for a part in a new situation comedy planned by ABC called *Welcome Back Kotter*. He landed the role of Vincent ("Vinnie") Barbarino, the cocky Italian-American "unofficial official" leader of a group of remedial students at James Buchanan High School called the Sweathogs. Travolta's charisma was in no small part responsible for the popularity of the show, which led to him winning the role of Tony Manero in the blockbuster 1977 hit *Saturday Night Fever*, for which he received an Oscar. A year later he co-starred with Olivia Newton John in the movie production of *Grease*, where he played greaser Danny Zuco. At the time, *Grease* was the most successful musical of all time. John Travolta was a member of Hollywood's A-List.

And then he wasn't. After having been type-cast as an oversexed, wise cracking street kid, Travolta's star soon faded. But fifteen years later there was a resurrection, after Quentin Tarantino cast him as a hitman in *Pulp Fiction*. This led to a series of roles, and Travolta was once again a massive success. The Hollywood riches-to-rags-to-riches journey is hardly unique to Travolta. A similar story could be told about Robert Downey Jr., Betty White, Christian Slater or Drew Barrymore, to name just a few.

A similar phenomenon is common on Wall Street. Some stock will capture investors' interest for a brief period before fading from view. In most cases, it will never regain its previous luster. But in some cases, like the living dead, it will re-invent its business and have a second star turn.

Consider as an example the stock of Apple. As a member of the FAANG quintet (Facebook, Amazon, Apple, Netflix and Google) that have led the bull market's long rally, Apple is undoubtedly one of the most prominent members of Wall Street's A-List. But it was not always so.

Apple went public in 1980 at a price of $22/share, equivalent to only $0.39 after adjusting for stock splits over the past 39 years. The prior year Radio Shack had introduced the first personal computer, the TRS 80, and Apple's debut was buoyed by its introduction of the Apple I. A few years later the company introduced the MacIntosh as an alternative to the IBM PC. At around the same time John Sculley was brought in as chief executive. Sculley clashed repeatedly with founders Steve Jobs and Steve Wozniak, and the latter left in 1985 and sold all his stock. Jobs was soon stripped of his duties and he, too, departed in late 1985. Apple stock peaked soon after, having risen nearly 550% from its initial public offering.

But it soon became apparent that the MacIntosh line would never displace the popularity of Windows based machines, and the stock drifted lower for a decade, losing more than half its value. By 1997 there were rumors of its imminent bankruptcy, but it was saved by a cash infusion from Microsoft. At about the same time Steve Jobs was lured back to the company, and began one of the most stunning comebacks in U.S. corporate history. He radically altered the company from an also-ran in personal computers into a consumer product and technology behemoth focused on merging technology, design and intuitiveness of use. In fairly short order Apple introduced the redesigned iMac, the iPod, the iPhone and iPad. It opened flashy retail stores around the world, and fostered the creation of an ecosystem of apps which built brand loyalty while generating a large and growing revenue stream. From a mere $1.7 billion in revenue and $2.7 billion in market cap at the time of Jobs' return, Apple has grown to a $270 billion revenue colossus with a market cap exceeding $1 trillion. Undoubtedly, this was the greatest strategic redesign in corporate history.

Ironically, Apple's savior Microsoft has also enjoyed a second star turn. Founded in the mid-1970s, the company introduced its flagship Windows and Office products in 1985 and went public the following year. Its market share (more than 90%) in the growing PC market made it a Wall Street favorite and its stock rose more than 35,000% over the next 24 years. But then came the bursting of the tech bubble, followed by declining demand for desktop computers. Microsoft stock lost 60% of its value and languished for more than a dozen years. In early 2014 CEO Steve Ballmer was replaced by Satya Nadella, who re-focused Microsoft as a cloud computing company. Once again, Microsoft was a member of Wall Street's elite, one of only three companies to be valued in excess of $1 trillion.

Not all re-invented stock market winners are technology companies. Dow Jones Average component American Express has been a standout performer this year, up nearly 25%. Originally founded in 1850, it was formed by the consolidation of three express freight companies (privately owned versions of the Pony Express). It provided transport of valuables between Buffalo, New York and New York City, as well as selected Mid-West cities. In the late 1880s it began offering American Express Money Orders and Travelers Checks. Fast forward to the 1960s and 70s, when the company engineered a series of ill-advised acquisitions to diversify its business: Fireman's Fund Insurance, Shearson Loeb Rhoades brokerage, and Investors Diversified Services, a financial planning and mutual fund management company. Results were less than stellar, and from 1980 to 1995 the stock never traded above $10/share. A series of divestitures allowed management to focus attention on an array of travel related services, and the shares now trade above $118.

Of course, not all companies that attempt a corporate reinvention succeed. Eastman Kodak, for example, once dominated photography, with its ubiquitous Brownie cameras and Kodachrome film. But after the emergence of digital photography the company tried to refashion itself as a pharmaceutical maker, a producer of memory chips, and a healthcare imaging company, all without much success. The stock is down more than 95% from its 1997 high. Sears is another prominent example. Once the premier catalog sales company in the U.S., it sold everything for the home (including the home itself) to a burgeoning market of suburbanites, with reliable brands like Craftsman and Kenmore. When it became clear that its retail stores were losing ground to more efficient competitors, it tried its hand at stock brokerage (Dean Witter Reynolds), real estate brokerage (Coldwell Banker), insurance (Allstate) and internet services (Prodigy). But at its core, it remains a failed retailer.

While more companies have failed to transform themselves than have succeeded, the ones that made it (like Apple and Microsoft) have provided outsized returns to those early patient investors who embraced the vision.

Currently, there are several companies which once dominated huge growth markets, have fallen out of favor, but are in the midst of a radical restructuring. Most prominent would have to be IBM. The company's origins date back to 1911 when four separate companies were merged into a single holding company called the Computing-Tabulating-Recording Company. At the time it was a manufacturer of punch cards, punch card readers, adding machines and time clocks. It was renamed a few years later as International Business Machines (IBM) by legendary president Thomas J. Watson, who created IBM's (rigid but successful) corporate structure. In the 1950s IBM's Selectric typewriters could be found in every office. But IBM's glory days started in the 1960s when the System/360 line of computers ran the back office of most of the Fortune 500 companies. It was ubiquitous enough to be featured in the Mad Men television series. In the 1970s and 80s, IBM was considered America's most admired company.

But management failed to perceive the threat posed first from minicomputers (manufactured by companies like Digital Equipment, Data General and Wang) and later by personal computers (from Dell, Compaq and Apple). The mainframe computer business began a three-decade decline, and IBM's stock is the same price today as it was twenty years ago.

Along the way, though, the company has made impressive strides in other areas. Its Watson product is one of the leading artificial intelligence products in the world. Its cloud computing business, called IBM Cloud, can be found in 80% of the Fortune 500. The recent acquisition of Red Hat for $34 billion positions the company as perhaps the leading hybrid cloud solution vendor (hybrid is the fusion of public and private cloud). It is an open question whether these more exciting initiatives can overcome the drag of the declining Systems business. But if it works, this is a stock which could trade at a much higher multiple than the 10x price/earnings ratio it currently sports.

It is not just technology companies which undertake radical restructurings. Alcoa is another case in point. The company was founded in 1888 by Charles Martin Hall as the Pittsburgh Reduction Company to capitalize on Hunt's discovery of the process to smelt aluminum by electrolysis (the same method still in use today). Because aluminum was both lightweight and strong, in the early 1900s management succeeded in getting automobile manufacturers to substitute aluminum parts for heavier steel. The crankcase and engine block for the Wright brothers' airplane was forged using aluminum from the Pittsburgh Reduction Company. In 1907 it was renamed Aluminum

Company of America, a name that persisted for nearly a century until it was again renamed Alcoa. It engineered the first aluminum foil, manufactured the first aluminum wheels for cars and trucks, and introduced the aluminum beverage can with a pull tab. It was added to the Dow Jones Industrial Average in 1959. At the time aluminum production in the United States was 0.2% of GDP, and its stock was a stellar performer, peaking over $100/share in 2008. But competition from foreign producers was ferocious, and the U.S. economy was shifting away from manufacturing towards services. In 2013, aluminum production comprised only 0.02% of GDP, and Alcoa had the indignity of being replaced in the Dow Jones Average by Nike.

Since that time the company has undertaken a restructuring. It split itself into two parts. The old refining business retains the Alcoa name, and is a relatively small company. The other (larger) piece is called Arconic and is a provider of value-added components to the aerospace, commercial transportation and oil and gas industries. It remains to be seen how successful the transformation will be, but it is worth noting that a similarly configured competitor named Precision Castparts was acquired three years ago by Warren Buffett's Berkshire Hathaway. There is certainly potential here.

Our point is not to argue for the purchase of any specific company. Even in a market that looks expensive, there are always industries in a secular decline which have "cheap" stocks: newspaper publishers, publishers of phone books and directories, check printers, cable TV providers or video and electronic game rental stores, to name but a few. Most companies in these industries will fade from our consciousness like 1940s movie stars. But a special few will reinvent themselves and get a second (or third) life, and we have seen that stocks with low expectations can provide the biggest upside surprises.