

What is a Large Cap Stock?

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Many investors consider market capitalization to be a central measure of risk. However, when one looks at an index qualitatively, as opposed to quantitatively, one may question the validity of this metric. Consider that the S&P 500 Index (“S&P 500”) includes firms such as Amazon.com Inc. and Facebook, Inc. The key question insofar as risk is concerned is whether or not these firms have risk characteristics comparable to companies such as The Coca-Cola Company or The Home Depot, Inc. If capitalization is a true measure of risk, then the index that effectively defines the large capitalization universe should include companies with comparable risk profiles. However, few would suggest that the risks of owning Facebook are comparable to the risks of owning Coca-Cola.

Generally, investors purchase investment products that track large capitalization indexes as a means of investing in mature, stable firms. The unspoken presumption is that mature, stable firms will have large market capitalizations, and firms with immature businesses will have small market capitalizations. It seems reasonable to suppose that Facebook’s business is still immature, large though it may be. That is the problem with capitalization as a risk measure, and it is reflective of a relatively recent shift in the manner in which new companies develop. In the modern world, it is possible to have a nascent, immature business that operates on a vast scale and merits a large market capitalization. However, that does not mean the company has low risk.

To illustrate, suppose one were to exclude The Priceline Group Inc. from the S&P 500. It is in the S&P 500 simply because it has a market capitalization of \$60 billion and a rather high float—roughly 99% of its shares are held by the public (meaning that its management cares to own very little of it). Priceline has a trailing price to earnings (P/E) ratio of roughly 32x; if one excludes it from the S&P 500, arguably, the P/E of the Index would be reduced, albeit by a negligible amount. Also, arguably, the risk of owning the Index would be lessened. However, Priceline trades at 18x analysts’ estimates of its 2015 earnings, and its revenues are growing at over 20% a year. Very few firms in the S&P 500 can match that pace. Ergo, if Priceline were excluded, would one lower the future return of the S&P 500 by a measurable quantity? Similar remarks could be made about Netflix, Inc., also in the S&P 500, and which trades at about 56x 2015 earnings as of this writing.

One might ask, then, whether the P/E ratio of the S&P 500, which is an averaged figure, is even meaningful given that the index includes both low P/E and high P/E stocks. It is at least arithmetically conceivable that the P/E of the S&P 500 could deflate. The deflation could be caused by that group of companies that trade at levels similar to Netflix or Amazon (which has an even higher P/E).

The problem is that the system of classifying companies by market value was designed for the historical character of the S&P 500. Historically, the index consisted of relatively stable firms, such as Coca-Cola and Procter & Gamble, as well as cyclical firms, such as U.S. Steel and General Motors, which were also large components of the Index. The cyclical firms usually would lose large amounts of money during weak economic periods and make large amounts during strong economies. Investors would try to optimize performance by gravitating between the cyclical and the ‘defensives’.

Over the decades, on balance, this proved to be a remarkably unsuccessful approach, as reasonable as it appears to be. In fact, it was so unsuccessful that most managers underperformed the S&P 500, which is the reason that indexation has become the dominant strategy.

In the contemporary era, investors using indexes have fashioned a comparable type of trade. This is the art of buying and selling the high-beta (more volatile) versus the low-beta stocks. For instance, Coca-Cola trades at roughly 22x 2013 earnings and 18x 2015 earnings. As noted above, Priceline trades at 32x 2013 earnings and 18x 2015 earnings. Assuming the estimates prove to be accurate, as far as 2015 is concerned, Coca-Cola and Priceline are comparably valued.

Of course, one cannot be sure that the estimated 2015 earnings will ultimately materialize. As long as there is doubt, people will trade both companies. If we assume the estimates prove to be accurate, as a practical matter it should be self-evident that given Priceline's growth rate, it should end up with a higher P/E than Coca-Cola. Therefore, if you try to control a portfolio of risk by trading a company like Priceline against a company like Coca-Cola, what are you actually asserting?

A more profound problem is represented by the relative valuation statistics of a company such as Pfizer Inc. versus a company such as Regeneron Pharmaceuticals Inc. Pfizer trades at 9.6x trailing 2013 earnings and 13.4x estimated 2015 earnings. These earnings are in decline due to various drug patent expirations. In contradistinction, Regeneron trades at 74x 2013 earnings and 42x 2015 earnings estimates. What assertion, if any, can we make about the meaning of the earnings and, therefore, the meaning of the P/E?

Pfizer spends 13% of its revenue on research and development. This expenditure is scheduled to shrink in the next 24 months, in order to manage earnings to meet expectations, as patent expirations negatively impact revenues. Regeneron spends 38% of its revenues on research and development. Clearly, if Regeneron were to spend 13% of its revenues on R&D like Pfizer, it would have much higher earnings. Instead, it chooses to invest a higher proportion of its available revenues in research and development. Is that a deficiency or is that a virtue? What is the point of naively comparing P/Es?

Google is another example. It was founded in 1998. In 1999, during the then-internet technology bubble, the current management of Google wanted to sell the company to Excite, at the time a much larger website and search engine. Excite, incidentally, is now owned by IAC/Interactive Corp. It could have bought Google for \$1 million, but the Excite management at the time felt that price was excessive and did not do it.

In 1999, having been rejected by Excite, Google's management managed to obtain a \$25 million mezzanine round of financing from Kleiner Perkins Caufield & Byers, and Sequoia Capital, two leading venture capital firms. In August of 2004, the company came public at a \$23 billion market capitalization. We could examine that valuation based on trailing earnings, but let us just look at the earnings of 2004, the magnitude of which no one could be sure in August of that year. In fact, Google earned about \$400 million that calendar year. Assuming one had a crystal ball and knew what the earnings would be, Google, on a prospective basis, was valued at 57.5x earnings by the venture capital firms at the time of their investment.

The question, therefore, becomes whether or not that multiple was excessive. In this case, we know the answer, because the Google shares returned 20-fold in ten years. Alternatively, if one had made 20

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investments, each at a 5% position and Google had been one of the investments, even if the other 19 all went bankrupt, with the Google gains, one would have broken even. Clearly, we cannot merely assert that if a company trades at 57x earnings, we will dismiss it as an investment. That would not be reflective of reality.

With new technologies and a true global market for such products, which we never really had until recently, is the potential market so enormous that it is possible for a company with an immature business to expand on a truly gigantic scale in a very short period of time? It is possible.

From a different perspective, if one said one would not buy Google unless it were to trade at 15x earnings, and then Google really did trade at 15x earnings and one bought it, the return would not be 20-fold. The return would be 80-fold. If one had a 5% position in Google, it really would not matter what happened in any other investment over 10 years. Therefore, Google stock trading at 15x earnings would be preposterously undervalued.

To be an investor and assert that even a company with Google's potential (and some companies have Google's potential, although it is never realized) should trade at multiples approaching 15x, is asking something very extraordinary of the investors who are selling the company, because most companies do not grow at Google's rate. That is asking the investors who know the company best to dismiss all the possibilities of growth, and to value the company in a way that a venture investor never would. Therefore, is it realistic that a company with the potential of Google is ever going to trade at a P/E of 15X on a prolonged, sustained basis? It seems not.

To move on, in 2007, Microsoft invested \$240 million for a 1.6% position in Facebook; when Facebook was clearly an immature company, Microsoft gave it an implicit value of \$15 billion. Facebook did not even turn cash flow positive until 2009. In 2010, Facebook was trading on Second Market, one of the websites that trades unregistered securities, such as partnerships in stock. At that time, Facebook was trading at a \$40 billion market capitalization. Presumably, the people who were trading it were the most informed buyers. Are we to dismiss the informed buyers? On the evidence, that does not appear to be a reasonable proposition.

The basic problem of the market capitalization classification system is the evolution of a class of firms such as Google, eBay, Inc., Facebook, Priceline, Regeneron, and others that can literally create new industries on an enormous scale in relatively short periods of time. It has already happened, and it can happen in the future. There is no obvious means of quantitatively identifying such firms, and it is not obvious how a company that deliberately spends its potential near term earnings on expansion possibilities should be valued.

A further issue with regard to such firms is that in success mode they substantially disrupt the stable businesses that carry low P/Es. It seems obvious that any objective assessment of relative value has to be accompanied by some objective assessment of the propensity to disruption of the incumbent company businesses, meaning the vulnerability of the stable firms to new technologies and new innovations—in other words, by companies that might be trading at very high P/Es.

The history of the S&P 500 is a history of disruption. Microsoft Corp. disrupted the whole computer industry, as did Apple Inc. Intel Corp., via its innovations in microprocessors, made that type of disruption possible. In fact, during their eras of prosperity, Intel, Microsoft, and Apple together represent a meaningful proportion of the return of the S&P 500 in the past 30 years. Even in failure mode, Amazon can, and already has, fundamentally disrupted the retail industry.

The identification of disruptive influences is surely a very important part of the art of generating return but, to our knowledge, there is no academic study of how to do so. If there is actually some logic to what we would term excessive valuations, then we are just going to have to find a way to deal with high P/Es. As long as it is possible to create companies at this scale of revenue, then not a few will trade at high P/Es. It looks like it is going to be a permanent part of the investment landscape.

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