LESSONS FROM THE TRENCHES:

VALUE INVESTING, ENTREPRENEURSHIP & LIFE

THOUGHTS ON PORTFOLIO MANAGEMENT, HOW TO FIND WINNING STOCKS, THE POWER OF ACCELERATING GROWTH, AND GOOGLE/FACEBOOK

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WHITNEY TILSON'S KASE LEARNING BOOTCAMP

PORTFOLIO MANAGEMENT

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LET YOUR WINNERS RUN AS LONG AS: 1) THE STORY IS INTACT; AND 2) YOU MANAGE RISK VIA POSITION SIZING

- My failure to let my winners run cost me dearly
  - I let Berkshire run for two decades
  - But after nailing Netflix, the stock of the decade, at its lows (it's up 54x in the last six years), I started trimming after it doubled and was out by the time it was up 5x
  - Other flowers I pulled include AAPL, MCD, HD, MSFT, BUD, QSR, HUN, AAON and SODA
- In 34 years of owning Brown Forman, Tom Russo has never sold a share; ditto for Chris Stavrou and Berkshire Hathaway
- Avoid portfolio management that picks flowers and waters weeds
- However, you must manage risk by:
  1. Trimming or exiting if the story starts to fall apart
  2. Trimming winners and managing position sizes

POSITION SIZING

- There is no right answer to how concentrated your portfolio should be – it depends on many factors:
  - What are you comfortable with personally?
  - How volatile and risky are the positions?
  - Who are your investors and what are they expecting?
- Generally I had a few 8-10% long positions, many 4-6% ones, and a few 2-3% ones
  - Much smaller on the short side

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THE PRESSURE TO TAKE BIG BETS

- When you're just starting out, there's huge pressure to put up big numbers to stand out so you can raise money
- It's hard to do so, especially in a complacent bull market, without taking big risks
  - Leverage, speculative stocks, big positions
  - The latter is the most common among value investors
  - But how big is too big?

WHAT TO DO WHEN A POSITION IS RUNNING AGAINST YOU?

- This is so hard!
  - All sorts of emotions and biases kick in, so you must be highly rational and self-aware (easier said than done!)
  - No wonder mismanaging this has blown up some of the world's smartest investors
  - It's especially hard for value investors, who are taught that a lower price means "buy more!" (or a higher price means "short more!")
  - Classic value investors are going to screen a lot of value traps as attractive
    - We will probably buy some of them
    - Performance will be enhanced by recognizing mistakes on value traps and getting out quickly instead of digging in stubbornly

WHAT TO DO WHEN A POSITION IS RUNNING AGAINST YOU? (2)

- You must ask – and honestly and correctly answer – a series of key questions:
  - Have I made a research error? Have I done full 360-degree research diligence on this (not only talked to company, but customers, suppliers, competitors, other industry participants, etc.)? Am I possibly missing anything? Have I talked to or read a piece by someone I respect who has the opposite position on?
  - Has the stock moved with the market or the sector or is it stock-specific?
  - Is there new information that led to a big one day move (earnings, M&A, litigation, management changes) and, if so, how does it impact my original thesis? Do I have thesis drift?
  - What position limits and risk overlay should I apply?
  - How many basis points of total portfolio performance have I lost? If I double down and it goes another 20% against me, how much would that be, and am I ok with that? How many basis points of the total portfolio performance am I willing to lose on a single position?
- Consider stop losses, particularly on the short side

HOW TO FIND WINNING STOCKS

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STOCK PRICES REFLECT EXPECTATIONS

- Nearly every company's stock price reflects the consensus expectations that investors have about that company's future
  - This is usually fairly easy to determine by reading a few analyst reports
- Whether a stock goes up or down over time is largely determined by whether a company's performance exceeds or underperforms investors' expectations
- Therefore, investment success is rooted in accurately betting against the "herd"
  - Sometimes this involves identifying companies encountering difficulties that investors think are secular, but prove to be fixable (e.g., McDonalds, Best Buy, Restoration Hardware)
  - Other times, it's great companies that can maintain high rates of growth for longer than the market anticipates (e.g., Amazon, Google, Facebook)

"I MISSED IT" – THE THREE MOST DANGEROUS WORDS IN INVESTING

- Just because a stock has gone up – even a lot, even rapidly – doesn't mean it's not cheap and can't go up a lot more
  - Chris Stavrou and Berkshire Hathaway
  - Mike Burry and Office Depot
  - Me and Netflix
  - Warren Buffett and Google
- If you find yourself saying "I missed it", stop, clear your mind, do the work, and make a decision without any consideration for where the stock has been

THE POWER OF ACCELERATING GROWTH

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NEVER SHORT ACCELERATING GROWTH – AND MAYBE EVEN GO LONG IT

- A wise friend told me years ago, "It's ok to short *declining* growth, but never short *accelerating* growth."
- What he forgot to tell me – and which it took me years to figure out on my own – is that when I find a company showing accelerating growth that I think is sustainable, I should look hard at buying the stock, even if the valuation appears high

SALESFORCE.COM HAS BEEN AN INCREDIBLE GROWTH STORY

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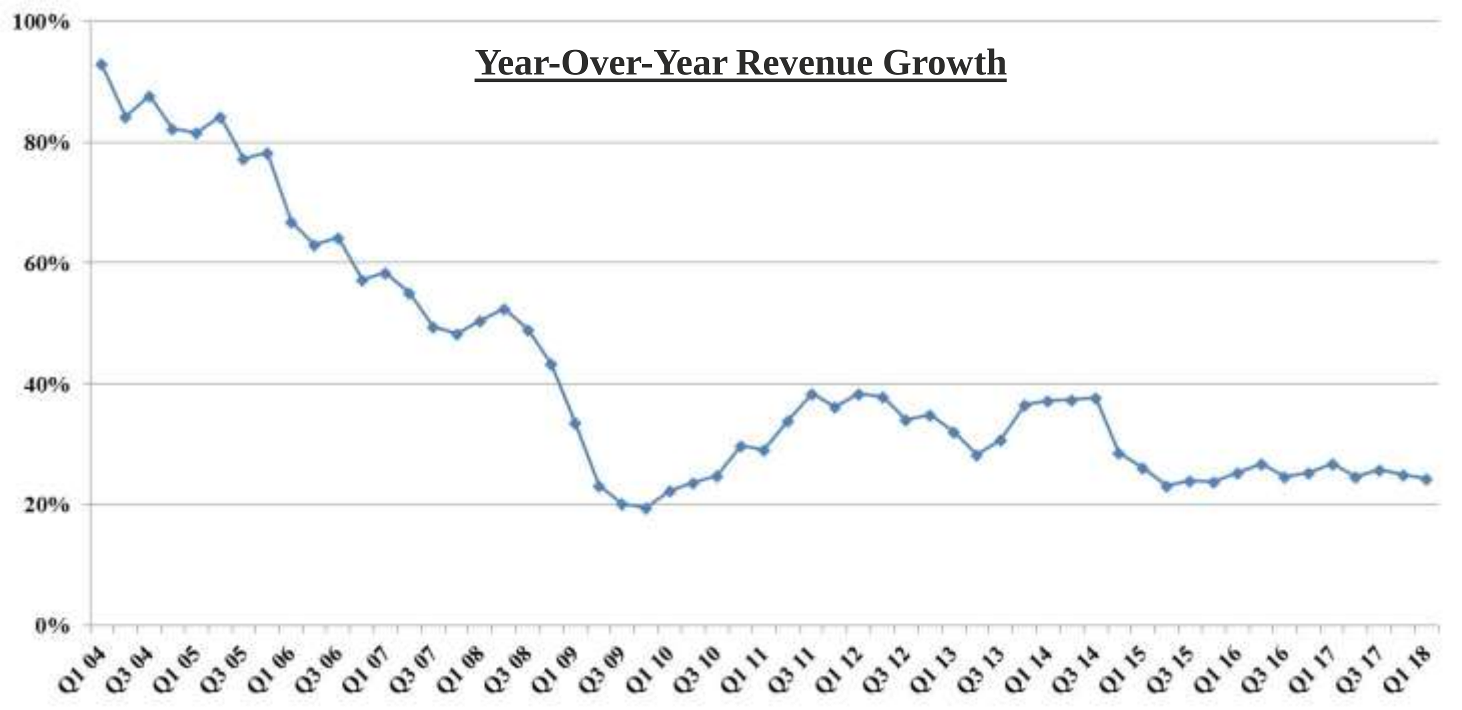
BUT ITS *RATE* OF GROWTH HAS SLOWED

Albeit at a very healthy 25% level



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NEVERTHELESS, ITS STOCK HAS BEEN A MONSTER, UP 4x IN THE LAST FIVE YEARS

MICROSOFT'S STOCK HAS TRIPLED IN THE LAST FIVE YEARS

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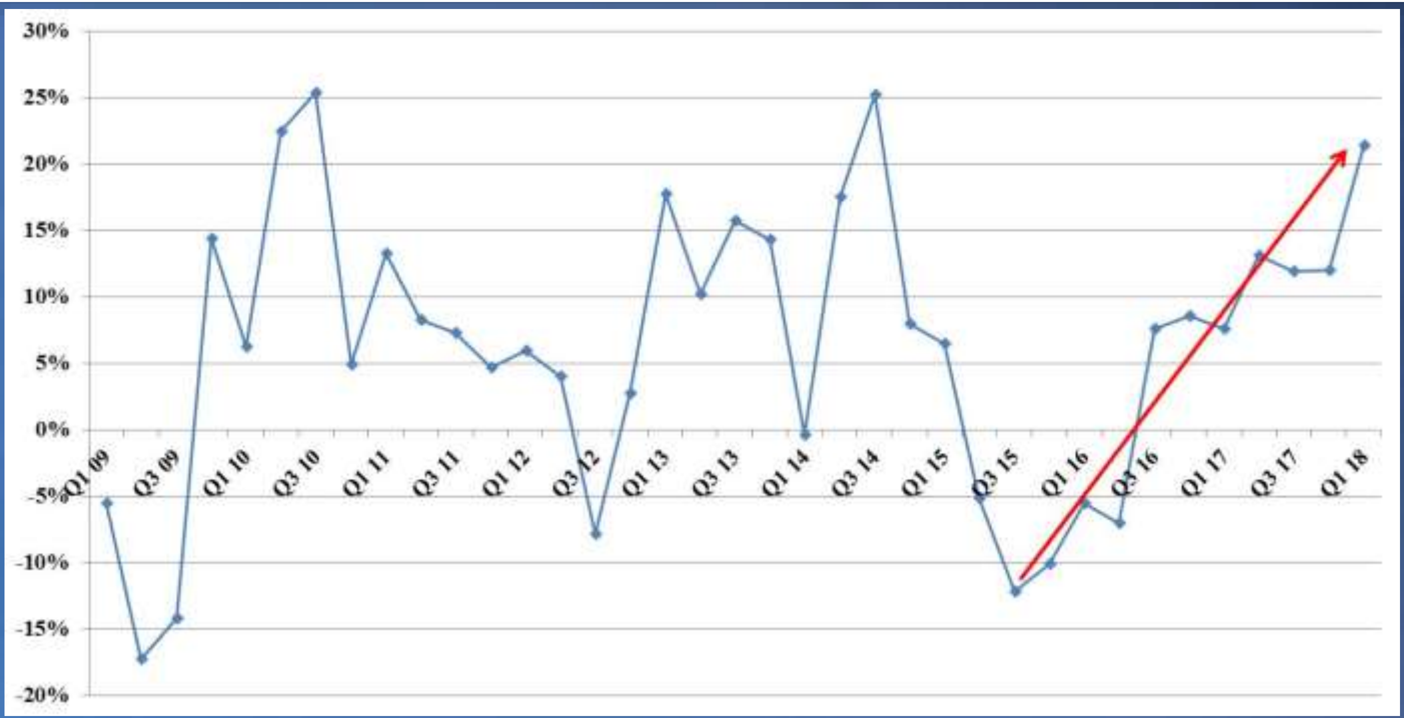
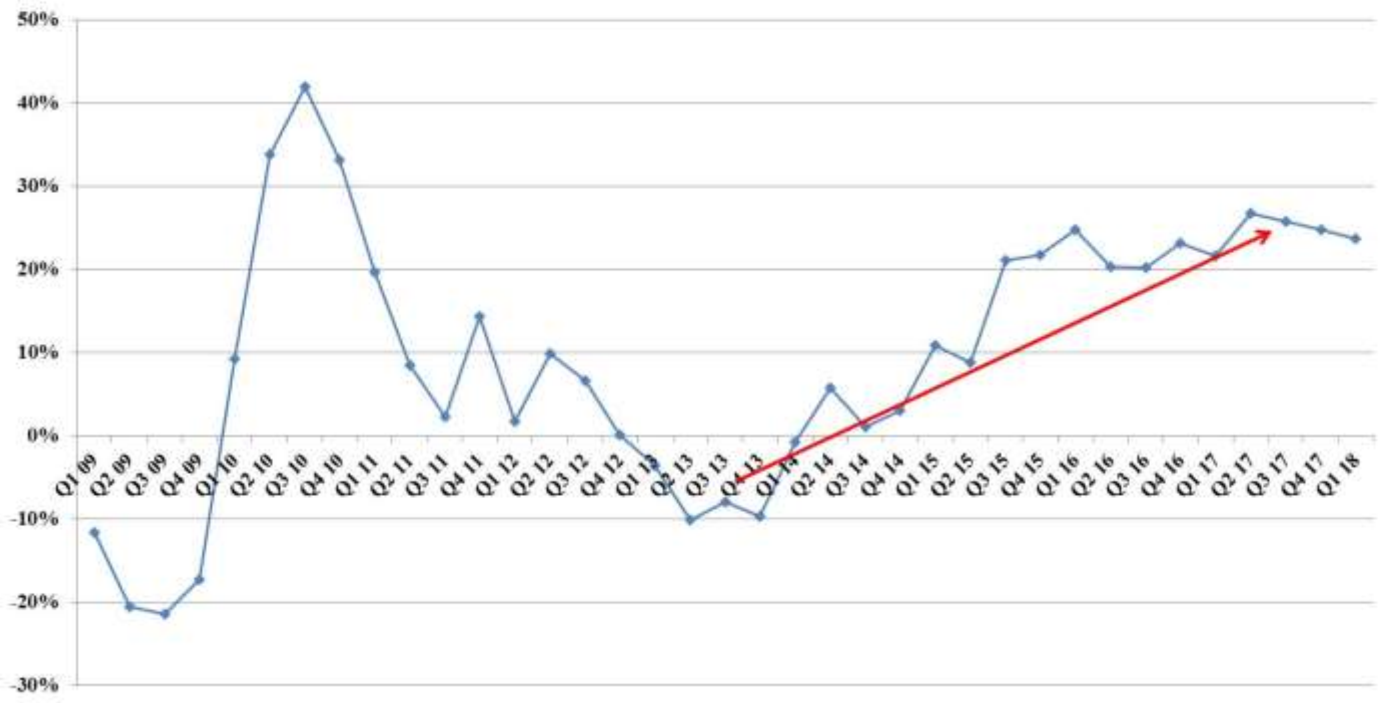
THANKS TO *ACCELERATING* GROWTH IN THE PAST 2½ YEARS



ADOBE'S STOCK IS UP 5x IN THE LAST FIVE YEARS

THANKS TO *ACCELERATING* GROWTH



AMAZON'S STOCK IS UP 7x IN THE LAST FIVE YEARS

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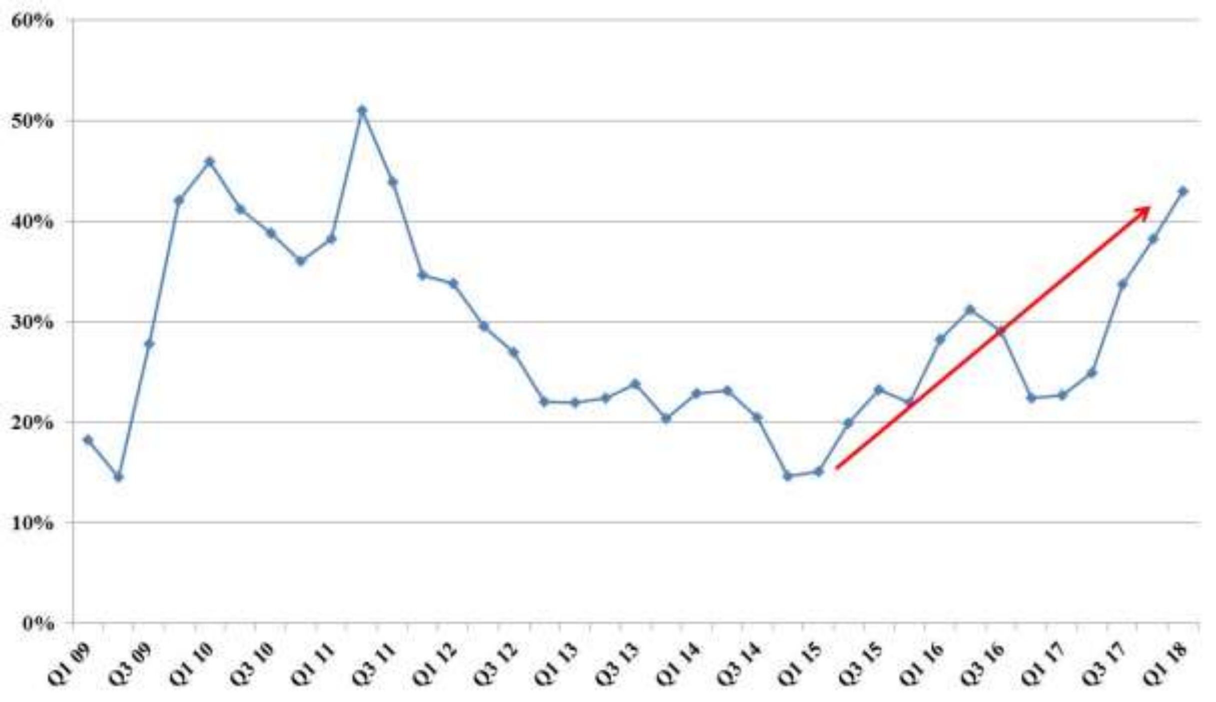
DRIVEN BY *ACCELERATING* GROWTH

This is truly remarkable for a company this large (revenue run-rate of $200+ billion)



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NETFLIX'S STOCK IS UP 10x IN THE LAST FIVE YEARS

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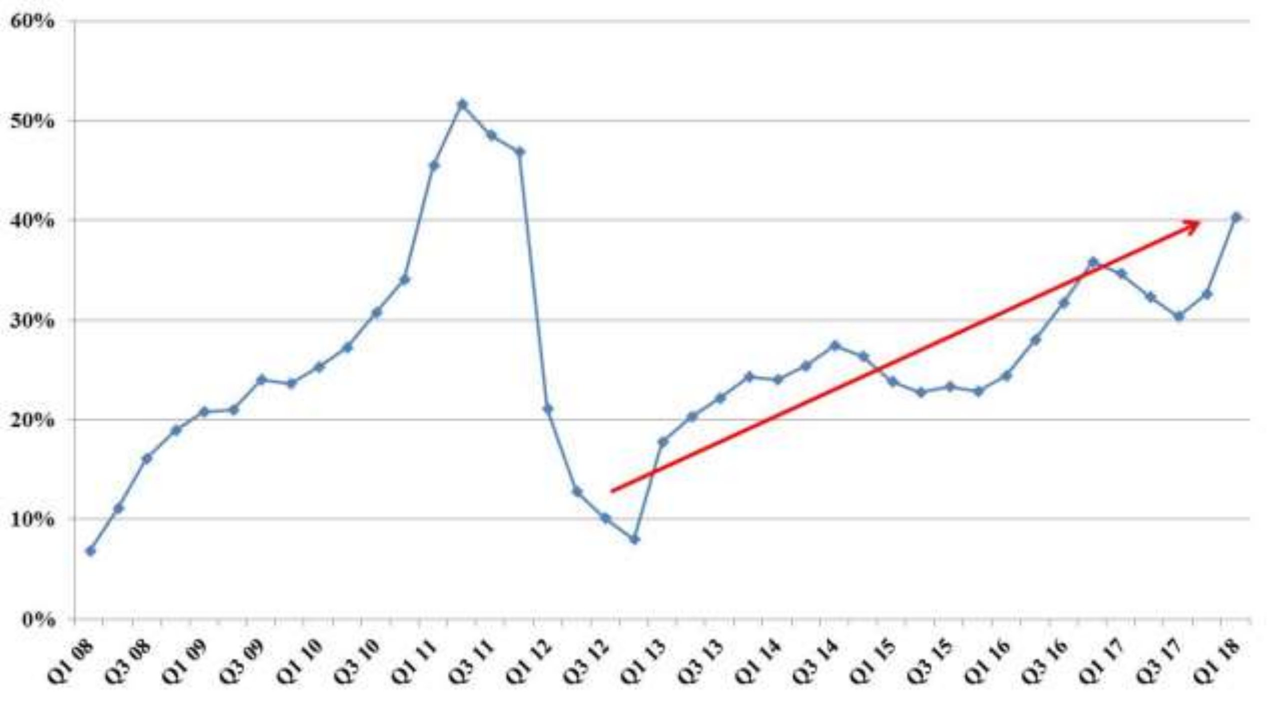
DRIVEN BY *ACCELERATING* GROWTH



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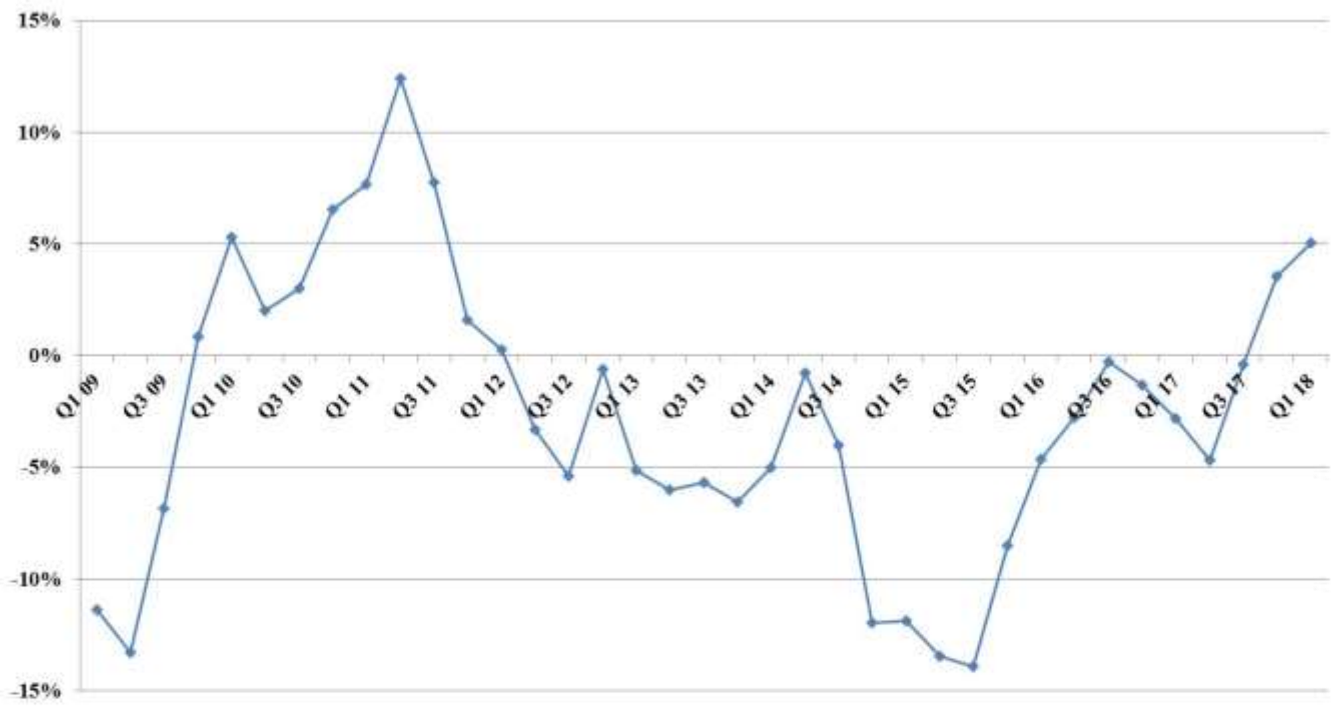
IBM'S STOCK HAS BEEN A VALUE TRAP OVER THE PAST FIVE YEARS

GROWTH DECLINED FOR 22 CONSECUTIVE QUARTERS

Though the trend has improved recently



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ALPHABET'S STOCK HAS "ONLY" DOUBLED IN THE LAST FIVE YEARS

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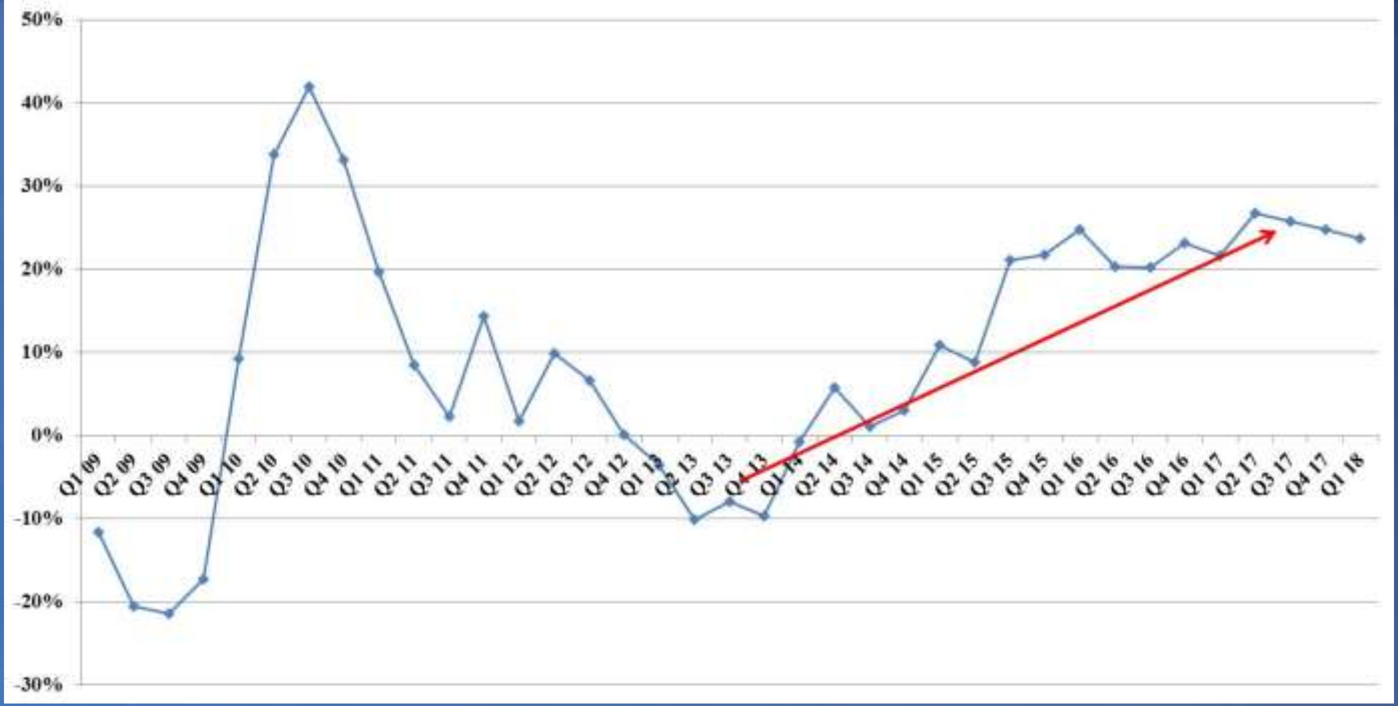
DESPITE *ACCELERATING* GROWTH

This is truly remarkable for a company this large (revenue run-rate of $125+ billion)



BETTING ON THE BEST: ALPHABET AND FACEBOOK

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THE BASICS

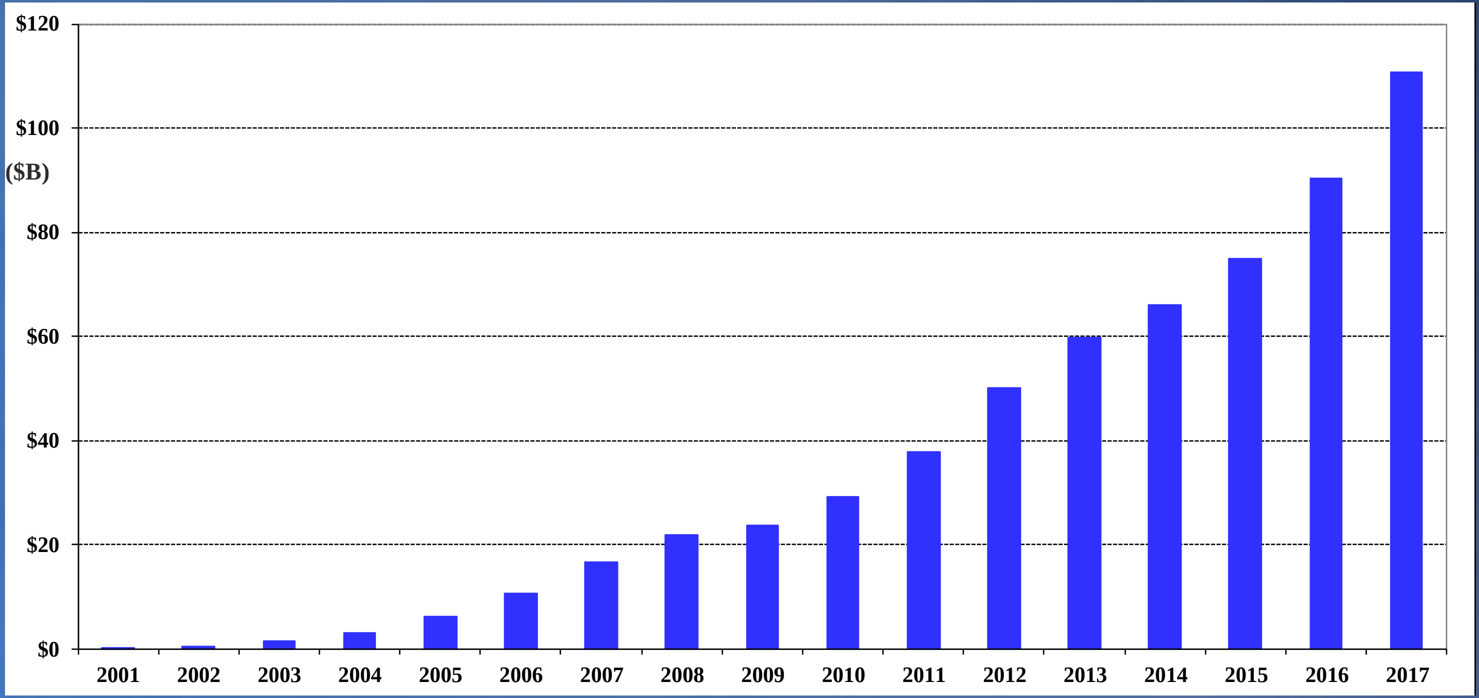
- Stock price (7/11/18 close): $1,071.46 (GOOGL)
- Market cap: $808 billion
- Cash & STI: $103 billion ($147/share)
- Debt: $5 billion
- Enterprise value: $710 billion
- 2017 EPS and P/E: $32.25, 36.3x
- 2018 est. EPS and P/E: $44.28, 26.5x

Q1 ‘18 EARNINGS WERE EXCEPTIONAL

- Revenue up 26%
- Operating cash flow up 22%
- Aggregate paid clicks up 55%

REVENUE GROWTH HAS BEEN REMARKABLE

UP 35x SINCE 2004



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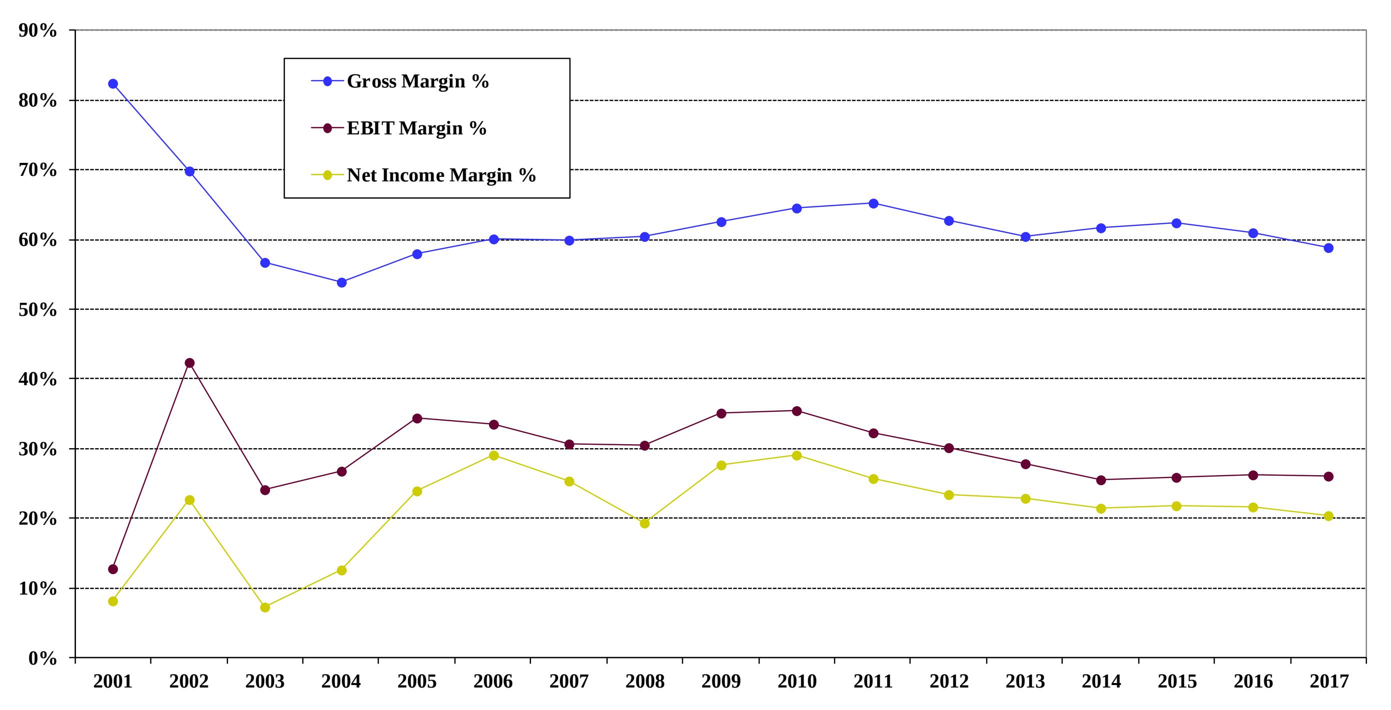
REVENUE GROWTH IS *ACCELERATING*

This is truly remarkable for a company this large (revenue run-rate of $125+ billion)

MARGINS ARE HIGH AND STABLE



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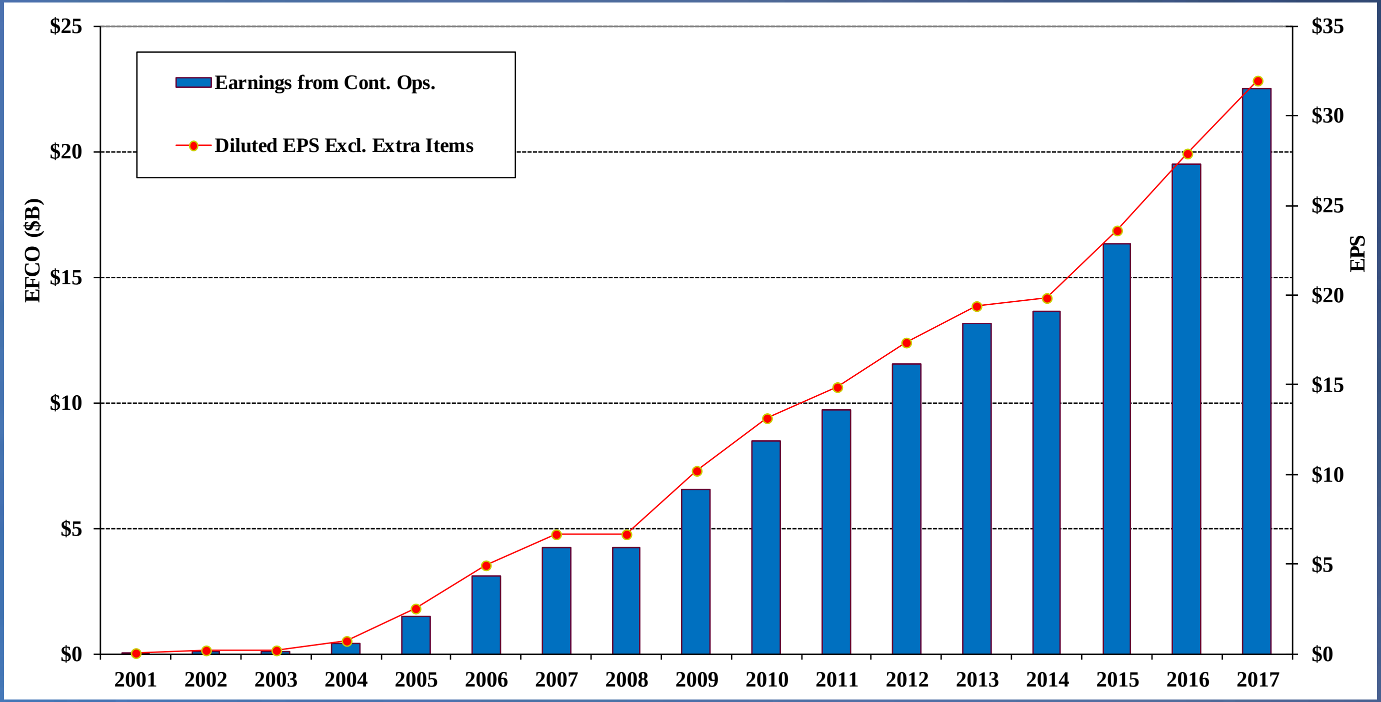
EARNINGS GROWTH HAS BEEN PHENOMENAL



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THE STOCK HAS BEEN A HUGE WINNER

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ALPHABET IS ONE OF THE GREATEST BUSINESSES ON EARTH

- It dominates its sectors globally, is growing rapidly, has enormous, sustainable competitive advantages in the form of brands, habits, and network effects, and has a low-capital-intensive, high-margin business models that generates gobs of free cash flow
- It has seven products with more than one billion monthly average users: Search, Android, Maps, Chrome, YouTube, Google Play and Gmail
- Google Search has 90% share of search in most countries, Android has ~90% share of smartphones globally (vs. 5% in 2010), and YouTube serves ~20% (and growing) of all video consumed on the internet
- Alphabet currently captures 14-15% of global advertising spending
- 100% of the incremental ad spending in the world is going to Alphabet and Facebook
- There is plenty of room for growth:
  - Enormous trend of advertising moving from traditional media to online
  - Only ~12% of U.S. commerce is online today
  - Smartphone penetration is only ~32% globally

YOUTUBE HAS ENORMOUS POTENTIAL

- The world's second-most visited website (after Google.com), 80% outside of the U.S.
- Video appears to be at an inflection point, and Alphabet has arguably the most valuable video platform in the world, as users watch 1.3 billion hours/day (5 billion videos/day) and upload 300 hours of video every minute
- The average mobile viewing session lasts more than 40 minutes, up with more than 50% year-over-year
- Video is currently ~15% of Alphabet gross advertising revenue, growing at twice Alphabet's overall rate
- Opportunity to increase monetization, as YouTube serves ~20% of the web's videos, yet only ~10% of the web's video ads
- In the U.S. YouTube currently monetizes at 60-70% the level of TV despite significantly better targeting
- Annual revenue/user is slightly below Twitter despite having nearly 3x time spent/user
- If Alphabet spun off YouTube, how would the market value it?
  - How it's currently valued within Alphabet: $17 billion (est. $12 billion in revenue * ~4% net margin * 35x) = $25/share
  - How it could be valued: $190 billion (assuming 40 cents/hour viewed, half of what cable companies are valued at) = $270/share (source: Bill Nygren, VII, 5/17)

"OTHER BETS" DEPRESS REPORTED PROFITABILITY

- Alphabet's "Other Bets" segment includes Waymo (autonomous vehicles), Nest (thermostats), Verily (life sciences & healthcare), Access, Calico, CapitalG, GV, and X
- In 2017, Other Bets generated revenues of $1.2 billion (up 49% YOY) and operating losses of $3.4 billion (down 6% YOY; down 19% in Q1 '18)
- Alphabet's operating income in 2017 was $26.1 billion, so excluding Other Bets, it would have been $29.5 billion or 13% higher
- Alphabet has invested ~$25/share into Other Bets; a conservative estimate is that this could be worth ~$50/share or 4% of Alphabet's value

BUT WHAT ABOUT VALUATION?

- It's hard to argue that Alphabet is misunderstood, with 41 analysts following the company
- But the stock looks reasonably valued, at 26.5x 2018 EPS estimates
- This multiple isn't crazy in light of the quality and growth prospects of Alphabet's core businesses
- They're even less crazy if you adjust for various factors:
  - If you subtract net cash ($141/share) and the value of Other Bets ($50/share), and add $2.7 billion ($3.89/share) to net income for after-tax losses on Other Bets, Alphabet is trading at 20x 2018 earnings estimates – not far above the average for the S&P 500, for a company that is vastly superior to the average large U.S. corporation
  - If you think YouTube adds $255/share of extra value, the P/E drops to 15x
- If revenues continue to grow at ~20% annually and margins and multiples remain steady, then the stock will also grow at ~20% annually
- If you asked me to name 10 stocks that I think are most likely to outperform the S&P 500 over the next five and ten years, Alphabet would be on the list (after Berkshire Hathaway and Howard Hughes, to be sure), so I've made a bit of room for it in my portfolio

FACEBOOK

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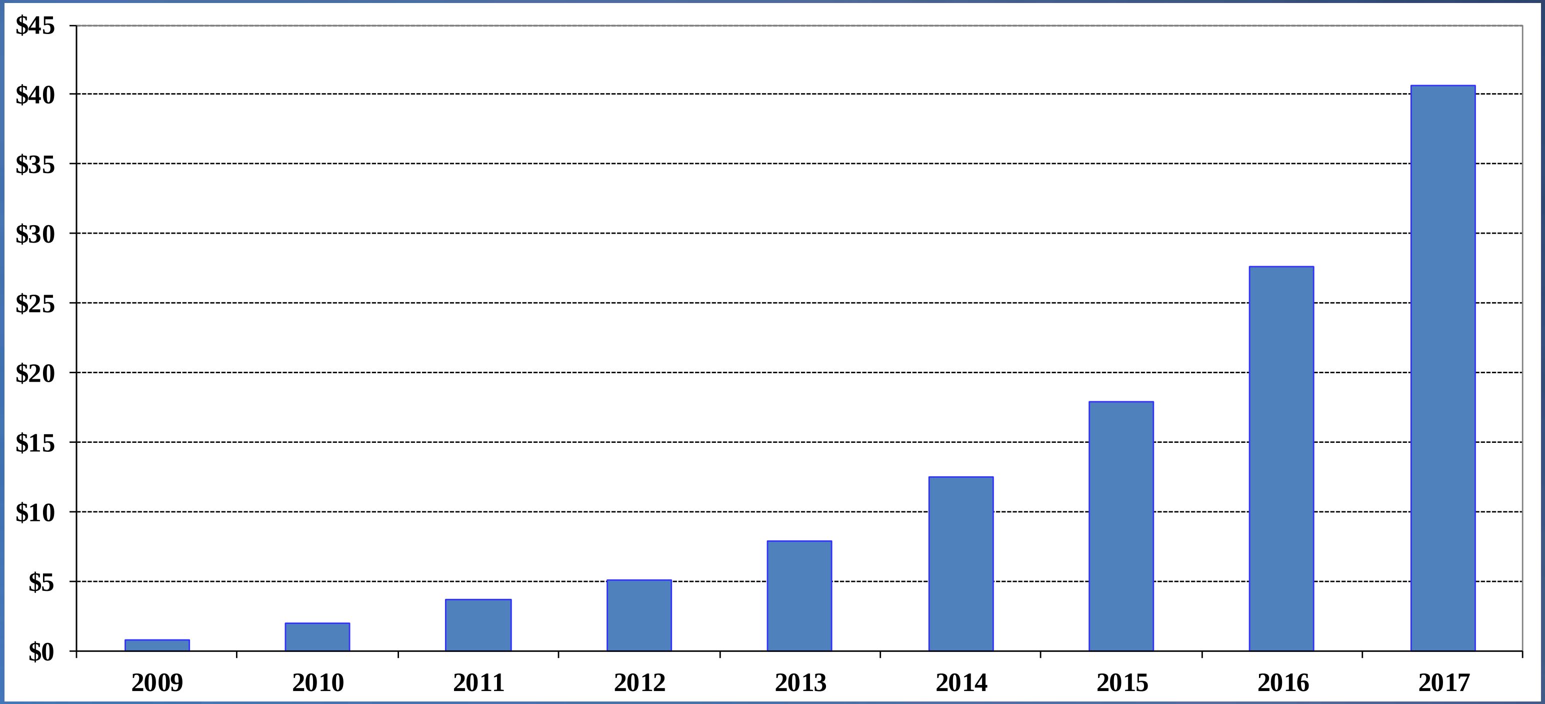
THE BASICS

- Stock price (7/11/18 close): $202.54
- Market cap: $586 billion
- Cash & STI: $44 billion ($15/share)
- Debt: $0
- Enterprise value: $544 billion
- TTM EPS and P/E: $6.04, 33.5x
- 2018 est. EPS and P/E: $7.73, 26.2x
- 2019 est. EPS and P/E: $9.26, 21.9x

Q1 '18 EARNINGS WERE EXCEPTIONAL

- Revenue up 49%
- EPS up 63%
- Operating cash flow up 55%
- Monthly active users at 2.2 *billion* (!), up 13% YOY
  - 2/3 are daily active users (1.45 billion)
  - Massive potential to further monetize users, as Average Revenue Per User is $26.76 in the U.S. and only $8.86 in Europe, $2.54 in Asia/Pacific, and $1.86 in the rest of the world

REVENUE GROWTH IS ASTRONOMICAL



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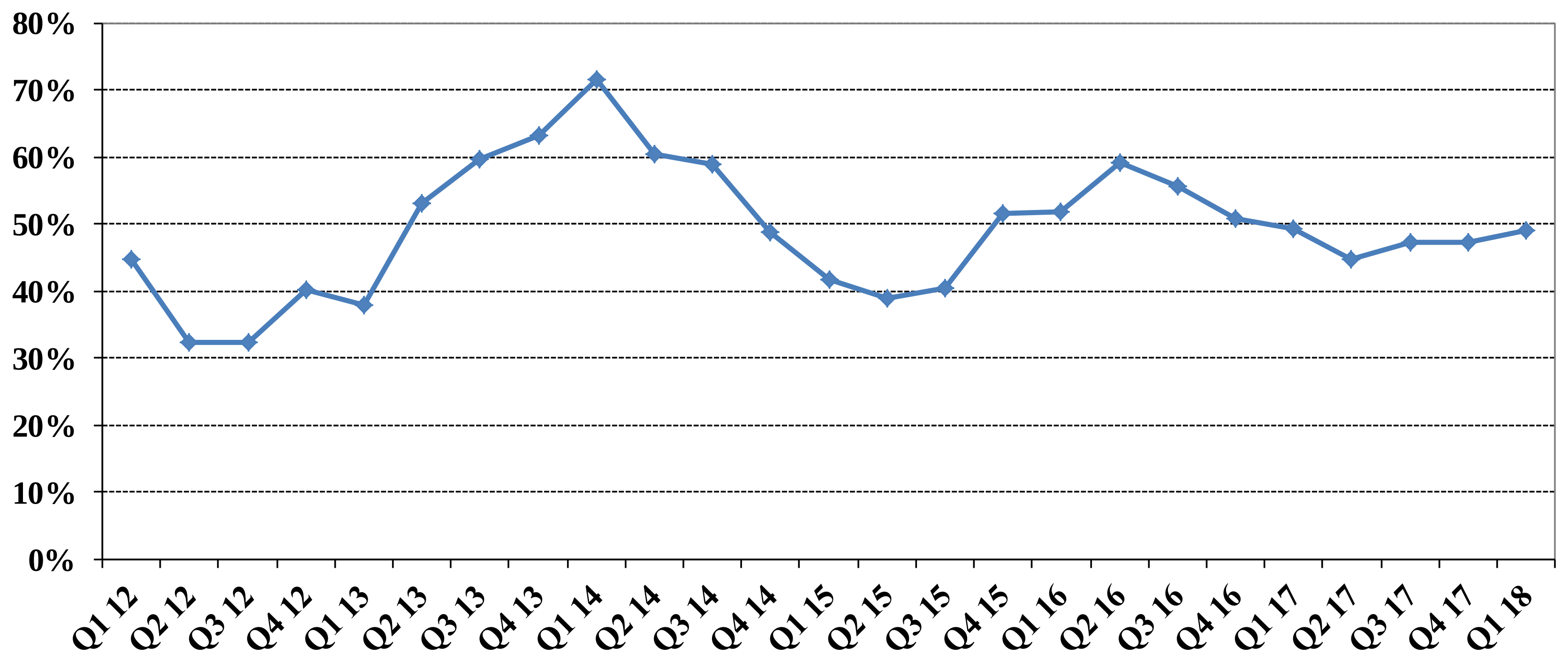
THE RATE OF GROWTH IS MIND-BOGGLING



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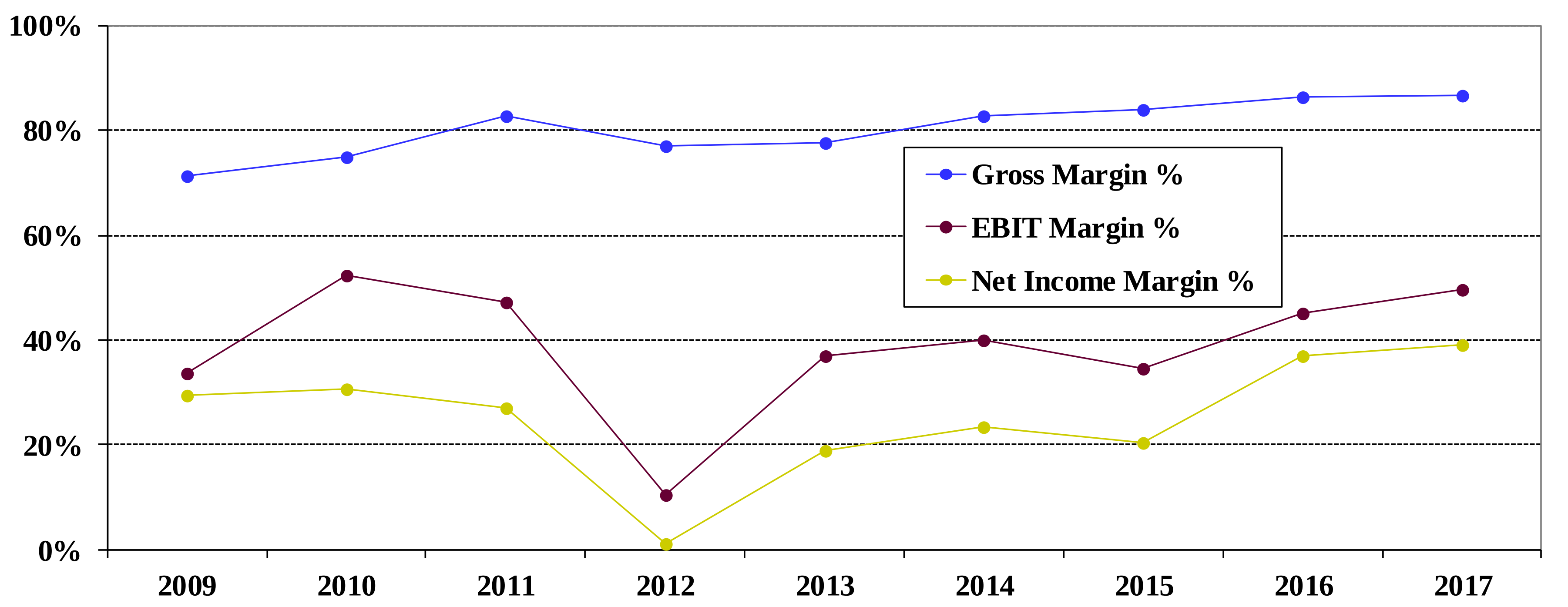
MARGINS ARE ASTRONOMICAL AS WELL



THE STOCK HAS BEEN A MONSTER

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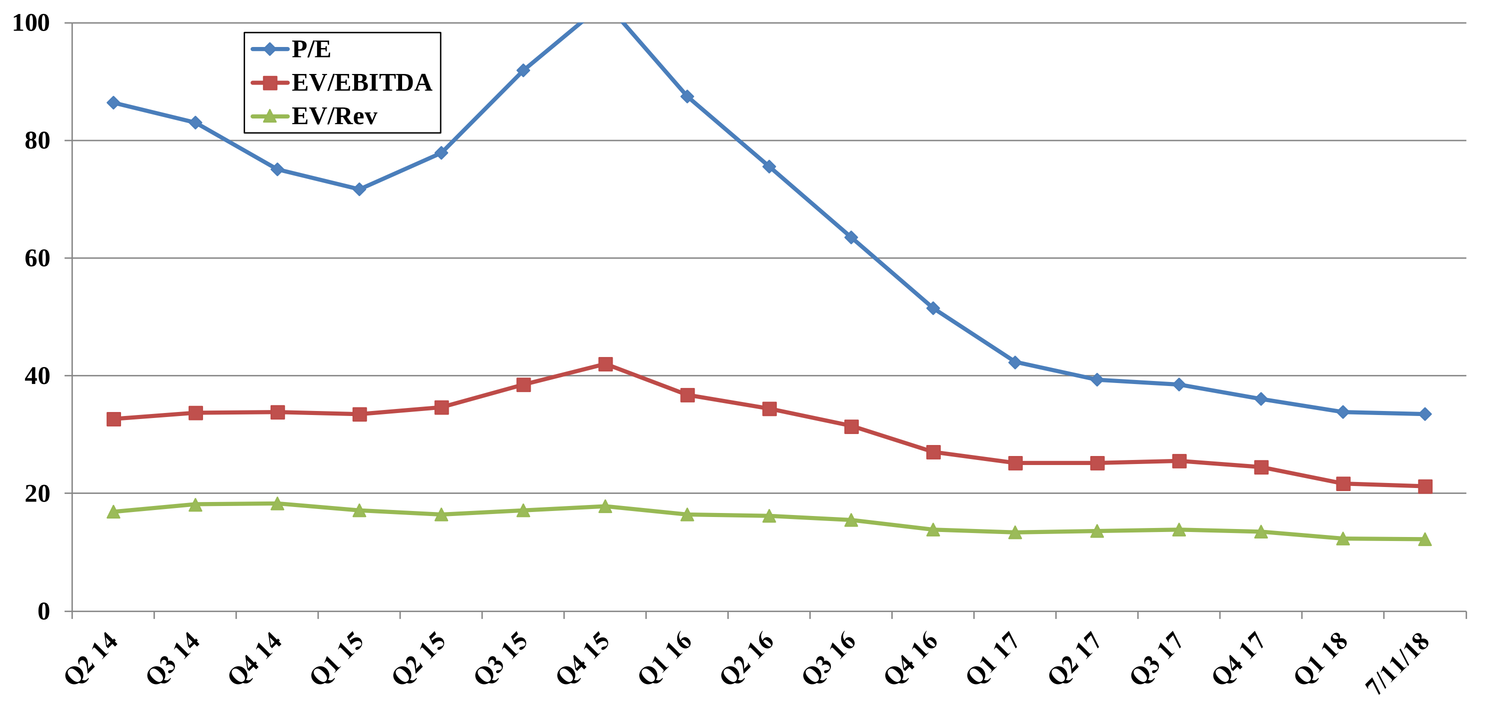
THE STOCK IS TRADING AT ITS LOWEST MULTIPLES EVER



FACEBOOK HAS VAST OPPORTUNITY TO MONETIZE FOREIGN USERS

SUMMARY

- Despite all of the bad press in Q1, revenue growth *accelerated* to 49%
- It appears unlikely that regulators will take action that meaningfully crimps growth or margins
  - In fact, certain proposed regulations, ironically, might further entrench Facebook (and Google)
- There is massive potential to further monetize users, as Average Revenue Per User was $23.59 in the U.S. and only $8.12 in Europe, $2.46 in Asia/Pacific, and $1.68 in the rest of the world in Q1
- The stock is trading at its lowest valuation multiples ever
- While the valuation doesn't appear low based on traditional metrics, if Facebook can continue to grow at anything close to its historical rates, the stock is a huge bargain today

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