

The first issue to be addressed is why are you buying a company? Why are you investing in it? To own it for the sake of owning it is collecting. To own for a guarantee of income is different from the concept of a growth in income. Assuming that P/E is looked upon from only one perspective leads to a misunderstanding in my opinion of the markets. McDonalds is trading at the same PE at the moment as Google. Are investors assuming that McDonalds will have the same growth as Google? I'd argue that no. The investors in McDonalds have more confidence in the McDonalds ability to produce profits (net profits) than Googles. However the investors in Google probably believe that the risk to the business's profits balance with the possibility of a growth in earnings over time. It means that how one chooses his assets makes more of a difference on his interpretation of a certain PE than a PE itself.

Another thing to consider is how one benchmarks a desirable return in comparison to risk. These are subjective, but this is the basis of valuation. In Security Analysis, as in the Intelligent Investor, as far as my recollection goes (and I reread both books recently) there is no mention of DCF. I believe that it is because you cannot depend on it. Aswath Damodaran outlines it as a sort of basis for valuation, because everyone uses it. The basis is the Interest rate on treasuries. So, the return one would want in exchange for the risk, is how much one is willing to risk that capital for a certain gain. In addition, the risk for me to invest in Amazon would be different than yours because I look or understand the business in a different way than you, because it is also subjective. That would be established in how much either of us would be willing to risk for a certain return we would expect that would come into fruition in the earnings and not in the stock price. It has occurred many times that the stock price diverged completely from the return of earnings. Aswath Damodaran ties to this the importance of narrative. A company with a strong narrative is more likely to grasp hearts and minds.

You asked me once about will a certain performance in a business will lead to a change in the stock price. This is an important question. I have 3 points to outline before we reach a conclusion about the stock price.

It begins with the efficient market hypothesis. In a well-known story often told to explain the concept, a finance professor and a student are walking to class when they come across a \$100 bill lying on the ground. As the student stops to pick it up, the professor says, "Don't bother. If it were really a \$100 bill, it wouldn't be there". This assumption comes from the notion that everyone who knows anything about the company has their own analysis and prediction on the performance of the business or stock over time. Using DCF, or any other metric, analysts and speculators make guesses about the future. Interest rates, growth rates, expected earnings, these are the unknowables. Even the Fed does not know what interest rates will be in a year from now. The efficient market hypothesis assumes that all the assumptions and all the expectation sort of get balanced out and everything that you or anyone can know in a business. Furthermore, in theory the combination of DCF and the efficient market hypothesis, the current price of a stock should be the total value of the cash it will generate through the lifetime of the business or the foreseeable future that you or anyone can see. In this case why should the stock price go up? Because every year we advance we add another year that we can supposedly see into the future, which means more of that eventual cash will end up in the business and it gets added to the stock's market cap. If you believe in this theory, and in the ability of the overall market to make sound predictions at any given moment, then you will listen to the predictions of analysts, and the current PE ratios. This would mean that any business with a PE of less than 10 should be gone within a decade. I do not think that people believe in this wholeheartedly anymore.

(Point 2) This comes into full circle with Warren Buffett as he said numerous times that he used to be able to buy dollar bills for 50 cents. Howard Marks added to this, that in the 80s you were able to buy 80 cents for a dollar bill, and now you can make returns pretty much only if you have keen insight into the future of the business. This is because the more people trading and investing, alongside much more information available than in the past, should lead to more able investors competing in the market. Because you have no idea who is on the other side of the trade, you could be trading against one of the world's very best.

(point 3) For the large asset managers, the question of the stock price going up should never matter. In theory if the business does great and no one picks up on it and you own the business, you will be able to purchase more and more stock and eventually control the company and its earning power. If the business is managed well and the stock price is low compared to the value of the business will keep buying in the stock of the company eventually giving you control. Large asset managers will be able to take advantage of this more quickly, the retail investor slowly. This will happen in an inefficient market. Peter Lynch tells a tale of a company he bought the stock of at 13 dollars a share, it came down to 11, then 9, and then 7 dollars. His thoughts kept on going with "how much lower can this go?" the company never regained the stock price, and eventually it liquidated all the assets, paying off the shareholders at above 50 dollars a share. If this happens, it is evidence that the markets aren't completely efficient.

This brings me to my conclusion that markets are inefficient at any given time, but they are efficient on average. Think of a pendulum swinging from side to side forever. It'll only be in the exact middle a fraction of the time. We have no idea when any stock price will be an accurate estimate which the precise value of the business. I believe that the stronger the narrative of a company the more volatile the price will be, as good news or bad news will have great effect on the price, which leads to more opportunities to get more extreme prices to sell or to buy. Companies with a boring narrative such as coca cola will tend to have less volatility in the price.

The Macro economics should not be an influence on the price one wants to buy a company in. In theory the trust in the management should include the trust that it will be able to navigate through bad economic times. Macro economic trends will have an influence, but if you understand the economics of the business then you should be fine with understanding their influence of the business. If you don't understand what higher interest rates, inflation or war will do to a business, you don't understand it. The reason why finance papers and news shoes speak so much about macro economics is because so much is going on, and you can speculate in every direction. Warren Buffett said once in an annual meeting, if I could know one single thing about the future it would be Interest Rates. In a lunch Howard Marks and Warren Buffett had together, Mr. Buffett told Mr. Marks that Marks said billionaire investor Warren Buffett told him that for any piece of information to be desirable, it has to satisfy two criteria: It has to be important, and it has to be knowable. Interest rates are important. However, any forecast about it is not knowable, therefore it has no value. In addition, Mr. Buffet and Mr. Munger tell tales of countless times they were told forecasts about a business for the year ahead just for the forecast is far off the mark.

In order to be able to think of an investment one needs to first and foremost have insight into the industry to be able to evaluate why one business will do better than others in that realm. Understand

the economics, culture and business strategy of a given business. Have faith in the management to deal with bad times, especially what it known as the black swans. You will not be able to think of every possible scenario, and although one can anticipate a storm and prepare the ship for it, being able to sail through it will require additional skills. However, superior cultures will triumph over superior CEOs. In the words of Peter Lynch (this quote is quoted often by Mr. Buffett) "Go for a business that any idiot can run - because sooner or later, any idiot probably is going to run it". Andrew Grove in his masterpiece "Only The Paranoid Survives" outlines the importance of great low tier management and employees in dealing with a crisis or avoiding one. What makes great low tier management and employees is culture. A great culture leads in many cases to a wonderful brand.

These are all difficult to assess, and that is why in most cases, businesses should end up in the too hard pile. However, in the case that one has superior insight into these things, it is likely that he can make a good estimate when the market is focusing too much on a margin of safety and not enough on the ability of the business to do well beyond what certain economic factors may suggest.

If businesses pass through this screening, comes the next step in valuation, price. If you follow Aswath Damodaran, you will hear him speak of PE only when it comes to relative valuation, that means, different businesses in the same industry that will have similar economics. Why is this the case? If you fully own a business, and you are in no need of cash, you're ideal situation is having no absolute earnings, that means to break even by plowing and leftover cash, back into the business for the growth of the business. Businesses in different industries, and definitely in different sizes can reinvest the money differently. Companies that are competitors in theory will have similar economics, and therefore you can compare their PE ratios. The PE ratio can also be a gauge for the investor as to how much net profit after everything has been paid off is left in comparison to the price.

All this is why the idea of a margin of safety and buying things well come in. The margin of safety comes in the form of the business was lousy or didn't perform like you believed in the long term, but the economics were solid enough that you're return of the capital is ensured. This where the idea of buying below book value, or any other accounting metrics. This is where all the above comes into something hopefully measurable. Assuming that the books are honest, and no manipulation has been made, these will tell the tale of capital is allocated within the business, and the returns on it.

SO why does PE matter? It depends on the benchmark return you are looking for annually without compounding the return (let's say you take the cash and don't reinvest it). A PE of 10 makes it easy. You get your cash back in total after 10 years, so you double your investment every 10 years in the case that the company's liquidation value stays the same (assuming you liquidate the company after the 10 years). A PE of 30 in comparison, to generate an equal return will need have a growth rate of 12% a year to lead to the same result (assuming you liquidate the company after the 10 years). Any valuation based on PE can be played around these figures. One can figure out the growth rate needed to match a certain benchmark result you are interested in. Using your desired return in yield (either compounded or not depending on your desire or need or ability) , Translating that into a PE, then comparing it with other PE ratios (in how many years would doubling your investment take using different growth rates). If a company needs to have earnings growth of 12% a year to hit your benchmark, and it's earnings are already 5 billion a year, it will be very hard for a lot of business that big to do it. They might do it for 3, 5 years, but a decade? That is really really hard.

So with all this baring in mind I will now address the original summarized correspondence:

Q: "However, Amazon has a P/E of 76, vs 25.5 for Goo

So the market is saying Amazon is a better growth stock, but 3x better? Your opinion, please."

My answer: "The free cash flow is what matters more than the PE. Also the only reason to buy a stock is because you think the market is pricing it wrong.

Your reply: That's one factor that I never include. . I look to growth of component parts, current price to current year's range and cash flow.

And % price increase in current. year.

This reflects that the horizon you are looking into is short term, less than 5 years, could be even 1 year. I have no idea. I don't think in these time frames. Sadly "The markets can stay irrational longer than you can stay solvent". Even if you invest in a great business that will triple its value in a decade, that could be reflected in the price maybe only in year 10. There are an infinite number of scenarios how this could be played out. You mentioned "That's one factor that I never include.". If the factor you do not include is the market's rationality or irrationality, then I can't understand how one would expect to have a return that is better than the market. Because if the market is rational, it will dump all the businesses that will underperform and buy the companies that will outperform until they will bring a return similar to the overall market. So if one does not think that the market is irrational, I believe that the only thing that makes sense in that case is buying the average, which is a stock market index. A pure index. If one thinks that the stock market is irrational, then there is no guarantee it will come to its senses, ever.

Comparing the current stock price to a recent stock price (let's say in the last year) is just comparing the general opinion of the market on average compared to an earlier date. A stock price at a given moment is an average (there are many kinds of averages) of opinion. Anyone who knows the stock price should be lower has sold, anyone who knows the stock price should be higher has bought (knowing is different than thinking. Here both parties know that the stock price should go in one way or another, and make a move based on what they think they know).

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so. " – Mark Twain

The history of the company's stock price just gives a window into what people thought they knew at the time. It is however that a strong upward trend may show that a stock has been overbought, and a strong downward trend may show that a company has been oversold. It is important to understand that the price is the highest at the highest level of overall optimism and lowest at highest level of pessimism. This means that in order to have the most superior returns on an asset, you have to be at the most extreme levels of disagreement with it. This is why contrarians are held in high regard in financial markets. However being a contrarian for the sake of contrarianism is counterproductive. One must notice when the crowd is right and when it is wrong. It could be easiest or also the hardest, to notice the mistakes of the crowds at the extremes. This is what Howard Marks speaks of the pendulum swinging in between total euphoria and total paranoia in markets. So, past performance can be useful to identify when the likelihood of a stock being overbought or oversold. Of course the ideal is recognizing Peter Lynch's "out of the dip". However I have grown accustomed

to a stock I am buying to tank another 10% or more after I bought it before it might go into the other direction.

So, this means to me that the shorter the runway the more likely it is that if one is right about the company in the long run he will not see returns in the short term.

Now, a comparison between Google or Amazon. Amazon is a lot riskier to me than Google, so I would want a much higher margin of safety for it. Amazon is having labour issues, and high costs when it comes to their logistics and delivery. Amazon has a lot more debt and a lot less cash. Google is more software intense, therefore the overall costs of operating should be lower. Due to these factors, if both companies were identical in everything else, I would actually want Amazon to have a lower PE for me to buy it, Amazon however currently has a higher PE by far. So based on what you wrote me, assuming that higher PE means higher Growth, Amazon in this case would need much more than 3 times earnings.

That is a brief outlook. Diving into the numbers. Assuming that the past is a reference, Amazon's free cash flow has been inconsistent over the last 5 years, where Alphabet (besides 2022 and since then rebounded) has been rising consistently. Amazon generates nearly twice the revenue, but their overall Free Cash, and net earnings are substantially smaller. Now this could mean that Amazon is just that much better at plowing cash into the business. In the case of return of the capital, Alphabet seems like a safer bet. Again these would make Amazon to demand a much better margin of safety, again a lower PE than Alphabet. However, that is not the case, and Amazon would need much greater growth than 3 times, because the numbers are at least twice as bad. One would imagine that Amazon would need to have at least 6 times the growth in earnings that Alphabet does.

Here is the final note, it is much easier to generate a growth in earnings by cutting costs, something that many companies did last year that turned their earnings around. Amazon is an interesting company, it is well known that Amazon is incredible at redeploying cash into the business. The big question is which fields of operation do you think is more likely to do better over time? Both are in entertainment with YouTube and Prime, both are in the cloud. Both are trying to bring automated driving. Amazon is in logistics, entering medicine. It is in retail. Google is in hardware, internet fiber, Amazon is in the satellite.

Amazon struggles with operating with consumers outside of the USA, Google does really well outside the U.S. I guess the bottom line is how optimistic you are about Amazon or Google. I would personally want to be very optimistic in Amazon compared to Google\Alphabet. The biggest question is price. I like them both better than most businesses. The largest question is first and foremost who is the investor. Are you looking to speculate? Play safe? I think Alphabet is a better call for the short term because it is safer. The reason Amazon commands such a high PE is because of future speculation. I wouldn't buy either at these prices, at this point in the market cycle. Still the reason to buy is so subjective in the end. Purpose in portfolio, how a portfolio is built, how someone thinks about not risking money in comparison with not missing opportunities. If someone trims positions because he is afraid of a downturn he has to be right and quickly. Peter Lynch has said: "more money has been lost waiting for a down turn to come than in the actual down turn", and you can wait a very long time for a market crash to happen. One could have a lot of cash generated and a long runway ahead, one could have no cash being generated and a shorter runway ahead. The first question before which is a better investment, is what kind of investment am I looking for? Alphabet seems to me safer in regards to the return of my capital, and seems to me like less can go wrong, but who

knows? I just know that I feel uneasy about investing personally at these prices in either of them. Amazon makes me feel more uncomfortable at this price than Alphabet. And in the end there is the place of narrative. Alibaba has a PE of 10 and much healthier positioning, but China now is a bad story just like a decade ago it was a wonderful story. The narrative can go either way.

Love Shaked