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FINANCIAL RESEARCH

WORDS OF CAUTION FROM A VETERAN INVESTOR

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INTRODUCTION

- I launched my first fund more than 20 years ago in 1999 and managed numerous hedge funds and mutual funds for nearly 18 years
- I started out of my bedroom with $1 million and built the business to $200 million under management at its peak
- I closed my funds and returned capital to my investors in late 2017
- Earlier this year I launched an investment newsletter business, *Empire Financial Research*
- I publish a free email every weekday (you can sign up at www.empirefinancialresearch.com) and a monthly subscription newsletter with my best investment ideas

WHY YOU SHOULD LISTEN TO ME

- I both predicted and successfully navigated through two of the biggest stock market busts in history, the internet and housing bubbles
- I've accurately called both the top and the bottom of numerous stocks and sectors

THE INTERNET BUBBLE

- On March 6, 2000, the week the Nasdaq peaked, I defended Warren Buffett's refusal to buy tech stocks (*Why Won't Buffett Invest in Tech Stocks?*)
- October 16, 2000, I warned investors away from Cisco (then trading at $56.06, equal to 182x free cash flow) and instead recommended Apple (then trading at $1.54 split adjusted, with a mere $3.3 billion enterprise value) (*Cisco, Apple, and Probabilities*)

THE TOP OF THE HOUSING BUBBLE

- In early 2008 I put together a 100+ slide presentation predicting that the housing/mortgage crisis would be much worse than investors anticipated ("We're in the second inning, not the seventh inning, of the unwinding of this bubble.")
- On March 20, 2008 on CNBC, I said "We're short across the financial sector [including] Lehman Brothers and Bear Stearns…We think there are a lot more shoes to drop."
- In a presentation at the Value Investing Congress on May 7, 2008 entitled *Why We Are Still in the Early Innings of the Bursting of the Housing and Credit Bubbles – And How to Profit From It*, I said "things are terrible and there's no sign of a bottom" and recommended shorting Washington Mutual, which filed for bankruptcy four months later

THE BOTTOM OF THE HOUSING BUBBLE

- On December 14, 2008, I was featured in a *60 Minutes* segment on the housing crisis that won an Emmy, in which I said: "We're the most bullish we've been in 10 years.... With U.S. stocks down nearly 50% from their highs, we're actually finding bargains galore. We think corporate America is on sale."
- On March 27, 2009 on CNBC, I said: "Valuations have compressed so much that some things we were actually short we've flipped around and gone long, Wells Fargo being the most noteworthy example. We're also long American Express."

SINCE THEN WELLS FARGO AND AMEX ARE UP 3x AND 9x, RESPECTIVELY

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NETFLIX

- On October 1, 2012, the day it bottomed at $7.78, I pitched Netflix at the Value Investing Congress (slides here) and on CNBC, saying it was "this decade's Amazon." It's up *47x* since then.

LUMBER LIQUIDATORS

- On November 22, 2013, I pitched it at the Robin Hood conference on the day it peaked at $115. I later discovered that the company was selling toxic Chinese-made formaldehyde-drenched laminate and took the story to *60 Minutes*, which aired an epic takedown on March 1, 2015

THE 3D PRINTING BUBBLE

- On January 4, 2014, I wrote: "DDD is one of so many unbelievably great shorts out there right now…Mark my words: this will end very badly. I think DDD is maybe worth 2x revenues, so my price target is around $10 – down nearly 90% from here." It was then at $96.42 and today trades at $8.40.

THE BITCOIN BUBBLE

- On December 16, 2017, the very hour bitcoin peaked at $20,000, I wrote: "I'm calling the top right now…I do know the ultimate outcome: smoldering rubble, a lot of finger-pointing (where were the regulators?!), and a lot of tears and empty bank accounts, especially among those who can least afford it."

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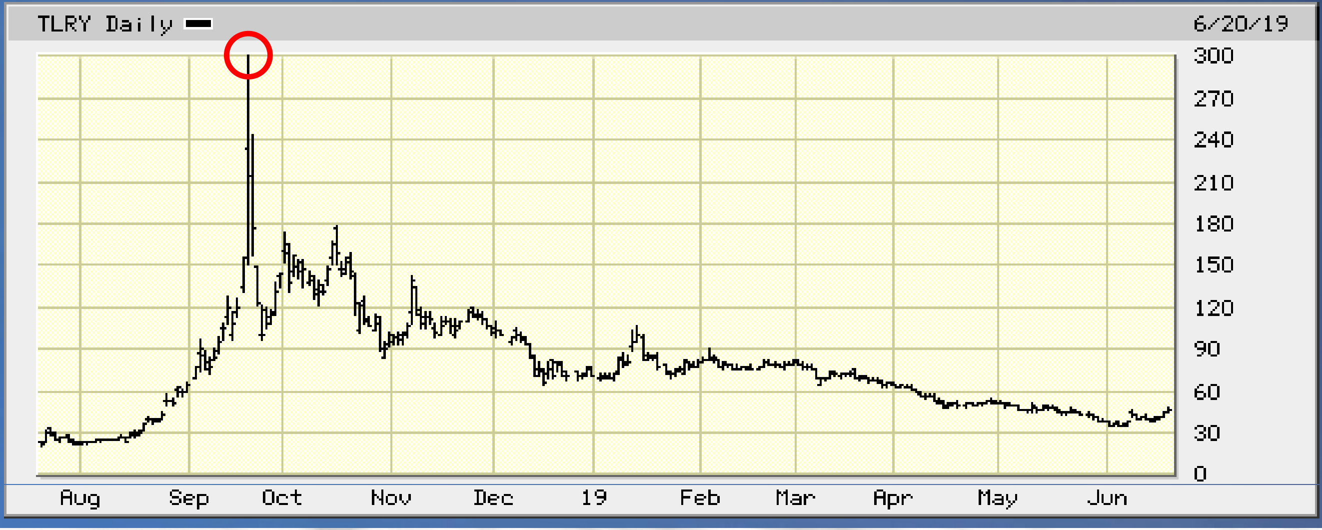
MY CURRENT VIEW ON BITCOIN AND OTHER CRYPTOCURRENCIES

- I think the entire sector is a techno-libertarian pump-and-dump scheme
- It's similar to what the scammers did in the movie, *The Wolf of Wall Street*: took a worthless stock, traded it furiously among themselves at ever higher prices, and then flipped it to gullible average investors
- I agree 100% with Warren Buffett, who called bitcoin "rat poison squared," and Charlie Munger, who said that trading in cryptocurrencies "is just dementia"
- Don't get fooled by the dead-cat-bounce sucker's rally that we've seen this year

THE POT STOCK BUBBLE

- On September 19, 2018, the very hour Tilray hit $300, I went on Yahoo Finance TV and said the stock would likely fall below $100 within a month and by 90% within a year (it's at $47 today)



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MY CURRENT VIEW OF THE CANNABIS SECTOR

- Unlike the cryptocurrency sector, I think it's possible to invest (as opposed to speculate) in the cannabis sector
- There will be massive growth due to the trend toward legalization for both medical and recreational use
- But most investors should avoid the sector, as it's filled with every form of charlatan and scam artist, plus valuations are still high

THE TESLA BUBBLE

- On March 4, 2019, with the stock at $295, I wrote that this “was the beginning of the end for Tesla’s stock. I think Musk has no more rabbits to pull out of his hat and therefore it's all downhill from here. I predict that by the end of the year, the stock, today at $295, will be under $100” (it’s down 26% since then)

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MY CURRENT VIEW OF TESLA – THE FOUNDER, COMPANY AND PRODUCT

- I think Elon Musk is an incredible visionary, entrepreneur and engineer
- What he's built at Tesla and SpaceX is extraordinary
- He's single-handedly shaken up two of the largest, most complex industries in the world
- Humanity owes him a debt of gratitude for forcing every major auto manufacturer in the world to invest billions into developing electric vehicles
- Everyone I know who owns a Tesla loves it

MY CURRENT VIEW OF TESLA – THE STOCK

- However, I am very bearish on the stock
- The company appears to have mostly solved its "manufacturing hell"
- But I think it's significantly overestimated demand and built an unsustainable cost structure
- There has been strong demand from wealthy, environmentally-sensitive buyers on the coasts, but it's not clear that Tesla will go mainstream, or that it can profitably make cars at mainstream price points
- Tesla was profitable in Q3 and Q4 last year as it filled pent-up demand for the Model 3, but I question whether it will ever be profitable again
- I maintain my $100 price target by year end

CONCLUSION:

- When I launched my first hedge fund more than 20 years ago, I was 32 years old and had never worked a day in the financial industry; I had only managed accounts for myself and my parents
- It was near the end of a long bull market, so the only world I knew was one in which stocks went up every year and the more risk I took, the higher my returns
- <u>*I was a classic bull market genius – like a lot of young investors I see today*</u>
- I owned a few value stocks like Berkshire Hathaway, Freddie Mac and some big-cap pharma stocks
- But most of my portfolio was in the popular stocks of the day – AOL, Amazon, Microsoft, Intel, Dell, Gateway, Yahoo and eBay
- Plus some total speculations like Visible Genetics and Celera Genomics
- Thankfully, I discovered value investing in the nick of time and pivoted into beaten-down value stocks in 2000

THE S&P 500 ROSE 4.2x IN THE 1990s

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HISTORY DOES NOT REPEAT ITSELF, BUT IT RHYMES

There are some striking similarities between 1999 and today

- Stocks up ~4x over the previous decade
- The more risk investors have taken, the higher their returns
- A wide swath of investors who have never experienced a bear market
- A hot IPO market, especially for rapidly growing, money-losing companies in exciting new areas

THE S&P 500 HAS RISEN 4.4x SINCE THE BOTTOM ON MARCH 9, 2009

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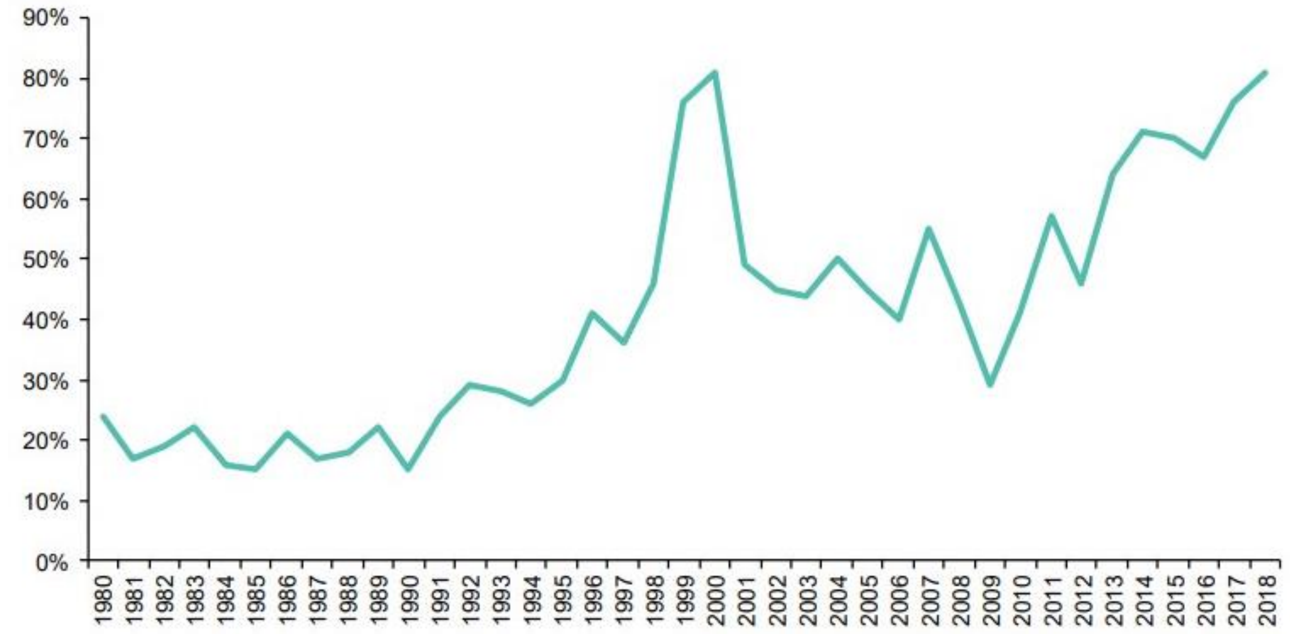
THE PERCENTAGE OF IPOs OF MONEY-LOSING COMPANIES IS NEAR THE 1999 HIGH



Source: Initial Public Offerings: Updated Statistics, Jay R. Ritter, Cordell Professor of Finance, University of Florida, December 31, 2018

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THE S&P 500 FELL 24% IN THE 2000s

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WHAT WILL THE MARKET DO OVER THE NEXT DECADE?

- I don’t know
- While there are some similarities, I do not think we’re in bubble like we were at the end of 1999 so *I’m <u>not</u> predicting a market crash*
- That said, the market is at an all-time high, valuations are full and interest rates have nowhere to go but up over time, so I expect mid-single-digit returns for the S&P 500 (including dividends) over the next 5-10 years
- But speculators could really get clobbered

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INVESTORS VS. SPECULATORS

- Investors know what they own, why they own it, and have a reasonable estimate of what it’s worth
- Speculators buy something in the hope that someone will buy it from them at a higher price – but hope is not a strategy

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HOW TO BE AN INVESTOR

- Turn off the TV and avoid the hype of Twitter and message boards
- Instead, spend your time doing in-depth research
- Try to develop knowledge, experience and relationships so you'll have an edge, rather than being the sucker at the poker table
- Be very careful to stay within your circle of competence

TRADING IS HAZARDOUS TO YOUR WEALTH

- Countless studies show that the more trading you do, the lower your returns.
- Why?
- By far the biggest reason is that investors chase performance, piling into hot stocks or sectors near the peak, and selling near the trough
- Also, taxes, bid-ask spreads and trading costs erode returns
- At most, you should make no more than one investment decision in a typical month

OPTIONS ARE ALSO HAZARDOUS TO YOUR WEALTH

- Options are a form of leverage and therefore magnify returns – which is great when you're right, but a disaster when you're wrong... so BE CAREFUL!
- Over the years, I've had good success buying long-dated, in-the-money, LEAP call options on a handful of low-volatility stocks like McDonald’s, Home Depot, AB-InBev, Canadian Pacific Railway, and Berkshire Hathaway
- But otherwise, I mostly lost money on options
- If you don't know what you're doing, options will kill you – so most investors should avoid them entirely

AVOID HOT IPOs

- Simply because a company or sector is experiencing high growth and/or has exciting technology doesn’t mean the stock will do well
- Numerous studies show that the single worst investment strategy is buying IPOs, especially in the hottest, most overhyped sectors
- In Buffett’s entire career, he’s never bought an IPO; neither have I

REMEMBER THESE HOT IPOs?