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# Laser eyes on price

When the S&P 500, after a pullback, changes hands at 25.5 times trailing net income, you can be sure—well, reasonably sure—that it's not the bottom of the market. While CPI inflation is the kind that gets the air time today, we write to consider the asset-price variety.

Christopher Bloomstran, whose friendly cooperation in this project will tip the knowing reader to the conclusion to which the analysis is already pointing, is a dyed-in-the-wool value seeker. Indeed, it is no exaggeration to say that Bloomstran, age 53, is all about price. "Price matters" is the theme of his closely read recent tweets and the unofficial motto of his firm, Semper Augustus Investment Group, LLC, which he co-founded in 1998. It was a year in which, for all intents and purposes, price hardly mattered.

Nor does it seem to count for much today. At presstime, 83 constituents of the S&P 500 trade at a ratio of enterprise value to revenue of more than 10 times. At the top of the dot-com market, March 24, 2000, a mere 38 did (though it seemed like a lot at the time). Last year, Bloomstran devoted a portion of his typically voluminous annual letter to a report on the analysis that his firm had conducted on the investment returns generated by stocks that, over the previous two decades, had been valued at 10, 20 and 30-plus times revenue. At the end of the costly, time-consuming and data-demanding exercise, he tells *Grant's*, "we concluded what you would have hypothesized going in. When you pay those kind of multiples, you don't get a good outcome," the occasional Tesla-like shooting star notwithstanding.

A Denver native, Bloomstran arrived in St. Louis in 1994 to manage money for the trust department of the United Missouri Bank. "I thought I would be here for a couple of years and find my way back to Denver," he says, "but lo and behold, I was introduced to, and partnered with, the patriarch of a very wealthy family, who asked if I would take over the investment portfolio that he had been building since 1932, having gotten out of the market in 1928."

At the time of that fateful decision, the patriarch was the 25-year-old heir to his late father's brokerage business. For the next 18 months or so, until the 1929 break, the young bear had the pleasure of watching other people get rich. "But he was vindicated, of course, by the subsequent 89% decline," Bloomstran relates, referring to the post-Crash track of the Dow, "and theorized that, instead of owning gilts and Treasurys and some railroad bonds, he could buy GE for less than the cash in the business and get everything else for free."

Fast-forward to the dot-com bubble. It had come to the now-aged patriarch's attention that the talented Bloomstran was bearish, which state of mind exactly conformed to his own. The two joined forces. Bloomstran, leaving the bank, hung out his own shingle, which playfully alluded to the rarest, most coveted bulb of the 17th-century Dutch tulipomania, "Semper Augustus."

In January 2000, Bloomstran addressed his clients in a letter that featured a dozen short predictions about the market through 2015, some of which Nostradamus himself would be proud to have written. For instance: "Microsoft shareholders won't be very happy"; "[i]nterest rates, as measured by the 30-year U.S. Treasury Bond, may fall as low as 3%"; and "[m]any of today's pure internet stocks will crumble as the companies run out of the cash raised in recent IPOs." Over the ensuing decade and a half, Microsoft generated a compound annual return of 1%, including reinvested dividends, versus a 4.4% compound annual return for the S&P 500; the yield on the 30-year fell to 2.2% from 6.5%; and not a few dot-com stocks did, indeed, go poof.

However, Mr. Market was not done testing the mettle of the surviving remnant of value seekers. The Nasdaq 100 index began 2000 with a final upside spasm. "Even though I've built this undervalued portfolio," Bloomstran recounts, "every day for that last 20–30 days leading into March 10, the Nasdaq was going up 1%–2% a day. I was going down every day. Everything I owned was red. All of the crazy stuff was green. I was trembling at my desk, and the insanity was nothing I had experienced then or since—and that happened to be the peak."

The Microsoft example holds particular relevance today. The Bill Gates brainchild was, and is, a superb business. Its problem was not its own. It was the price that the market was prepared to pay for its stock.

"On a $620 billion market cap, Microsoft was doing $20 billion in revenues, or 31 times sales," Bloomstran recalls. "Unlike a lot of these businesses today that are so fancifully valued, Microsoft was extremely profitable. They were doing a 38% profit margin, so $7.5 billion profits on $20 billion in

## Top 10 positions of Semper Augustus Investment Group, LLC

| ticker | name | market cap (in $ bns) | P/E | EV/ Ebitda |
|---|---|---|---|---|
| BRK/B@US | Berkshire Hathaway, Inc. | $648,688.7 | 26.6 | – |
| OLN@US | Olin Corp. | 8,402.4 | 5.0 | 6.0 |
| VIAC@US | ViacomCBS, Inc. | 18,700.5 | 6.9 | 6.2 |
| NEM@US | Newmont Corp. | 46,817.4 | 18.1 | 9.4 |
| CFR@SW | Cie Financiere Richemont S.A. | 82,642.0 | 30.4 | 16.4 |
| KGC@US | Kinross Gold Corp. | 6,983.3 | 10.6 | 3.3 |
| XOM@US | Exxon Mobil Corp. | 250,457.8 | 18.1 | 9.5 |
| SBUX@US | Starbucks Corp. | 126,811.2 | 34.2 | 18.4 |
| SUBC@NO | Subsea 7 S.A. | 2,097.3 | 61.6 | 5.6 |
| HFC@US | HollyFrontier Corp. | 5,105.6 | 15.1 | 6.8 |

sources: Semper Augustus Investment Group, LLC, the Bloomberg

sales, but you can't pay 31 times sales discounting 15 years. I ended up being right. Even with dividends, it was a negative total return for 15 years. You link all of the periods together, and now it is 9.5% compounded from the [2000] peak, which as big as the business is and as dominant as they are and as well as the stock has done for the last decade, it was discounting too much of the future."

Semper manages about $400 million ("marketing is not our forte") and generated a compound annual return of 9% from Feb. 28, 1999 through Sept. 30, 2021 versus 7.7% over the same span for the S&P 500. This track record encompasses the great value drought: From 2015 through the third quarter of this year, Semper compounded at a 9.6% annual rate, trailing the S&P by 4.2 percentage points.

At the end of the third quarter, Semper's portfolio comprised 31 stocks. "We have a portfolio, if you can believe this," says Bloomstran, "that was, on Sept. 30, valued at 11.1 times earnings, and giving us a 9% earnings yield and is about as undervalued as it's been. You have the S&P in the mid-20s and a 4% or less earnings yield. We're trading at a third of the multiple to book, a third of the multiple to sales, just under a third of the multiple to cash flow [of the benchmark index].

"The difference being that we are very disciplined on business quality and management quality. We are very debt-averse. Our companies have about a 50% debt-to-equity ratio against over 100% for the S&P. When you net cash out, we barely have any leverage. Our companies earn almost 15% on equity and 13.5% or thereabouts on capital. Our ROE is less than the apparent ROE of the S&P and the broad market, but our return on capital is two or three points higher.

"I think the difference," Bloomstran goes on, "when you say, 'How are you positioning yourself?,' there are several nuances. We do a good job of trading around our positions. The businesses I own that are now fashionably called 'compounders,' the ones that have gotten expensive, I've trimmed those way back, but I've learned not to completely blow them out because you tend to not come back to them. We have really underweighted a lot of the companies we've made a lot of money in but are now trading at very full valuations."

A current emphasis on energy and cyclical names explains the blended 11.1 price-earnings multiple: "If you look at the way that our managements approach capital allocation, we get maybe 30% of our profits paid to us as dividends. So I have a 70% retained earnings of the aggregate portfolio. That gets skewed by Berkshire, which is a little more than 20% of our portfolio. They don't pay a dividend at all. Look down the roster of companies that I own, and the vast majority of cases, to the extent they are retaining earnings, they really do have places to reinvest: opening new stores, reinvesting in capex, investing in R&D, bolt-on acquisitions. They are generally reinvesting at my aggregate 15% return on equity. Some are much higher."

Compare and contrast the S&P, Bloomstran proposes, with its 4% earnings yield and sub-2% dividend yield. Retained earnings, slight as they are, are not really retained but rather deployed in share repurchases to offset the dilution attendant on the gifting of stock options to the C-suite. "At the margin," says Bloomstran, "you've got supply and demand driving share prices up, but that doesn't necessarily correlate with the progression of earning power. Share prices have grown far in excess of earning power, which is how you get valuations in line with where you were in 2000, 1966 and 1929."

HollyFrontier Corp. (HFC on the New York Stock Exchange), an oil refiner, and for that reason cheap and unloved, is a characteristic Semper Augustus name. Yes, California has announced a ban on the sale of vehicles with internal combustion engines starting in 2035. What not even the Sacramento buttinskis have proposed, however, is the outright extinction of the gas guzzler. At the end of last year, electric vehicles composed only 2.5% of the U.S. automotive fleet. Given the 15-year average life of a new car, there's every reason to expect a long tail of demand for the products that HollyFrontier refines.

Besides, companies like Holly make more than diesel and gasoline. "You want asphalt?," Bloomstran asks without needing to answer. "You have to refine crude. You want to have plastic? You have to have petrochemicals and feedstocks. A lot of what we need cannot be produced without the refining of crude."

Yet non-ESG-compliant business units crowd the divesture block, and environmentally conscious investors continue to dump essential, if dirty, industries like refining. "Earlier this year Holly had an opportunity to buy a refinery from Shell for $500 million, including the inventory in the refinery and the storage assets that went with it," Bloomstran reports. "Net of inventory they paid $350 million for an asset that had averaged about $235 million in Ebitda for the prior five years." In other words, the Puget Sound Refinery in Anacortes, Wash. commanded a price tag of 1.5 times historical Ebitda.

"I bought HollyFrontier and Valero [Energy Corp.] in October of last year at prices that made no sense," Bloomstran marvels. "I was paying low single-digit multiples to cash flow." Despite rallying by 75% since Oct. 31, 2020, HollyFrontier trades at just 8.3 times consensus 2022 earnings.

"A few years back," remembers the president of Semper Augustus Investment Groups, "I fielded a call from a lady from the Rockefeller Foundation who had nice things to say and said they had been following us and would we be interested in going down the path of due diligence, and they may get to an investment. But there would be one caveat. I asked what that would be. She said you would have to divest all of your energy assets. I thought, 'Aren't you the same Rockefeller as John D. Rockefeller'?"

Recalling Bloomstran's eerily accurate market calls of 20-odd years ago, we asked him exactly when the stock market was going to top out.

"Today," he said.

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