Warnke/Nichols Ltd.
Investment Management

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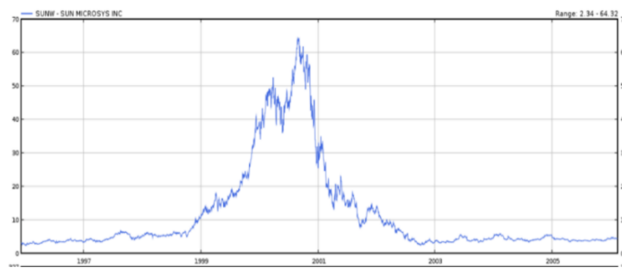
PORTFOLIO NOTES **AUGUST 2021**

To our Business Partners:

- ***"WHAT WERE YOU THINKING?!"*** This is what Scott McNealy, founder and CEO of Sun Microsystems, asked rhetorically in the aftermath of the crash in technology stocks 20 years ago. Sun Micro was one of the most popular and most overvalued stocks during the height of the "dot-com" mania. The stock rose in 1996 from around $5 per share to over $60 in 2000 – notably, a valuation of more than **10 times the company's *SALES***. Like dozens of other high-fliers of the era, the stock lost nearly 98% of its value by 2002 and was finally sold to Oracle Systems in 2009 for a mere $9.50 a share.



We'll get to today's insane stock valuations in a minute. First, here's the full McNelly quote:

> *"At **10 times revenues**, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero costs of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. **What were you thinking**?"*

The price-to-sales ratio is a key stock valuation multiple showing the price investors are willing to pay for a dollar's worth of sales. The nice thing about this ratio is that a company's sales (revenues) can't be manipulated nearly as much as bottom-line earnings. Generally, the lower the P-S ratio, the better are stock return prospects. The higher the ratio, the riskier the stock.

At the peak of the tech mania in March 2000, just before the crash, there were 29 stocks within the S&P 500 that traded above 10 times sales. Today, **seventy-five** companies in the S&P index trade at 10-times sales or more. While valuation multiples are never good for market timing, the fact that two-and-a-half times as many companies as the biggest boom/bust period in history carry this valuation is cause for great concern.

Perhaps, in hindsight, when the air is eventually let out of today's widely held, highly priced stocks (and mutual funds), speculators who paid outrageous valuations will ask themselves, "What was I thinking?"

- ***VALUATION.*** Stocks generally are still pretty expensive. Related to the discussion above, the price-to-sales ratio of the entire S&P 500 Index is at an all-time record, eclipsing the highs of the dot-com bubble in 2000 and the financial services/real estate bubble in 2008. Our own group* of stocks is selling for a mere 2.4 times sales, a far greater portfolio value and seemingly less downside risk than the overall market.

- ***RECENT RESULTS.*** Stock market returns were mixed in July, with the large cap indexes gaining 1-2%, and the small and medium cap index losing 1-4%. Year to date, the smaller company indexes still have the advantage, scoring returns of 17-20%, while the large company indexes have risen 13-14%. The same holds true over the last twelve months, as the smaller cap indexes are up 45-55% versus 32-36% for the large company indexes. Our group* of portfolio stocks compares well with the market indexes over the past month, year-to-date, and 12-month periods.

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The group of "portfolio stocks" -- our Equity Composite for the purpose of evaluating investment performance -- consists of 18 stocks that are held in our clients' accounts. Portfolios might hold some or all of these stocks, depending on investment guidelines unique to each client, the timing of purchases and sales, and start dates of accounts. The performance of this group of stocks is a good proxy for our equity performance but might vary widely among accounts. Of course, past performance is not necessarily indicative of future results.

We hereby offer to deliver to you without charge a copy of our current Form ADV Part 2, in accordance with the U.S. Securities and Exchange Commission's "Brochure Rule." Please contact us if you would like us to send you a copy.

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