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ON OUR MINDS

Facebook Faces the Music and Dances a New Tune

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We don't normally comment on individual portfolio holdings, but the biggest one-day loss of shareholder value in history certainly merits notice. Facebook's share price dropped by over 19% on Thursday, wiping out over $119 billion of market value, after the company missed its earnings forecast. Management tempered investors' expectations for future profitability, based primarily on added costs required to remedy privacy and security issues. Facebook also now sees a slower pace of revenue generation from newer product platforms like Stories.

While management's commentary was certainly a shock, we think the market's response was overly punitive. Even after incorporating more conservative assumptions into our earnings models, we find that Facebook still offers a premium growth story at a reasonable price. Revenues are still expected to grow by more than 20% in each of the next few years. Importantly, user engagement remains strong, a critical element for future success.

The added costs for privacy and security will strengthen the company and are necessary for Facebook to excel over the long term; the higher spending rate may also appease regulators who are eager to see Facebook take aggressive action to protect users. We believe that management's new forecasts are conservative; if so, this guidance would make it easier for the company to beat profit expectations in future quarters. We believe Facebook to be very innovative, and we expect the company to monetize its assets regardless of which format people use to access content – whether it be on Instagram, WhatsApp, Messenger, or the new Stories format.

Facebook's solid fundamentals – despite last Thursday's surprising shortfall – are only half the story. From a valuation perspective, the stock trades at 21.4 times year-ahead earnings per share, a reasonable multiple in relation to the company's growth profile. We think the market's current valuation amounts to a "show me" attitude, in which investors are no longer willing to give management as much credit for future earnings as they had in the past. We are comfortable with our Facebook position, but as always, we will continue to monitor the situation.

Lessons from prior "torpedoes"

The 19% drop in Facebook's stock price last Thursday was large by any measure, but it wasn't especially noteworthy in percentage terms; many technology companies have seen considerably worse percentage drops after earnings shortfalls or other adverse events.

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[1] This series of commentaries is called *On Our Minds* and not *On My Mind* because our investment team operates collaboratively. From time to time, we highlight other members of the team, based on the topic; as our lead equity analyst for technology companies, Allen Laine is the right person to discuss Facebook.

What sets Facebook's plunge apart is the dollar value: Most torpedoes strike much smaller companies. While it is still a young technology company, Facebook is nonetheless an aircraft carrier compared to the PT patrol boats that absorb most stock market torpedoes. It's actually fairly rare for such a large company (the fifth most valuable public company in the United States) to drop so suddenly.

Table 1 below shows Facebook in comparison to the next ten largest one-day market value drops in U.S. history. The last two columns show what happened to the stock price a year after the torpedo struck, and give some insight into what may happen with Facebook.

Table 1: 10 Worst U.S. Torpedoes	Torpedo Date	Lost Value ($BB)	Closing Price	Year-Later Price	1-Year Price Change
Facebook	Jul. 26, 2018	$119.1	$176.26	??	??
Intel	Sep. 22, 2000	$90.7	$47.94	$21.31	-55.5%
Microsoft	Apr. 3, 2000	$80.0	$45.44	$26.69	-41.3%
Apple	Jan. 24, 2013	$59.6	$63.36	$78.79	+22.4%
Exxon Mobil	Oct. 15, 2008	$52.5	$62.35	$72.94	+17.0%
General Electric	Apr. 11, 2008	$46.9	$32.05	$12.13	-62.2%
Alphabet (Google)	Feb. 2, 2018	$41.1	$1,119.20	$1,252.89*	+11.9%*
Bank of America	Oct. 7, 2008	$38.5	$23.77	$17.35	-27.0%
Amazon.com	Apr. 2, 2018	$36.5	$1,371.99	$1,817.27*	+32.5%*
Wells Fargo	Feb. 5, 2018	$28.9	$58.16	$58.63*	+0.8%*
Citigroup	Jul. 23, 2002	$25.9	$251.83	$456.40	+81.2%
*Note: Data for Alphabet, Amazon.com, and Wells Fargo represent periods of less than six months from the "torpedo date" to July 27, 2018.					

Source: FactSet, CNBC

Three points can be gleaned from Table 1:

- Bad things happen to good companies. All of the names in Table 1 were (and are) solid blue-chips, and all of them remain vital and valuable companies today.

- More often than not, stock prices recover. In the ten previous episodes, the company's stock price was higher a year after the torpedo struck. Facebook's earnings will continue growing apace, and its stock price should likewise recover.

- Market context matters. In all four of the instances where prices fell further in the ensuing year, the U.S. was in the early stages of a vicious bear market that took all stocks sharply lower. Facebook's downdraft was triggered by company-specific issues and not by broader market concerns, so its recovery won't be dependent on the overall stock market.

Impact on client portfolios

In most of our Core (and related) equity portfolios, we had added to our Facebook holdings in late March, when the stock was trading at $158; Facebook closed last Friday at $175. In effect, our Facebook holdings lost just the gains from the past two months, but are still ahead year-to-date.

From another perspective, our investments in Facebook dented overall equity performance by less than 0.35% last week in comparison to the S&P 500 benchmark, and by less than 0.75% overall. Because we invest in a broadly diversified portfolio of American companies and because Facebook's downdraft didn't precipitate a contagion effect to other companies, our client portfolios remain solidly in the black for July and for the year-to-date period.