
AI Peaks and Valleys, Short-Termism, and Stock Price Discovery

From our perspective, the market today is focused on the very short term, perhaps more than it has been in quite some time. Maybe more than when retail investors were buying Zoom and Peloton during COVID. Maybe even more than when tech investors were buying Pets.com and Webvan in 1999.

Meanwhile, with an increased trend toward indexation, a great portion of a stock's float is effectively not really in the float. This reduced float means there can be more volatility, particularly so if those actively trading the stocks are, by definition, shorter-term in focus.

For more thoughtful investors, this can be an opportunity.

And a short-term focus is exactly what we are dealing with today. Firstly, the pod shops have tremendous influence. They are raising all the money, have more than they know what to do with, and like to use leverage. Because their trading activity is such a relatively large part of the float, this cabal of pod shops (and their ilk) aren't taking prices, they are making them.

Meanwhile, many PMs and their teams are trying to make money this year. Not over the next five, or even the next three, but this year. Meanwhile, the "risk management" (if you want to call it that) at these pod shops is relatively tight. Risk tolerance isn't defined ex-ante as much as it is ex-post. And by ex-post we mean yesterday. Capital allocation isn't defined by how a position has performed over the last 3-5 years, or what expectations are for the next 3-5 years, but by how the stock did yesterday.

The bottom line is that short-term winners get more capital, and short-term losers get it taken away. And this feeds on itself.

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Add to this the gamification of retail investing, and the short-term horizon becomes even more so. Between folks treating Robinhood like a gambling site, to prediction markets like Kalshi or Polymarket which literally are gambling sites; some estimate that the flow traded by retail investors since the pre-COVID days has increased by 2-3x, and now represents nearly a third of all volumes. That's an even bigger impact on security prices when you consider that the effective float has been dropping.

And let's not forget the ODTE (Zero Days to Expiration) options market. As most of you know, these are option contracts which literally expire at the end of the day that you buy or sell them. Why do people trade them? Good question. Well, they don't cost much (essentially no time value), and offer high leverage. You know, sort of like lottery tickets. You know, sort of like gambling. And before you dismiss this as an interesting but irrelevant fact, know this: The CBOE (where these options trade) suggests that nearly 30% of all US options volume is via ODTE options, and this percentage number for the S&P 500 is even higher.

So, not only is short-termism a thing, it's probably a bigger thing than many of you thought it was.

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Meanwhile, hordes of investment firms are collecting hoards of data. This short-term data can sometimes help folks understand the big picture, but it also can overcomplicate it. But whether or not the data is helpful, or even good, *doesn't actually matter* much to many “investors”. They arguably don't even care if the data is misleading, or their conclusions are wrong. They only care if other short-term traders will believe the information matters, and if the stock will start incorporating this belief. They want to see others hop onto the bandwagon. Thus, once the stock starts moving in a certain direction, it's almost guaranteed to continue higher, for some period of time. The excitement will eventually fade, but by then the trade will be over, and those short-term trend-followers will have moved on to the next idea.

Consequently, we get mispricing. And in this particular environment, with these particular market dynamics, the mispricing does not get corrected as quickly as one might expect.

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So, putting it all together, we are reminded of two periods in particular. One was the tech bubble in 1999 and early 2000. I was covering tech stocks for Fidelity Investments back then, and remember it well. Yes, there were a lot of “zeroes” like Webvan and Pets.com mentioned above. But there were many long-term winners, literally great companies, that just got extremely overpriced.

Who was going to short Cisco or Nokia in 1999? Very few.

Indeed, who was going to short Amazon? Even fewer.

I mean, look at them today, paraphrasing Billy Squier, “everybody wants them.” In December of 1999, everyone wanted them too. And in less than two years, everyone lost 95% of their investment.

Great, high-quality, winning companies can become overpriced.

And in our “Magnificent Seven” this time around, we do indeed have some great companies. As some of you might know, it is unlikely we will ever call Tesla a great company (despite the recently-introduced Flying Roadster). But Amazon is one. Google (Alphabet) is one. Apple is one. Facebook (Meta) is one. Microsoft is one. And Nvidia sure as hell is one. But are their prices right?

Back in the early 1970s there was a cadre of great US companies then too. Individually, they were called names like McDonald's or Coca-Cola, or IBM, or GE, or Xerox, or Polaroid, or Gillette. Collectively, they were called the Nifty Fifty.

And everyone wanted them. No price was too high for these obviously wonderful businesses.

But, as we said a few paragraphs back, great, high-quality, winning companies can become overpriced.

And, of course, from the peak of the crowded hysteria in December of 1971, they fell. The fall wasn't as dramatic as that 25-30 years later during the tech bubble peak in March of 2000, but similar. Most components of The Nifty Fifty lost 50-80% of their market caps.

The current period in which we find ourselves feels like a combination of two of these historical periods in stock market history. It feels like history repeating itself every 25-30 years.

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There seems to be a yin to the market's yang. A dichotomy. Or even a polarity, if you will.

In bubble-land, there are not only AI peaks, there are also anti-AI valleys. AI peaks happen to companies where investors believe that AI is not only a panacea, but will help them to grow, ad infinitum, without much threat of competition (even from other AI players) and thus they deserve a valuation representing that undefined upside potential.

AI valleys are the opposite. AI valleys are the companies where investors assume that AI will destroy their business models, and that all will eventually (if not sooner) be relegated to the dustbin of corporate history. The valuations that this very short-term focused market is willing to ascribe to them are extremely low. So low that we see high-teen free cash flow yields, or low-to-mid single digit P/Es across many different opportunities.

And as hinted above, given the sector exposures, geographically, most of these peaks are in the US, while the valleys are in Europe and that certainly piques us.

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