Blue Chip Blues

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Financial advisors routinely recommend that one should own a basket of blue chip companies to avoid some of the risk typically associated with lesser known names, emerging markets or technology stocks. Conventional wisdom is that not only are blue chips safe investments, they also offer decent returns over the long haul.

The Dow Jones Industrial Average (Dow) is the most widely recognized index of 30 solid US blue chip companies. Some of the companies on the index are among the most admired companies on the planet – names like Microsoft, Disney, and Wal-Mart.

But let's examine the Dow a little further to evaluate its risk/return characteristics. In 1997, Bethlehem Steel was dropped from the Dow and replaced with Johnson & Johnson. A $10,000 investment on January 1, 1974 in Bethlehem was worth $2700 in 1997 – inclusive of all dividends. Over the same period the $10,000 invested in Johnson & Johnson has turned multiplied over 10 fold to $106,133. Why was Bethlehem part of the Dow from 1974 to 1997, but J&J excluded from it?

Coca Cola was dropped from the Dow in 1932 and put back on in 1987. Ironically, in 1932, Coke was at its 100-year low! IBM too was dropped in 1932 and put back on in 1979. The Dow would probably be sitting at 30,000+ today had they just kept Coke and IBM in during those years of explosive growth for both companies. The one that takes the cake is NCR. It was added to the Dow in 1929 (when it was trading at over 100 times earnings) and removed just three years later (during which time it had lost 92% of its value).

From 1974 to 1997, a $10,000 investment in Wal-Mart would have grown to an amazing $3.64 Million. Wal-Mart was only added to the Dow in 1997. In other words, Wal-Mart delivered a 364 fold return in the 23 years preceding its inclusion in the Dow. In the next 23 years (1997-2020), I'd predict that Wal-Mart's return to shareholders will be nowhere near 300 times their money (or even 30 times their investment). To go up just 30 fold, Wal-Mart would need to be generating about $6 Trillion in annual revenues – or about $2000 annually from *every household on the planet!* It's worth noting that the vast majority of households on planet Earth have well under $2000/year in *total annual household income!*

A clear pattern emerges. To be considered for the Dow, a given company must be a dominant force in its industry. It needs to have demonstrated highly consistent growth and profitability for decades on end. But why would past performance indicate continued stellar performance in the future? I'm reminded of one of the best lines by Warren Buffett's partner Charlie Munger at the Berkshire Hathaway annual meeting last year.

"The way people extrapolate the past is stupid.
Not just slightly stupid but massively stupid."

Charlie wasn't referring to the bright folks who "manage" the Dow, but he might as well have been. In 1997, Arie de Geus wrote a fascinating book called *The Living Company*. Geus studied the life-expectancy of companies of all sizes and was very surprised to find that the average Fortune 500 company had a life-expectancy of just 40-50 years. Fully 1/3 of the companies on the Fortune 500 in 1970 did not even exist in 1983. It takes about 25-30 years from inception for a highly successful company to earn a spot on the Fortune 500. Geus found that it typically takes many a blue chip less than 20 years after they get on the list to cease to exist!

Almost at same time as Geus, Harvard professor, Clay Christensen wrote a terrific book entitled *The Innovator's Dilemma.* The book clearly outlines how the success and scale of many blue chips is precisely what is responsible for their eventual demise. Investors would be well served to read both the books to get a sense for what the future might do to their seemingly bulletproof blue chip portfolio. It clearly outlines why seemingly formidable companies are, in reality, very fragile.

AT&T is a typical example of Christensen's disruptive innovation thesis. Its core business of long distance voice traffic will eventually become nearly free for all of us. AT&T's revenue model is slowly but surely being decimated. A $10,000 investment in AT&T (another Dow stock) in 1974 would be down to less than $5000 today (including all dividends and spin-offs). In 1974, AT&T was the epitome of an ideal blue chip. It was a monopoly with a strong recurring revenue model. The company has always been regarded as a risk-free blue chip - one that widows could safely own. It is one of the most widely held stocks in the world. There was no visible data point in 1974 that would have suggested that in just 25 years the company would be on its knees. Indeed, there was well over 50 years of stellar performance to look back upon. Disruptive changes in the regulatory environment, wireless, internet and optical technologies have collectively done them in. More importantly, all of these changes were totally unpredictable in 1974.

How can investors avoid all these Blue Chip Blues?

One needs to get back to the Ben Graham fundamentals of cash flow and intrinsic value. The intrinsic value of a company is the total sum of free cash flow it will generate from now until eternity (Refer to the July 2001 article in Silicon India entitled *Intrinsic Value*). When one looks at even dominant blue chips like Wal-Mart, American Express or Disney, investors would be very well served to shorten eternity to 10 years and assume that the company is sold at 10 times its estimated free cash flow (FCF) in year 10. Then do a present value calculation based on your annual return expectation. Finally, take the value per share you come up with and divide it by two to add a 50% Graham margin of safety.

Most likely, the current stock quote will be significantly higher than your valuation. In that case, just pass on the company and move on to the next one. If the current stock quote is below its intrinsic value, its time to roll up your sleeves and think about Charlie Munger's Latticework of Mental Models to build a solid model of what the likely future of the business might be.

When you run this 10-year FCF on the virtually any blue chip company, you'll learn that, at present prices, these companies are very risky investments. They remind me of a Peter Lynch quote that encapsulates it beautifully:

It's a real tragedy when you buy a stock that's overpriced;
the company is a big success , and you still don't make any money.

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