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### **General Market Thoughts 12/26/18**

Dear Investment Partner,

Happy Holidays to all readers! I hope you are enjoying some family time this week. As I sat around my Christmas tree last night after all the presents were opened and the kids were in bed, I was jotting down a few quick thoughts I wanted to share.

There are certain times when it's effective to remind yourself of some of the simple principles of investing, and one of the simplest of all is what Buffett has said throughout his career: *"Be greedy when others are fearful."*

As I write this, the S&P 500 is down about 20% from its high. (Update: I finished writing this note early on 12/26, but I am now editing it after the market has closed, and the markets were up 5% today, which is actually a microcosm of the inefficiencies that are caused by Mr. Market's mood swings: the total quoted value of US stocks is roughly \$1.3 trillion higher than where it was just 8 hours ago. I can assure you that the intrinsic value of American business hasn't changed by \$1.3 trillion since lunch time earlier today).

On Christmas Eve, I believe the index technically entered "bear market territory", down just over 20%. These types of declines don't come around often, but just about every time they do, they are great times to be buying stocks. This doesn't mean that stocks won't go lower. In a recent [write-up I sent to investors on Facebook](#), I referenced Buffett's October 2008 op-ed where he said he was buying US stocks and that over time they would be great investments at those levels. I recall Buffett being criticized and even mocked at times as stocks fell much lower over the following months. But Buffett never said he thought stocks would be higher in 6 months or a year (in fact, he went out of his way to say he didn't know where stocks would go in that time frame), but he did think they'd be higher in five years. And they were higher in five years. A lot higher.

When stocks have fallen by 20%, there is always a reason that is attributed to that decline, and there will always be pessimistic views on why that decline is justified and why stocks will go lower still. I have seen numerous market pundits suggest that now is not the time to buy; that it's better to wait for more "clarity", etc... When pundits say to "wait for more clarity", what they really mean is "wait for pessimism to subside", and what they are really thinking is "wait until stocks aren't going down anymore". The problem is that there is never more clarity, and when there is less pessimism, stocks will already be higher.

As Buffett says: *"You pay a very high price in the stock market for a cherry consensus."*

In my opinion, this is a great time to buy stocks. Again, I don't want to rank this with March of 2009 or October 2002, but I do think that stocks generally will be significantly higher five and ten years from now, and returns from these levels will likely be attractive.

This is my general view of stocks from this level, but we're trying to earn returns that exceed average levels by a comfortable margin. So more specifically, I think there are some great values in stocks that I've talked about before on these pages. I'll outline just a few examples here, but there are others that are both in my portfolio and on my watchlist that I think offer great value at these levels.

I have laid out our thoughts on why we like these businesses, so for now, I'll just highlight the current back of the napkin valuations:

## Apple

- \$60 billion net income
- 4.8b shares outstanding fully diluted at 9/30/18
- \$60 billion free cash flow
- \$12.50 FCF/share
- \$89 billion net cash including the overseas tax liability (\$19 per share in net cash)

So at \$156 per share (\$749 billion market cap), Apple is trading at 12.5 P/FCF, and 10.9 P/FCF ex-cash.

They also bought back **\$73 billion in stock this past year.**

Including dividends, Apple has returned \$86 billion in 2018. The market cap of the company is \$749 billion at \$156 per share, which means Apple's buyback and dividend total "yield" is **11.5%** at the current levels.

Also, Apple has earned \$169 billion in free cash flow over the last three years and has spent \$135 billion on buybacks during that time. If they can earn this same amount over the next three years, they'll be able to buy back 865 million shares at \$156 per share. If the stock price didn't budge, the share count would be around 3.9 billion in three years, which means Apple will be doing around \$15.25 per share in earnings with 0% earnings growth. **This could accelerate even further since they have said that they intend to bring their net cash position to \$0** (meaning use the \$89 billion in net cash on buybacks).

The excess cash plus the next three years of free cash flow means Apple could buy 1.4 billion shares at the current level. That would leave 3.4 billion shares left, and at \$60 billion free cash flow, that would be over \$17.50 free cash flow per share. And again, this assume no overall earnings growth, which I think far too conservative.

I think \$17.50 per share is worth 15 times earnings at least for a company as good as Apple, especially since the company's recurring high margin revenue streams are becoming a bigger piece of the pie. This is over \$260 per share of value, about 70% higher than the current price. This is one reason why it's logical to hope for your stocks to decline in price. The lower the share price, the more value that is created for each remaining share.

I'm not sure when the stock price will get closer to its fair value, but I do think the value will approximate that level and I do know that stock prices eventually mirror intrinsic values over time.

Apple looks extremely cheap to me at this price.

## Other Ideas

There are a number of other cheap stocks out there as well. As far as stocks I've talked about previously: I outlined [my thoughts on Facebook](#) a few weeks ago. I've mentioned the banks before as well. JPM and BAC are also buying back a lot of stock, and both are trading around 8-9 times the earnings that I think they'll produce over the next year. I've bought some shares of both in recent days.

Tencent is still growing fast, and it looks very cheap. It also received some good news. The stock has fallen due to company-specific concerns around their ability to monetize some of their video games, and also due to China-specific macro worries. The macro worries remain, but those aren't concerning to me (China's economy over the long run will do extraordinarily well). But more importantly, the government has restarted the approval process of new games. This news seemed to be largely ignored here in the Western press, as there are lots of other interesting things going on, but it's big news for Tencent, which has an enormous amount of potential "pent-up" revenue from games that it hasn't yet been able to monetize.

Tencent's back of the napkin valuation:

- \$18 billion next year FCF
- Tencent has, by my calculation, roughly \$60 billion of net cash and investments
- The stock is currently trading at 17.7 times free cash flow (excluding net cash)
- This is a company that grew by over 50% last year, and likely still has a long runway left

These are some of the larger companies, and some of my larger investments, but there are other interesting ideas, including a number of new ideas I'm working on currently.

## Buybacks

One other comment; almost all of my portfolio holdings are companies that are producing a lot of excess free cash flow and that are using that cash to buy back a lot of shares right now. I think another important principle to remember is that when share prices decline, companies that are buying their own shares are acquiring more value for each dollar they spend on buybacks. And of course, the more value they acquire means the more value they create for shareholders. It is counterintuitive for most people, but lower stock prices are better for shareholders, unless you plan to sell your shares in the near future.

To sum up, I just wanted to mention that I think this is a great time to allocate to stocks generally, and if you're an investor who looks to locate individual stocks, there are lots of exciting ideas to evaluate and a number of bargains.

I have no idea where stocks will go in 2019, but I am much more excited about my portfolio's future returns going forward than I have been for some time.

**Your Partner,**

A handwritten signature in black ink, appearing to read "John Huber". The signature is fluid and cursive, with the first name "John" and last name "Huber" clearly distinguishable.

**John Huber**

Managing Partner

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