Wagner Road Capital Management

Three Times Crisis Created Opportunity

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Every year presents different challenges, and 2022 brought some of the hardest. But it's not necessary to repeat everything that happened during the year, because there is already plenty of commentary describing economic conditions and short-term market predictions. I would rather provide a unique historical context.

I don't think about investing as investing in the stock market—I think about it as investing in a business scenario that is independent of the stock market. The market provides the prices, but the business fundamentals create the long-term returns. A good business can become a great investment when something major changes. Three of the most common changes are management, strategy, and perception. And I've seen all three.

When Management Changes

A few months ago, while watching a video about the history of an obscure piece of old technology, I noticed a news blurb that sounds unbelievable. In a 1997 issue of *Computer World* magazine, this highlighted quote caught my attention: "Since Amelio took over as Apple's chairman and CEO, the company has posted losses totaling more than $1.6 billion." It went on to describe Apple's financials over the previous year and a half.

	Revenue (Billions)	Profit/Loss (Millions)
Q1 1996	$3.1	-$69
Q2 1996	$2.2	-$740
Q3 1996	$2.2	-$32
Q4 1996	$2.3	$25
Q1 1997	$2.1	-$120
Q2 1997	$1.6	-$708

I had to stop and think about those numbers. Is this the kind of company that I would want to invest in? Probably not! It was a turnaround that was not turning around. As the article says, it had just taken a huge write-off for its purchase of Next Software (the acquisition that brought Steve Jobs back to Apple), cut 4,000 jobs, had a weak position in the marketplace for personal computers, and was rumored to be a potential takeover target. No one could have predicted what would happen next, and certainly no one at that time could imagine that Apple would someday become the largest company in the world.

History disregards any prediction. An investment made after the second quarter of 1997 and held until today would have returned close to 100,000%, a number so large that no comparison is needed.

But if we wait a few years, after Steve Jobs takes over and introduces the iPod in 2001, it was a more solid, stable business. It was something more attractive to an investor who doesn't like turnarounds. An investment at that time would have returned about 30,000%, a number that is still too large to need a comparison.

If that still wasn't compelling, the iPhone, released in 2007, was an even more revolutionary product, introduced right at the beginning of widespread smartphone adoption. But by the end of 2007, Apple was a $175 billion company, already big enough that investors were openly wondering whether it could grow any larger.[1] It did. An investment from that time would have returned close to 3,000%, another number so large that it needs no comparison.

Even later, in 2016, Warren Buffett began buying Apple, owning more than 5% of the company by the end of 2018. For many investors, this was considered far too late to take advantage of Apple's influence in the smartphone market—still a good company, but no longer riding the growth of smartphone adoption. Apple was transitioning to the services that happen within its ecosystem, a less exciting story (but still extraordinarily profitable). Even with his "late" investment, Buffett's return on Apple is more than 200%. This also dwarfs the market return.

These numbers are certainly eye-opening, but the important part is that Apple's long-term success was not broken by the dotcom crash, or the great financial crisis, or even COVID. It has crossed many election cycles, interest rate cycles, and business cycles, each time coming out OK. Extraordinary returns were made possible by holding through all market and economic conditions. This is the benefit of looking at good companies with a long-term perspective.

On the other hand, technology companies are also more complicated because of the expectation that the industry will always be changing. If they catch the next wave of innovation, as Apple did with the shift to mobile phones (and has done many times before that), then simply getting the "theme" correct can have a bigger effect on returns than the quality of the company. But even then, Apple would not have become so successful without the return of Steve Jobs. It still takes management foresight to

[1] The investors I spoke with at the time believed that Apple was already too big to have meaningful growth. They did not say that it was overpriced; only that it was too big to be worth investing. I do not know if they found anything better.

navigate industry changes, regardless of how good the company is in the first place—outside of technology, Howard Schultz returning to Starbucks to change the company's direction (multiple times) follows the same pattern. And there are numerous examples of activist investors who successfully replaced ineffective management teams. Bad management can still destroy a good company.

When Strategy Changes

But sometimes changing things that *should not change* is the real mistake. The most well-known example of this is Coke's decision to replace its traditional Coke formula with "New Coke" in the 1980s, a move that was almost immediately recognized as a major mistake. A more modern example comes from Netflix.

In September of 2011, Netflix announced that it would split its DVD mail rental business from its streaming business, creating a new company called Qwikster to handle DVDs. This confusing brand change came right after a price increase that infuriated customers and prompted cuts to forecasted growth. Around the same time, Netflix also began losing access to valuable content.

It took the company less than a month to realize that creating Qwikster was a massive mistake, and the idea was quickly scrapped. But customers and investors both lost faith in Netflix management. The DVD business was certainly not the future of the company, but DVD customers still liked the Netflix brand. The stock fell by about 70% over three months (after it had already fallen significantly from its 2011 high).

It was a disaster—for the short-term. An investment made at the end of 2011 and held to today would return close to 3,000%, an excellent long-term result even after the dramatic decline from the pandemic peak.

As a comparison, I think it's also helpful to consider the most poorly-timed investment, made at the 2011 peak (when Netflix was likely to be significantly overpriced). It would take two years for that investment to breakeven, and it would *still* return more than 700% if held to today. But that's a big difference, and not many people would hold on for that long. Bailing out before the bad news became worse would have been OK.

In the short-term, attempting to split the company was a strategic mistake, but the long-term vision was correct. Continuing to build a platform for streaming video online was the right market choice. And the 2012 move into creating original content, while expensive, was also the right long-term vision. Netflix was a good company in the right place at the right time. It just made a mistake.[2]

When Perception Changes

Sometimes a company doesn't need to make any major mistakes to end up with a terrible short-term investment return. This can happen by price alone. And I think that Amazon is a model for this type of result. The company's annual shareholder's letter for the [year 2000] is one of the best that I have ever read. Jeff Bezos summarized the situation in only a few lines: "Ouch. It's been a brutal year for many in the capital markets and certainly for Amazon.com shareholders. As of this writing, our shares are down more than 80% from when I wrote you last year. Nevertheless, by almost any measure, Amazon.com the company is in a stronger position now than at any time in its past."[3]

He went on to describe the fundamentals of the business. The company's commitment to customers didn't change. It didn't need to change. There was no major mistake to correct—the stock was just overpriced. An investment made at the beginning of 2001 would have returned close to 10,000%.

But the risk of overpaying is still real. An investment made at the beginning of 2000 would have taken almost *10 years* to breakeven, and would it have returned "only" about 2,000%. It also wasn't anything close to a guarantee—there are many stocks that went to zero or never returned to their dotcom highs.

And this doesn't mean that there was nothing wrong with the company. The ecommerce opportunity was real, but Amazon's strategy of investing straight into pure growth at the expense of profits was also risky. It could have easily led to getting overextended, something that I've seen with many companies over the past year.

When Changes are Opportunities

There are many different stories that fit these three themes (or a combination of themes), including more beyond the tech sector, but those three companies are unforgettable for a reason—I have looked at all three of them many times over the past 15 years, but never invested. I always found something else that I liked better, often because of a more attractive price or a more predictable business situation, and usually a competitor within the same industry.

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[2] Netflix made another major strategic change in 2022 with the announcement of a new advertisement-supported streaming service. In the short-term, the market hated it. But I think it will prove to be a valuable long-term addition.

[3] I expect to see many managers say the same thing about 2022.

The reason for thinking about it now is because there are probably some stocks that I have considered recently, and did not buy, that will go on to achieve similar results. But I'm not looking specifically for "the next Apple" or Netflix, or Amazon (all of them well-known as powerful first-movers, something that is not necessary to be a good business or a good investment). I'm looking for characteristics that successful companies share, and the history of those companies demonstrate different scenarios that create the potential to own a good business at a great price. I believe that 2022 has made a few more.

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