

I was a peripheral visionary. I could see the future, but only way off to the side.

~ Steven Wright, Actor and Comedian

March 2012: The Apple Conundrum

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The straight line ascension of Apple Inc.'s stock price over the last three years – from \$100/share in early 2009 to its recent price of \$600/share (as of 3/19/2012) – inspires awe. So far this quarter, Apple's stock is up 48%, outperforming just about every other investment on the planet. There seems to be an unceasing willingness on the part of investors to commit ever more capital to participate in Apple's future profitability. Many, including TV talking heads and tech consumers, view Apple as an infallible company that will always be on the leading edge of technology and will always launch products to which consumers will upgrade. CNBC pundits love to say Apple is "its own asset class," implying that it is immune to the law of gravity, the law of large numbers and the occurrence of obsolescence. This special moniker also suggests that this stock is priced by a separate, unknowable mechanism that is different from how other, more fallible investments are priced. Perhaps this is true, perhaps not.

Most members of the Obermeyer Asset Management team use Apple's products and highly respect the company and its achievements. We recognize that it has built a cult-like following of both technophiles and ordinary users who aspire to own its latest and greatest gadgets. We recognize the elegance of its platform, the ease, convenience and life-enhancing attributes of its apps, the effortless delivery of media content and how it has even transformed entire industries. We recognize the style element of owning Apple devices, we recognize the status that people derive as Apple users and we understand the mystique the company possesses in the way it operates.

Given our shared appreciation for Apple as a company, why aren't we making a place for it in client portfolios? We generally separate current and prospective investments into three broad categories: *Yes*, *No* and *Too Difficult*. In the case of Apple, we see this investment as *Too Difficult*. Let us explain:

With a market value of \$550 billion, Apple now comprises 4.4% of the S&P 500 index and, all by itself, is larger than the entire utilities industry. With 932 million shares outstanding, every dollar move in Apple's share price represents nearly \$1 billion in net new capital flowing to its shares. For context, the median company size of those in the S&P 500 is \$12 billion, so a 2%

move in Apple's stock is the equivalent of adding a whole new company at the median value to the index.

Since December 31st, Apple's market value has increased by \$172 billion, which is roughly the size of Johnson & Johnson, a large, well-established, innovative healthcare and consumer products company with a 125-year history. Johnson & Johnson has enjoyed many successes, has reinvested high levels of profit and is investing to expand its divisions, products and businesses. Apple attracted the same amount of investor capital in two and a half months that Johnson and Johnson attracted in its entire 125-year history.



Apple is now the largest company on earth by market value and attracts significant amounts of speculative capital with every press release, earnings release and product launch. Admittedly, the Fed is conjuring dollars out of thin air, and those that have first dibs on the newly conjured dollars (large brokerage firms, proprietary trading desks and certain hedge funds) tend to gravitate to what's "working" and are wont to speculate. As such, it is difficult to know how large or how long the capital flow to Apple will be sustained. But many of these large speculators have very short-term time horizons, and capital tends to chase things or go where it seems as though there is very little near-term risk...until the risk assessment changes.

The \$172 billion increase in Apple's enterprise value since the beginning of the year has been prompted by strong earnings for Apple's most recent quarter and the unveiling of the iPad 3 (promoted as the 'new iPad'). In calendar year 2011, total worldwide iPad sales were around 40 million units. At an average selling price of around \$650 and gross margin of around 40% (an educated guess), Apple earns roughly \$260 per iPad from which to pay its R&D and administrative costs. This should be similar for the new iPad.

Apple launched its first iPad in April 2010 and is now on its 3rd version, so the iPad has about a two-year shelf life for the company (it might milk a few more years out of each version, but the company's business model is to continually launch new product iterations and slash prices on the older versions). Though it's not disclosed in the financials, a guess would be that the new iPad will sell 26 million units its first year and 14 million in its second. If each version of the iPad earns \$260 per unit, then Apple investors can expect somewhere in the range of \$10 - \$15 billion in *total* pre-tax profit for this newest version of the iPad. Unless investors thought Apple's stock was way too cheap *before* the new iPad announcement, they seem to be expecting much *more* value to be delivered to shareholders from the iPad launch than can be reasonably be delivered by sales of the iPad device itself. The \$172 billion increase in the company's value far exceeds the approximately \$15 billion that will come from the iPad, so it will have to come from something else. We don't know yet what that "something else" is.

When we look at our cash flow models, assuming Apple can maintain its current operating margins (a heroic assumption in the face of increased competition in the tablet market), to justify the current stock price, it appears to us that Apple will have to sell about \$2.6 trillion worth of total products and services over the next ten years. Last year's revenues (for the fiscal year ending 9/24/11) totaled \$108 billion. If Apple's margins shrink, it will have to sell a lot more. This level of Apple product sales will make up almost 1.5% of U.S. GDP (of course it also sells products outside of the U.S.). That means that with the average GDP per capita in the United States being around \$50,000, each person must spend \$750 on Apple products and services annually (since 30% of sales are domestic, this means that about \$225 per U.S. citizen would go to Apple every year). Since not all 310 million people in America use Apple, those who *do* need to spend a lot more *and the vast majority of those sales will need to be on devices because iTunes sales do not bring much profitability.*

Is the market's assessment wrong? Nobody (including us) can say with certainty what Apple will do from here. But we *do* know how markets work, and we also know that obsolescence happens – two things that continue to give us pause. It's hard to see in the hype and awe of the moment, but obsolescence is inevitable, especially in products with a 1–2 year useful life. We have yet to see a technology company whose products didn't fade in popularity or that was able to sustain super-high operating margins forever. If you think about the leading producers of disruptive media technologies of the past – typewriters, transistor radios, televisions, copy machines, fax machines, personal computers, software, cell phones, routers, storage devices, etc. – despite the fact that all at one time had spectacular stock price performance, many don't even exist anymore.

We're not predicting the same fate for Apple, but we do see it as a risk. We've seen technology companies become the largest on earth, then have their stock price fall between 50% and 75% and stay there for over a decade. This effectively represented a permanent loss of capital for

late speculators who held on as market participants reassessed their views of risk, future growth and profitability. Cisco and Microsoft are two prime examples of this. We can't know what handheld or tablet technology will look like in ten years or even whether it will exist at all.

It's difficult to find an analyst who is not unflinchingly bullish on Apple. That bullishness is for good reason, not the least of which is that Apple has been consistently visionary in creating products that people want. Bullishness (and stock prices) reaches its maximum when the company in question has demonstrated a recent run of doing no wrong. But look at the history of Dell, Cisco, Nokia, Research in Motion, Netscape, Zenith, Sun Microsystems, Yahoo, Digital Equipment Corp. and Polaroid – they have all gone through the same phase.

None of this is to take anything away from Apple as an innovator, as a company full of brilliant developers, as a marketer, designer, distributor and overall profit machine. For people who *do* own Apple, we sincerely hope it works out in their favor, that the company keeps designing cool new devices and that its stock price continues to rise. As users, we *really* hope for it. But for our clients, we continue to believe that it's the right thing to do to let others, bolder than we, invest in history *not* repeating itself.

We take it as a given that the world is a complicated place and that the future cannot be predicted. What we *can* do is to try to intelligently assess investments' risks and construct a portfolio of those that are well-compensated, including many that will perform under the most-likely scenarios going forward, but also some that will perform well in unlikely scenarios.

Because markets are forward-looking, and because of Apple's success to-date, the high expectations of others and our experience in how markets work, we continue to believe it's best to stay away from its shares – whether that stance comes with an opportunity cost or a benefit. We are neither bullish nor bearish on Apple Inc.; we simply view investment in its stock at the current price as *Too Difficult*.

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