Basis Points – December 13, 2018

westwoodgroup.com/weeklyblog/basis-points-december-13-2018/

Above the Fold

The market rallied sharply yesterday as trade tensions with China eased somewhat. The Wall Street Journal reported that China is working to increase access to foreign companies, a move aimed at smoothing U.S.-China trade relations. This plan would replace the country's Made in China 2025 plan, a framework aimed at making China a leader in industries like clean-energy cars and robotics.

President Trump said on Tuesday that he would intervene in the Justice Department's case against a top executive at Chinese telecom giant Huawei if it would serve national security interests or help U.S./China trade talks. Trump also said that talks between Washington and Beijing were ongoing and confirmed he would not raise tariffs on Chinese imports until the two sides had reached a comprehensive trade agreement. Reports also pointed to China cutting tariffs on U.S.-made cars, as an official indicated China will lower auto tariffs, although details of this plan are still not clear.

Three Things

- The S&P 500 declined into 10 percent correction territory last Friday, before rising again this week. While 10 percent market corrections usually cause investor fear and angst, market declines of this magnitude are actually quite common. A “drawdown” is the loss in a calendar year from the high point of that year to the low point. Over the last 100 years, the average yearly drawdown has been 13 percent, and 54 percent of all years have seen a drawdown of at least 10 percent. A drawdown of less than 5 percent is very rare, as it has only happened in 7 percent of all calendar years. Eighty percent of all market years have shown positive performance, but with this strong track record comes downside volatility that is a normal part of equity market investing.
- The Harvard University endowment fund, one of the largest university endowments in the world at $39 billion in value, has been quietly purchasing large tracts of land in California’s wine country over the past 10 years. Using a front company named Brodiaea, Harvard has purchased 3,000 acres of agricultural land and has utilized it for a wine-growing business, a venture which it now values on its books at $305 million. The real value of the land for Harvard, however, is in the groundwater underneath the land. With constant drought conditions in California, Harvard is speculating that in the future water will be a scarce and valuable resource on the West Coast. While turning water into wine may be a modestly profitable business for the endowment now, having ownership of large underground water sources may be a far more lucrative investment in the future.
- If you have ever wondered how much cash sits in a bank vault, the Fed does provide those numbers. In the banking system, banks hold about $75 billion of actual cash in their vaults at any moment, which translates to about $230 for each U.S. resident. While most people have more than that amount of cash deposited in their accounts, banks are not required to hold that much in case you come in to withdraw it. The principal function of banks is to provide loans, and they use your deposits for this purpose. In normal times, only a fraction of deposits are claimed on any business day, so the remaining cash in the bank is plenty to cover the demand. Should that not be the case, the Federal Reserve can provide the required cash as a loan if the bank is solvent. Cash on hand in banks only spiked once in the past 50 years, in the months leading up to 2000. During the Y2K hysteria, both banks and the depositor public wanted to be assured there was enough cash on hand to complete whatever electronic transactions they needed if the system was in fact interrupted by the Y2K computer glitch. This fear was, of course, a non-issue and the cash pile on hand at banks was decreased shortly after.

Did You Know

The total market value of Microsoft recently surpassed Apple and is now the world's most valuable company by market cap. The reason for the growth in its value is directly tied to a change in its source of revenue. The subscription-based revenue model is a major evolution for many companies and is a change that is very powerful and here to stay. Barron's reports that the subscription model for sales of products is being utilized not only in the technology industry but also in consumer goods and services, automobile sharing and even in sales of large industrial equipment.

In days past, Microsoft sold its Windows Office software one copy at a time by sales of CDs that were downloaded onto desktop PCs. The company then had to convince that same user or company to purchase an upgraded new copy the next year. Now that model has drastically changed, and much of Microsoft's revenue is now subscription-based versions of its Office 365 franchise and cloud-based technology services. Wall Street has cheered this new base of recurring revenue, as it is revenue that flows automatically rather than from customer conscious choices. Investors have also rewarded subscription-based companies with much higher stock prices, as the businesses now have a far more predictable base of revenue. The subscription model is also more efficient, as a bug in the system or software can be fixed at company headquarters and pushed out to all users at the same time, rather than one-at-a-time fixes to users who have purchased the software individually.

Recurring payments have changed the way Americans purchase products such as software, music, movies, TV, fitness, clothing and food. Even tractor maker Deere is rolling out a subscription-based service to farmers. Adobe made the switch in 2013 from selling single copies of its software, and it now charges customers $10-50 a month for online use of its products. Ninety percent of its revenue is now considered recurring, vs. only 5 percent prior to the switch. Adobe earnings per share have jumped from $2.35 in 2013 to $6.85 in 2018, so the switch to a recurring revenue model has made the company far more profitable and predictable, which has led to a higher valuation from Wall Street. "Customer retention is the new growth," Adobe's CEO says.

The author notes that the subscription trend goes beyond Corporate America. Don Ward, who has shined shoes for 18 years just outside Barron's offices in midtown Manhattan, began offering a subscription service in 2010. For $100 a year, customers get unlimited shines. For $500 — the "platinum" service — customers get shoeshines for life. Ward likes that he receives the revenue up front, and the customers appreciate the unlimited service available for one fixed price.

solicitation, or recommendation to buy or sell or otherwise invest in any of the securities/sectors/countries that may be mentioned.