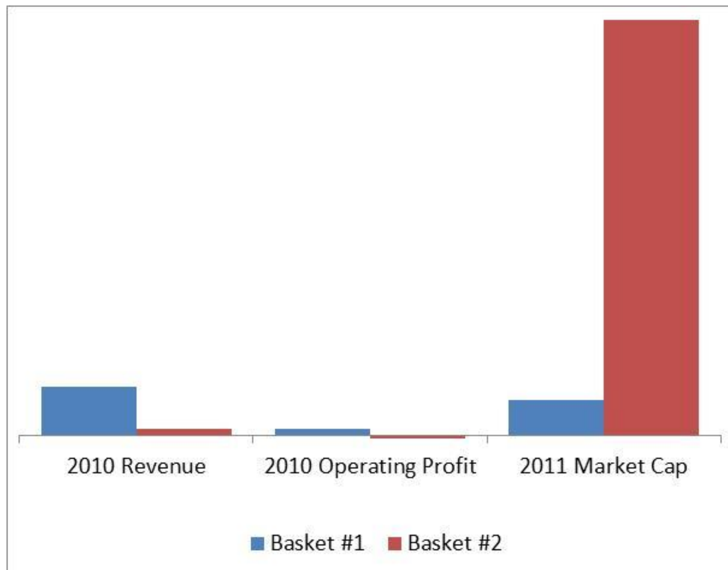
Better to Look Through the Windshield Than Through the Rear-View Mirror

We came across an astonishing piece of investment trivia a couple of years ago. It concerned the performance of two baskets of stocks.

The companies in Basket #1 earned aggregate revenues of $4.5 billion in 2010, compared to Basket #2's $1.3 billion. Basket #1 also earned operating profits of $600 million in 2010, compared to Basket #2's aggregate operating loss of nearly $300 million. Of course, the punch line is that Basket #2's combined market cap at the time was nearly $40 billion—many times greater than Basket #1's measly $3.5 billion.

Or, to make the point a bit more succinctly, here it is in graphical form:



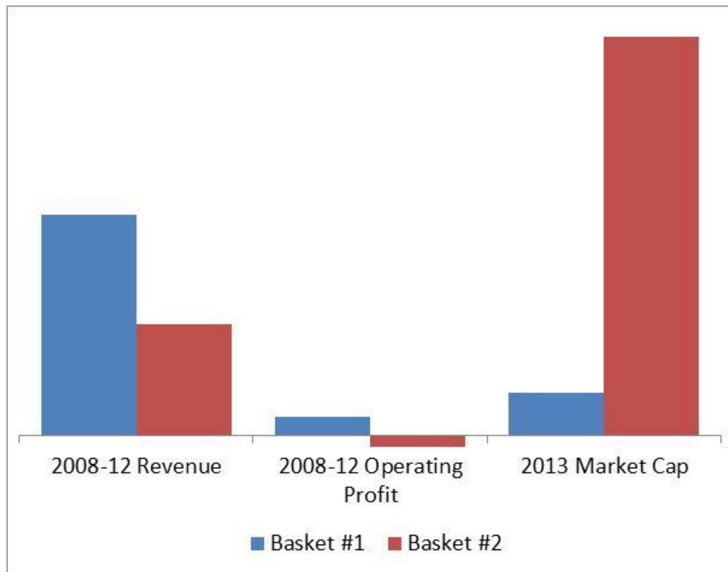
Bigger Basket, Smaller Value?

We thought this was an extraordinary result at the time, but none of the companies seemed like potential investments to us, so we made a note of the oddity and moved our attention elsewhere. Recently, as we were thumbing through our old notes, we came across this and decided to update the analysis to see how things stand today.

Instead of taking just a one-year snapshot of performance, though, let's see how our two baskets have performed over the previous five full-year periods.

Basket #1's aggregate revenues over that time were almost exactly double Basket #2's ($21 billion versus $10.5 billion), and its aggregate operating profit was about the same in size as Basket #2's aggregate operating loss (between $1 billion and $2 billion on either side of zero).

And yet the market cap figures have hardly budged in the ensuing two years:



New Versus Old

What could possibly be driving such a disparate and unexpected appraisal from the stock market for two baskets of stocks with such differing financial performances?

Perhaps one hint to solving the problem would be to examine the underlying stocks that make up each of these baskets.

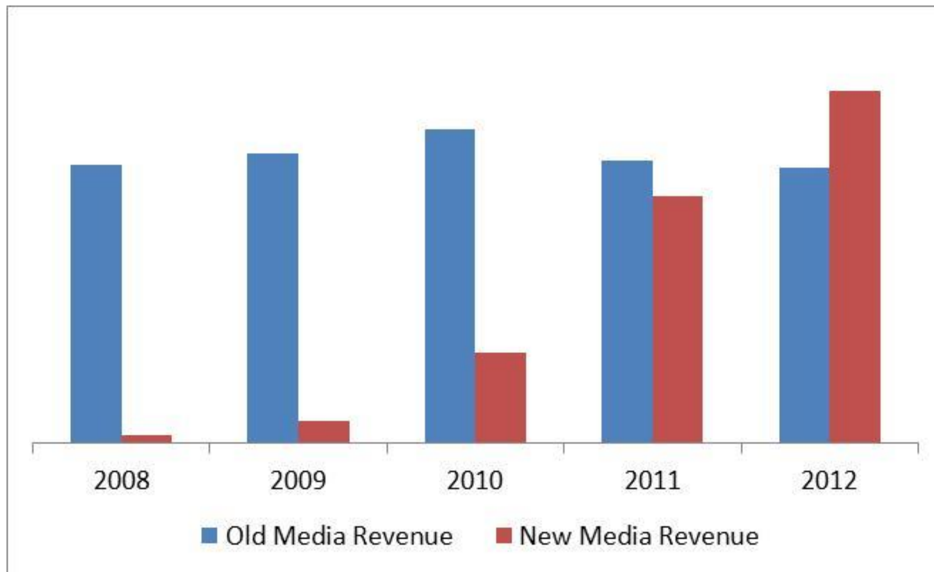
Basket #2 is comprised of five stocks, each of which has made its stock market debut in the last few years and each of which is involved primarily in online and/or digital media: Groupon, Zynga, LinkedIn, Pandora Media, and Zillow. In fact, instead of calling it Basket #2, let's change the moniker to New Media.

Can you guess what the new name for Basket #1 will be? Yep, let's call it Old Media. And there is actually only one stock in the basket: The Washington Post Company, one of the stalwart standard bearers of the dying newspaper industry.

So that's one very big clue as to why the stock market is assigning a much higher value to the New Media group than to the Old Media group. And incidentally, isn't it interesting to note that the boring old Washington Post has been putting up such steady and profitable numbers over the last five years?

The Trend is Your Friend

Another clue in the big valuation discrepancy is being obscured by the chart above. While we have showed you the last five years in aggregate, quite another story emerges when we look at each of the last five years individually:



The Washington Post's revenues have pretty much stagnated over the last five years. The highest level they reached in that time frame was $4.5 billion, and the lowest they reached was $4.0 billion. That lowest number tellingly came in the most recent year.

The New Media group's revenues, though, have practically exploded. From just $128 million in 2008, they grew to $5.1 billion by 2012. This represents an average annual growth rate of 109%. That means that these companies, as a group, have on average more than doubled in size every twelve months. Of course, the growth rate is slowing down, as all growth rates must over time: 2012 revenues were "only" 42% higher than the figure for 2011.

Clearly the stock market is looking at the revenue trends in the graph above when it is coming up with valuation figures for each of these companies.

The Moral of the Story

Are there any lessons we can draw from this analysis? Our first thought is that, while the valuation differential between the two groups does appear a little crazy to us, it doesn't seem *insane*. If we were back in 1998 or 1999, in the height of the bubble valuations of Internet-related companies, we are sure that the valuation of this New Media group would be many times higher than the roughly $40 billion we're seeing today.

Another thought is that the maxim "what have you done for me lately?", which is so prevalent within the business world, does not really apply to the stock market. The market isn't so much

concerned at what results a given company or basket of companies has shown in the recent past, as it is with the results that will be achieved in the years ahead.

Did the stock market know two years ago that the New Media group's revenue would go from $1.3 billion in 2010 (less than a third of Washington Post's revenues that year) to $5.1 billion in 2012 (nearly a third bigger than Washington Post)? Probably not with any precision, no. But it did have an idea that the group was going to grow very, very quickly, and so it ascribed what seemed like an astronomical valuation to the group.

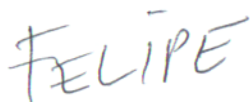
Show Us the Money

But what about the truest test of all? How have these stocks rewarded their investors?

Given our usual proclivity to tell O. Henry-like tales, you may expect us to reveal that it's the stodgy old Washington Post investors who have vastly out-performed the New Media investors. And, certainly, Washington Post investors have fared well so far this year. At the time of this writing, Washington Post stock is up 47% so far in 2013, as compared to just 15% for the S&P 500, our broad market index of choice.

However, all five of the New Media stocks have out-performed not only the S&P 500 but also the Washington Post's out-performance. Zynga's 48% return year to date is the lowest of the group, while Pandora and Zillow have more than doubled.*

Does this mean that these New Media stocks will see similar levels of growth going forward? By all means, no. It's certainly possible, but it will all depend on how those revenue and profit charts develop over the next five years. That's why investing can be so simultaneously rewarding and frustrating, and yet unendingly interesting. You never know how things are going to turn out until the end, and it can be not only fun but educational to watch the drama unfold.



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** post-script:*

We authored this article in late July 2013, and it was published in early August.

On August 5, the Washington Post Company announced that Amazon CEO Jeff Bezos will be purchasing its flagship product, the Washington Post newspaper. The timing of these events was a complete coincidence, but it fascinates us to witness the confluence of New Media and Old Media in this interesting acquisition.