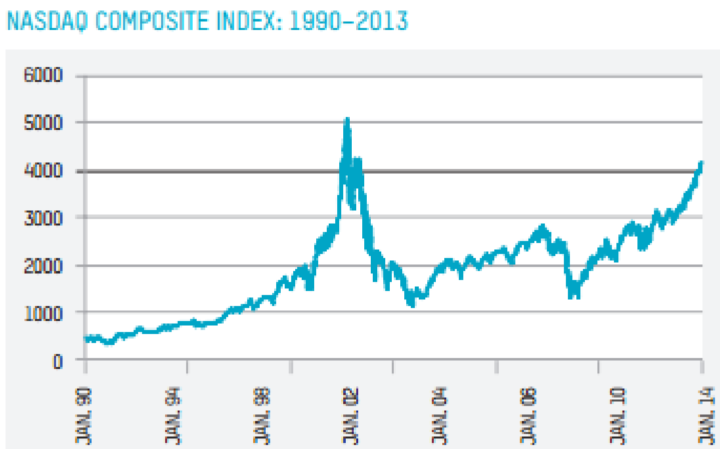
The *Investment* House LLC

The Investment House Quarterly: September, 2014

Index %	Q2 2014	YTD	2013
S&P 500	**+1.13**	**+ 8.34**	**+32.39**
Barclays US 20+ Yr Treasury	**+3.00**	**+16.58**	**-13.88**

Source: Morningstar

Will The Real Nasdaq Please Stand Up



Source: Nasdaq

As 2013 neared a close, the beloved Nasdaq Composite index crossed the 4000 mark for the first time since the early days of 1999 – the very height of the "tech bubble" of the last century. As everyone painfully recalls, that bubble went on to burst within the year, wiping out more that 80% of the index's prior peak valuation. As the Composite recently regained its old heights, the questions of history return: Will the same thing happen now? Are we currently in the same kind of bubble?

Such questions can be approached by asking an even simpler question: is the Nasdaq Composite of 2014 the same thing – financially speaking – as the Composite of 1999? As a recent White Paper by the NASDAQ/OMX Exchange makes clear ("The Nasdaq Composite Index, A Fourteen Year Perspective, April 2014") , the answer is a resounding NO. It is *quite* different. And the differences are not only large, but important for judging the investing environment in which we currently live, versus the historical setting of the late 1999s.

As a review, it is important to remember what the Nasdaq Composite actually represents. Unlike the Dow Jones Industrial Average and the S&P 500 – whose members are actually chosen by committee – the Nasdaq Composite simply represents the value of *all stocks* listed on the NASDAQ Stock Market. As the White Paper reminds us,

> From day to day, changes in the level of the NASDAQ… are reflective of the changes in the value of the component stocks…This is because the components, over short time periods, don't change very much [i.e. dropping in or out as in the Dow and S&P], except for their prices.
>
> However, over longer time periods such as the last 14 years, the component stocks [i.e. *the actual nature of the businesses*] ***do*** change in very significant ways…In fact; there are so many changes that have occurred in this 14-year period that several perspectives are warranted…

While the White Paper points out a host of interesting and important changes, we thought we'd share the major highlights: valuation, size, and composition.

TABLE 1: COMPONENTS OF COMPOSITE INDEX

	DEC 31, 1999	DEC 31, 2013	RATIO
VALUE OF INDEX	4069	4177	1.03
NUMBER OF COMPONENTS	4,715	2,472	0.52
TOTAL MARKET CAP ($B)	$5,453	$6,271	1.15
AVG MARKET CAP ($MM)	$1,157	$2,537	2.19

Source: Nasdaq

As this table shows, evolution has been at work in the Nasdaq, with the number of issues being cut in half over the last 14 years (through mergers or delistings) and the size of the survivors more than doubling. Likewise, the average age or maturity of

TABLE 6: MARKET CAP MEDIAN AGE OF NASDAQ COMPANIES

DEC 31, 1999	DEC 31, 2013
15.1 YEARS	25.0 YEARS

Source: Nasdaq

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the remaining companies has increased dramatically - 10 full years over the last 14! So the remaining companies have become stronger, bigger, and more skillful at sustaining themselves. Furthermore, the industrial composition of the index has changed markedly, with the weighting of information technology in the Composite declining a full 19% over the last 14 years – from 57% in 1999 to 38% in 2013 - as biotech, health care, consumer staples, and telecommunications have increased. Likewise, the companies comprising the top 10 in the index in 1999 versus the top 10 in 2013 have changed dramatically as well:

TABLE 2: TOP 10 COMPONENTS THEN AND NOW

12/31/99		12/31/13	
STOCK	MKT CAP ($BLNS)	STOCK	MKT CAP ($BLNS)
MICROSOFT	$606	APPLE	$505
CISCO	$360	MICROSOFT	$312
QUALCOMM	$332	GOOGLE	$310
INTEL	$277	AMAZON	$182
WORLDCOM	$228	INTEL	$129
ORACLE	$151	QUALCOMM	$125
DELL	$132	CISCO	$120
SUN MICROSYSTEMS	$117	GILEAD SCIENCES	$115
YAHOO	$103	COMCAST	$111
JDS UNIPHASE	$75	FACEBOOK	$102

Source: Nasdaq

Perhaps the most striking difference between the Nasdaq Composite of 1999 and that of the current day is valuation. There are two ways to see this: first, in the changes of valuation over that period from among the biggest 10 companies from 1999 which remained in the composite in 2014. The valuation compression by 2013 is nothing short of astonishing – from an average P/E multiple of 220 (!) in 1999 to 18 in 2013, a decline of more than 10 times! Note in the table above how many of the total market caps have actually *declined* over over these 14 years (Qualcom, Cisco, Intel) while some have disappeared (Worldcom, Sun) and others, suddenly sprung up (Google, Apple, Facebook, Amazon).

TABLE 10: PRICE/EARNINGS RATIOS OF SELECTED COMPANIES

STOCK	END OF 1999	END OF 2013
MICROSOFT	73	13
INTEL	35	14
CISCO	166	13
APPLE	37	14
QUALCOMM	224	19
YAHOO	787	35

Source: Nasdaq

Likewise, when we examine the comparative valuation metrics for the entire Composite Index, we see a similar, startling, compression: a decline in the average P/E from 152 to 31!

TABLE 11: BLOOMBERG VALUATION METRICS FOR NASDAQ COMPOSITE

	END OF 1999	END OF 2013
PRICE/EARNINGS	152	31

Source: Nasdaq

What can we conclude from this historical analysis? First, that even though the name or index level itself may not have changed, *the underlying economic and financial reality* in the Nasdaq Composite has changed *dramatically* and, from an investor's point of view, *dramatically for the better*: staggeringly lower valuations; greater maturity; bigger scale; higher diversity.

All of which make us believe that as future asset prices change, and stock prices resume a more normal range of volatility than their unusual calm of these last 2 years - despite what the talking heads will say, there is no 'voodoo curse' on the averages because of the crossing of some 'special' index number of the past. On the contrary. Since company economics and the valuations underneath them are completely different today than in 1999, we look forward to the opportunity to buy stronger, better-valued businesses while the uninformed discard them under the false assumption that past is prologue. Our view is not so much rooted in the past, but in the present values the businesses we see growing into the future, and growing our capital along with them.