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The Tesla Effect

"Don't sell the steak, sell the sizzle" – Elmer Wheeler

Elmer Wheeler was a marketing genius in the 1930's. He made a fortune helping major corporations sell their way out of the Great Depression. Another "Wheelerism" – *"Don't think about what you want to say as about what the prospect wants to hear - then the response you will get will more often be the one you are aiming for."* People love stories.

As I write this, Elon Musk, CEO and co-founder of Tesla Inc., has sent engineers to the site of the soccer team trapped 1.2 miles deep in an underwater cave in Thailand. He believes that his engineers can solve the problem of rescuing the 12 trapped school boys and their coach. Hopefully by the time you read this their ordeal will be over. Musk has "tweeted" out a number of possible solutions to the dilemma facing the group. According to the Social Bakers website, Elon has over 22 million followers on Twitter. That's 22 million people that want to know what Elon is thinking about on any and all matters.

Tesla's stock has had a wild ride this year. It opened the year with a price of just over $320 per share, dropped to $252 (21% loss) in April, climbed to $370 (47% gain) in June and has settled back to $309 (16% loss from June), and is down 3% for the year.

As of the close of the market today (July 6, 2018) the Tesla company is within a whisker of the value of General Motors ($53 Billion for Tesla vs. $54.5 Billion for GM) and was clearly worth much more than GM in June when Tesla's stock was priced at $370 per share.

To add some perspective to this, GM sold 10,000,000 cars in 2017. Tesla sold 103,000. Let that sink in. Tesla sold just 1% of the cars that GM sold in 2017 and had a value that, for a time this year, exceeded the value of GM. Hey, not so fast you say, what about profitability? In 2017, GM *made* $11.8 Billion pre-tax on $145 Billion of total revenue. Tesla *lost* $2.2 Billion pre-tax on $11.75 Billion of revenue (the good news, it didn't have any income tax expense). Tesla's loss in 2017 was almost 3 times greater than its loss in 2016, on revenues that were about 1.7 times greater.

So, comparing the two companies why would an investor buy Tesla over GM? There are a number of potential reasons for this. First, there is a group of investors that believe that they can overpay for a stock and sell it to someone else in the future for an even higher price (the greater fool theory). Another group believes that everything that Mr. Musk says eventually comes true (hero worship). And then there's the group that believes in the story (the sizzle). Even though Elon has failed to deliver on any production or profitability targets, there are many that believe he will eventually make good on promises made.

These true believers have confidence that Tesla will change the face of the auto industry and that the stock price today is but a mere fraction of what it will be in the future. For them, it’s not about what the company has done; only what it is going to do.

Right now that sentiment is dominating the investment landscape. Companies that look like they are growing rapidly are being snapped up by investors, while those that generate steady but boring profitability are being left behind. Since the Financial Crisis growth stocks have seen their stock prices climb significantly, and have price earnings (price divided by earnings, or p/e) ratios that are now in the top 30% of their recorded history, while value stocks languish in the bottom 25% of their range. History suggests that this performance gap is highly unusual and is likely to reverse itself.

Since 2009, growth stocks have trounced the performance of value stocks. The Russell 1000 Value Index (an index that tracks 1000 large US value stocks) returned 100% from when the stock market bottomed in 2009, compared to the Russell 1000 Growth Index (1000 large US growth stocks) which registered a blistering 170% return. You read that right, growth stocks have outperformed value stocks by 70% in the past nine years. However, the 26 year average for value stock performance ending in 2015 tells a very different story. The Russell 1000 Value index returned 9.03% per year versus the Russell 1000 Growth Index at 8.6%. In fact, in the 17 rolling ten year periods from 1990-2015 large value stocks outperformed large growth stocks 65% of the time. During that same period, value stocks also had 22% lower risk as measured by standard deviation.

The richest man in the world right now is Jeff Bezos, founder of Amazon (worth $112 Billion). The current p/e ratio for Amazon’s stock is 215 compared to the p/e ratio for the S&P 500 of 25. While the ratio for the S&P 500 is at the high end of its historical range, the p/e ratio for Amazon is over 8 times that number.

Many point to Amazon as the template for Tesla’s future success. For many years Amazon could not string together even two quarters of profitability. At the same time the company grew rapidly and transformed the retail landscape. With an Amazon Prime membership customers can have things delivered to their homes in two days with free shipping, and Amazon’s return policy is one of the most liberal in the retail world. Why go through the hassle of parking at the mall, lugging around packages and rubbing elbows with all sorts of humanity, when you can have a package delivered to your doorstep and return it for free if you don’t like it?

True believers of Tesla point to its own game changing story. A future filled with high tech, self-driving automobiles, purged of carbon monoxide spewing tailpipes. This story, though, is a bit different from Amazon’s. Major automobile manufacturers are not standing still while Tesla disrupts the industry. GM, and for that matter Toyota, Honda, Ford, Volkswagon, et al., have committed to developing electric vehicles (this group has an average p/e ratio of around 7, less than a third of the average stock in the S&P 500). These companies have real track records of earnings whereas Tesla has yet to put in a profitable quarter (the p/e ratio for Tesla is incalculable since there is no “e”).

When will investors return to value oriented stocks instead paying for stories? That is anyone’s guess. It may take a market shock, or it may be a realization by many that paying for a story is not without substantial risk. In the meantime, we’ll continue to enjoy our steak while others stare at empty plates.